MPC minutes: Enabling easing financial conditions

- **Overall the minutes could be deciphered as dovish, with growth concerns taking precedence over 'transient' elevated inflation prints**
- **The proclivities of the new external members seem to be more towards the dove/neutral camp, tilting the entire committee towards focusing on growth, given the expectations of moderation in inflation over the second half of the fiscal**
- **Explicit mention by members on concerns around elevated term-premia and forward guidance aimed to reduce spreads would be welcome by the markets**
- **Given this backdrop, we expect continued support by the RBI to maintain easing financial conditions, aiding monetary policy transmission and keeping costs of capital low**
- **OMO purchases could be used as the main tool to absorb the large supply of Government paper, with our estimates of ~INR 2.5 tn of OMO purchases in H2**
- **On policy rates, while currently our view is of a 25 bps cut in the February policy, continued high inflation prints, could lead us to revise our call to a pause for this fiscal**

Key takeaways from MPC members:

Dr. Shashank Bhide: advocated for an accommodative stance for this year and into next year, highlighting the key goals of monetary policy to enable sustained recovery of the economy and moderation in inflation rate. He expects GDP to see a sustained revival starting from Q2FY21. He mentioned the need for certain policy and administrative changes to mitigate the risk of further COVID transmission: including better health care provisioning, infrastructure improvement towards aiding to reduce the spread of the virus, which in turn could build consumer confidence and steps to maintain government spending to support livelihoods. On the price front, he mentioned that while food inflation could remain a concern, with food and fuel as the main drivers of inflation on supply side, going ahead there could be moderation in food aided by robust monsoons, and in fuel given global demand conditions. Overall given the outlook for growth and inflation, he decided to vote for a pause, with an accommodative stance at least during the current financial year and into the next financial year.

Dr. Ashima Goyal: raised concerns on the steep decline in growth and elevated inflation. In her view, demand constraints are of a greater concern than supply shocks. According to her there is a gradual recovery in the supply side, with structural food surpluses, agricultural reforms and global changes in oil demand and supply expected to keep commodity prices soft. In her view, reduction in these constraints could assist in moderation of inflation, over the medium-term. According to her, apart from supply side shocks, inflationary expectations and exchange rates are big determinants of inflation and need to be moderated.

She also thinks that COVID has brought about the opportunity of easing financial conditions. According to her, current elevated inflation is on account of supply constraints which should ease with the economy opening-up. Moreover, given the sharp crash in demand, she thinks that policy should enable demand conditions rather than suppress them. She also believes that there is scope for 'further prudent expansion of government spending to boost demand and trigger private spending to raise growth'. In this context, given the high government borrowings, monetary policy should be targeted to facilitate the borrowings at low costs, along with provisioning of higher liquidity, to improve transmission and bring down interest rate spreads. Advocating that policy should aim for balance and be "neither an over-reaction nor an untimely reversal," she voted to keep the policy repo rate unchanged and to continue with the accommodative stance in line with the forward guidance provided in the policy.

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Prof. Jayanth R Varma: voted in favour of an accommodative stance, explicitly mentioning that his preferred formulation of the forward guidance would be 1) an expectation rather than a decision, as in his view, MPC should be data driven and hence provide for a change in guidance, in case of some unforeseeable event like an inflation shock, 2) for a much longer period, as he believes that "to have the desired impact, it is desirable that the forward guidance extend beyond the one year horizon at which the steepness of the yield curve sets in."

He feels that the steep yield curve reflects a lack of creditability on the accommodative stance and hence the decision for a dated guidance has been introduced. Moreover, in his view, the excessively high long-term rates might impact the economy through low investments and also lead to REER appreciation with high rates inducing capital inflows into the bond markets at a time when the collapse of investment has led the current account into surplus. Hence he believes a sharp reduction in long term rates is important, sans a reduction in short-term rates which are already anchored to the reverse repo rate. Thus he supports a pause in policy rates with his formulation of the stance and forward guidance.

Dr. Saggar: advocates "shifting the growth-inflation policy trade-off in favour of supporting growth within the flexible inflation targeting paradigm", given the growth-inflation dynamics. On inflation he mentioned that the elevated prints are on account of supply side factors and are non-monetary in nature, with factors such as base effects, opening-up of the economy, high food grain production, could aid in easing inflation going ahead. Alluding to the Eisenhower recession, he mentioned that pandemics often lead to less competitive markets, leading to rise in prices. These factors should abate and have a salutary impact on inflation. He also feels that "there are no signs of generalisation of relative price shock from food items and agriculture and rural wage inflation has stayed muted."

He flagged three macro-financial risks that might have implications for monetary policy: 1) if growth contractions stay for long, recovering potential output will take longer and given the glut in savings and low investment, it could push the neutral interest rate lower than before. Acknowledging the role of monetary policy he explicitly mentions that despite doubling of supply in government paper, which has lead to elevated term-spreads, cost of government borrowing is at a 16-year low 2) if current real negative interest rates fall further, "it may generate significant distortions that could adversely affect aggregate savings, current account and medium-term growth in the economy" 3) interactions between monetary policy and financial stability, could intensify further and though low interest rates could lead to risks of excessive leverage, the current situation calls for measures to re-build 'consumer and business confidence', thus necessitating a forward guidance. Considering these aspects, he voted for leaving policy rates unchanged, with an accommodative stance and forward guidance as per the statement.

Dr. Patra: believes that the projections of GDP in MPC's resolution provides "a sense of the wounds on the soul of the economy inflicted by COVID19." He mentioned that with Q2 numbers expected to be in contraction, India could face the first technical recession in history. He also warned of 'pragmatic caution' over the nascent signs of recovery, which he deems could be short-lived "until pent-up demand has been satiated and replenishment of inventories has been completed". He highlights the importance of investments in driving growth, and with the lack of private investments in the current environment, public investments would hold the key to recovery on one hand and easing monetary policy to " engender favourable financing conditions by lowering the cost of capital and by narrowing risk spreads on financial instruments", on the other hand.

He also mentioned that MPC has adopted an ultra-accommodative stance to revive growth and hence would remain accommodative to exploit headroom that opens up when CPI eases post October. He mentioned that following aspects should be paid attention to: 1) need to separate false starts from durable growth drivers 2) need to monitor inflation dynamics closely for signs of generalization and persistence, including indicators for aggregate demand – monetary and credit aggregates 3) given the high degree of uncertainties around growth and inflation, the need for policy guidance to be unambiguous. He thus feels that "forward guidance has to be clear and decisive" aimed to 'anchor expectations' and thus voted to keep the policy rate unchanged, while retaining the accommodative stance in line with the forward guidance given in the statement.

Shri. Shaktikanta Das: While acknowledging improvement in high frequency indicators, he pointed the downside risks to growth through a second wave of infection, subdued private investments and weak external demand. On inflation, he mentioned the surge was on account of supply side issues, rise in retail margins and cost of businesses on account of social distancing norms. These according to him could moderate going forward. He also highlighted the proactive steps taken by RBI to improve policy transmission through provisioning of surplus liquidity and external loan benchmarking. He however expressed concern about the nervousness prevailing in financial markets, despite these measures and thus necessitating the need of a forward guidance to palliate uncertainties. This in his view would aid transmission to long-term yields, assisting consumption and investment. Moreover, given that the elevated inflation prints are on account of transient reasons, in his view, monetary policy could afford to look through them, and 'persevere with the accommodative stance for monetary policy as long as necessary to revive growth on a durable basis', along with a strong forward guidance to reduce uncertainties and aid in further transmission.

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