RBI MPC Meet: Focus moves away from rate action to policy normalisation roadmap

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For the RBI August policy, no one is expecting a change in the MPC's stance. A majority of economists as per a CNBC-TV18 poll believe that it will remain in accommodative mode until December.

The focus in the upcoming Reserve Bank of India's (RBI) August bi-monthly monetary policy review meet is not on interest rates. A roadmap for the inevitable policy normalisation is what the street will watch out for.

With inflation remaining high, and uncertainty about a potential third wave of COVID-19 infections, all 10 economists polled by CNBC-TV18 said they do not expect any tinkering in the repurchase or repo rate (currently at 4 percent), which is the rate at which banks borrow from the central bank. The reverse repo rate — the rate at which banks park excess funds with RBI — is also expected to be left unchanged at 3.35 percent, according to the respondents.

"We expect the RBI MPC to hold the repo rate at 4 percent and continue to be accommodating to support the nascent recovery, in the upcoming MPC. We also expect it to sound a cautionary note and emphasise the need to closely monitor the situation," said M Govinda Rao, Chief Economic Advisor at Brickwork Ratings. The Reserve Bank of India's Monetary Policy Committee will hold its bi-monthly policy meeting from August 4 to 6, and will announce its decision on Friday.

"While the expectation is for a status quo policy, in terms of interest rates and stance, what will be important to gauge is the Monetary Policy Committee's assessment on the economy and hence, the path forward from here on. Among a host of factors, it is the durability and sustainability of India's growth curve, in addition to inflation, that will drive its decision making," said Shanti Ekambaram, Group President, Consumer Banking at Kotak Mahindra Bank.

Sixty percent of the economists polled by CNBC-TV18 said the reverse repo rate will be hiked sometime during the financial year as it takes small steps towards policy normalisation. Forty percent expect a 25 basis point hike in reverse repo rate, and twenty percent expect a 50 basis point hike. Before that, RBI is expected to start draining excess liquidity, and seven out of 10 economists polled by CNBC-TV18 expect it to happen in the January-March quarter of the financial year.

But what exactly is policy normalisation? Over the past year or so, the economy has been ravaged by the COVID-19 pandemic. In order to support economic activity, which has been hard hit, RBI has been unusually generous with liquidity, keeping the daily surplus at Rs six trillion or more on average. It also kept its stance in 'accommodative' mode, which indicates that any rate hike is ruled out, and cut policy rates sharply to bring them at historic lows.

However, as life slowly starts to return to normal, and signs of economic recovery start taking root, the central bank will also have to start tracing back its steps and reverse the largesse of the past year. This return to what was 'normal' before the pandemic changed RBI's course is what is widely referred to as policy normalisation by economists.

What will policy normalisation entail? Step one would be draining of excess liquidity, followed by a change in stance to neutral from accommodative, and a hike in the reverse repo rate. These steps are expected to finally be followed by a hike in repo rates, which are currently at historic lows.

A majority of respondents expect that RBI will stick to its 9.5 percent growth forecast for FY22, while a third of the respondents said the growth forecast could be lowered to 9-9.4 percent.

"We don't think RBI is going to revise the growth numbers. It does appear now that the hit from second wave is perhaps less than what was feared which is not surprising to us and the recovery has also been quite swift. But more recently we have again started seeing cases pickup not just in Kerala and North east India but across the number of other states also. So I think while the rebound has been stronger than expected the assessment of whether the recovery is durable or sustainable cannot be convincingly made right now," said Sonal Varma, Chief Economist at Nomura.

RBI has been facing a growth-inflation trade-off, and markets also want to know how long it will continue to look through high inflation to continue supporting growth.

"If you just take a more holistic view of inflation over the last 18 months a core inflation has averaged above 5 percent since the pandemic began. So this is not a two or three month phenomenon, it actually lasted over the last 18 months. The second thing that is unique about India, vis-à-vis the US, for example, is that we have actually seen inflation expectations move up. Again, if you take March last year as your starting point, the RBI's own household survey has inflation expectations up between 100 and 150 basis points… So I think there is no doubt that there is a durable component to India's core inflation, and inflation expectations increasingly, that are going to, impact the MPC" said Sajjid Chinoy, Chief India Economist, JP Morgan.
All the respondents to CNBC-TV18's poll said that RBI will have to acknowledge inflation concerns by raising the CPI projection from 5.1 percent for FY22 to about 5.5 percent.

For the August policy, no one is expecting a change in the MPC's stance. Seventy percent believe that RBI will continue to remain in accommodative mode until December and the remaining expect it to stick with the stance until the end of the financial year, the CNBC-TV18 poll showed.