Money & Banking

Monetary Policy: Will RBI try to rein in inflation or boost growth?

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As they meet from August 4-6 to take a call on policy rates, the six members of the RBI's Monetary Policy Committee (MPC) will be torn between the need to rein in rising retail inflation and prioritise growth, which is sliding amid the pandemic.

Experts are divided on whether the RBI should pause for now and cut the repo rate rate closer to the busy season (beginning October) or front-load a rate cut now and pause later.

The members will find themselves in a Catch-22 situation as a higher retail inflation reading in June (6.09 per cent) suggests that there should be status quo on the repo rate. But there is also a need to address the significant downside risks to growth, which slumped to 3.1 per cent in Q4 FY20 and is expected to slip into the negative territory in FY21.

On March 27, the MPC cut the repo rate by a cumulative 115 basis points (bps), from 5.15 per cent to 4 per cent. Simultaneously, the reverse repo rate was slashed by a cumulative 155 bps, from 4.9 per cent to 3.35 per cent.

Repo rate is the interest rate at which the central bank provides liquidity to banks to overcome short-term liquidity mismatches. Reverse repo rate is the interest rate banks earn on the surplus funds they park with the central bank.

Wait-and-watch

According to Shanti Ekambaram, Group President - Consumer Banking, Kotak Mahindra Bank, the pandemic is hurting businesses and consumers alike and the uncertainty around when things will normalise has led to lacklustre and muted demand and supply disruptions.

"Having front loaded the rate cuts and with inflation still above the 6 per cent mark, the MPC may decide to wait and watch and take a pause in August to monitor India's progress in its fight against the virus — both from a health and economic point of view," she added.

The MPC could then possibly cut the policy rate by a further 25 bps in the policy meeting at the end of September, which is traditionally India's busy season, she said.

Madan Sabnavis, Chief Economist, CARE Ratings, underscored that the decision taken by the MPC is based on the inflation targeting mandate. However, of late, ensuring growth amid Covid-19 has been the over-riding factor. "With unlocking beginning and some sectors showing upward movement, the RBI may choose to hold on to a rate cut and continue to monitor the availability of liquidity in the system," he said.

With the rising inflation outlook and prevailing uncertainty over growth outlook, Brickwork Ratings expects the MPC to adopt a wait-and-watch approach — hold the repo rate at 4 per cent and continue with its accommodative monetary policy stance in its August meeting.

Better to move now

Rahul Bajoria, Chief India Economist, Barclays, however, feels that economic activity, or lack thereof, continues to favour more easing over less, and faster easing rather than a deliberate pace. He expects the repo rate to be cut at least 25 bps at the next policy meeting.

In a note, "Monetary Policy: Throw caution to the wind", Bajoria emphasised: "We do not believe the argument of saving 'ammunition' for future cuts holds water, given the inherent lags in transmission of policy rates into lending rates. To prepare the ground for cheaper lending costs in 6-12 months, we believe it is better to move now, rather than wait."

Given the time it takes for policy rate cuts to translate into lower borrowing costs and the uncertain state of the economy, Bajoria believes RBI will ease the policy by cutting both the repo and reverse repo rates at least 25 bps to 3.75 per cent and 3.10 per cent, respectively.

"We still see the terminal repo rate as being 3.50 per cent, which we now believe will be reached in Q4 (October-December) 20, instead of Q3 (July-September)," he added.