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Rates Have Bottomed Out, RBI may go on a Long Pause

ET Q&A

The year 2021 is promising to be a better one than 2020. But there are challenges that a recovery poses like price pressures and hardening credit demand. **B Prasanna**, head of global markets at ICICI Bank, tells **Saikat Das and MC Govardhana Rangan** about the opportunities and risks. Edited excerpts.

After the worst ever year in terms of economy there's likely to be a rebound in the next. But the question is how strong and how sustainable it could be?

Indian economy consistently surprises the doomsayers. There is an absolute loss in GDP this year to the extent of nine to ten trillion rupees. There are a lot of green shoots and not just green shoots, I would say animal spirits, starting with real estate – stamp-duty reduction, lower prices and low cost of borrowing. Another important reason is the PLI (production-linked incentive) schemes. And the amount that has been earmarked for it is something as much as ₹lakh crore. To get that ₹2 lakh crore across, industry will have to produce something like ₹40 lakh crore, and you need the capex. These two put together could make the recovery strong. Then the government is sitting on huge balances, which it could begin to spend. The only risk factor is the second wave or the new strain.

Does that settle the debate whether this recovery is sustainable?

Definitely, a lot of it which has happened has been pent-up demand. But things like private capex are not a single month or a two-month event. It is going to stay for at least a couple of years.

Is there a disconnect between the financial markets and the real economy?

Markets are forward-looking discounting machines. From complete pessimism to euphoria now, because now people are seeing the light at the end of the tunnel. Vaccines are really readily available and the effect on the growth is also not expected to be as bad as what was originally feared.

Report rate hike might come around Feb 2022... Stance shifting to a neutral one is very much possible by June 2021 policy

B PRASANNA
Head of global markets, ICICI Bank

If the economies recover and there's so much liquidity, what about inflation which is already worrying some in India?

I think I'm pretty clear that whether it is Fed or whether it is the ECB or whether it is the BOE, they are all going to provide more liquidity. Fed has brought out this average inflation targeting framework, which basically means that earlier, the minute inflation started edging towards 2%, they would have started thinking of hiking rates and reduce liquidity. So, they will be possibly be okay with inflation even at 2.5% for a six-month period. Global central banks are not going to switch off the tap easily.

What does it mean for the emerging markets, and India in particular, when we already have inflationary pressures? What are the choices for the RBI?

There are some estimates which forecast that EMs may see a flow of $350 billion. Then India will also get a fair share of the pie. That will lead to easing of financial services index. Rates have more or less bottomed out and the RBI is expected to go on a long pause. No more repo rate cuts can be expected. The first report rate hike might actually come around February 2022. Of course, this is contingent on how inflation pans out over the next year. But before that RBI will have to take certain other measures to unwind some of the extraordinary accommodation that it has provided in the form of liquidity. I really feel that the stance shifting to a neutral one is very much possible by June 2021 policy.

The RBI intervention made rupee an underperformer. With record high reserves and the impossible trinity at work, what could the RBI do?

The RBI's policy prevented a runaway appreciation in the rupee. From the real effective exchange rate (REER) point of view, I think rupee is overvalued somewhere between 16-and-a-half and 18 percent. With Indian inflation likely to gradually edge lower, hopefully even when compared to its trading partners, the REER might have a potential to correct on its own.

Other than another wave of Corona, what are the risks to a sustained revival?

A return of inflation and a very quick exit from the easy money policy is a risk factor that will bring back contraction in liquidity.