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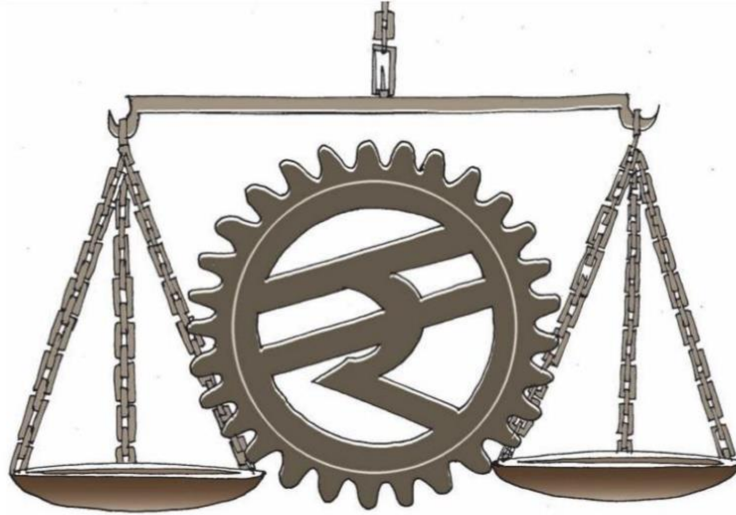

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● PRE-POLICY

What to expect from the MPC meeting

There is a fine balance that the Monetary Policy Committee needs to strike in the current scenario between the growth-inflation trade-off. For the sake of the economy and the growth impulses, we hope that the MPC may err on the side of caution and maintain status quo on both policy rates and forward-guidance in the upcoming policy

THE MARKETS AND policy-makers globally are on the cusp of an incredibly bipolar judgement on the short-term future of the global economy—beset, on one hand, by the pessimism surrounding the outbreak of the second wave of the Covid-19 pandemic in some developed economies, and on the other hand with the optimism surrounding the news about the development of multiple vaccines in recent weeks. With vaccine efficacy rates at the upper end of expectations, there is a possibility that the global economic activity will return to normal by the middle of 2021. However, countries around the world will still have to navigate the difficult winter months ahead before a vaccine is made available and is widely distributed.

Fortunately, the incoming data and high-frequency indicators have brightened the near-term outlook for the Indian economy, and stirred up consumer and business confidence. The Q2 GDP growth rose to a better-than-expected minus 7.5% year-on-year, a sharp rebound from the lockdown-induced decline of 23.9% in Q1. The internals of the GDP show that the rebound was led by fixed investment (on the demand side) and agriculture and industrial GVA growth (on the supply side). The recovery, however, remains uneven, with services lagging industrial growth and private consumption trailing investment. One of the noteworthy aspects of the latest reading was also the fact that core GVA (GVA excluding government) performed the best in recent times with government spending having contracted by a massive minus 22.2% year-on-year in Q2 versus plus 16.4% in Q1. The limited fiscal headroom has been playing a big part no doubt, with the fiscally conscious government stating that they would not like to have one foot on the accelerator while the other is on the brake (read: social distancing and partial lockdowns). With growth and high-frequency indicators evolving stronger than most analysts and RBI's baseline projections, it is quite possible that the government too is getting ready to press the accelerator in the current half of the fiscal. We expect RBI to revise up its FY21 GDP growth projection to minus 8.5% year-on-year from minus 9.5% earlier, while we retain our higher-than-street consensus of a GDP contraction close to 6%.

However, the problem lies on the inflation front. The headline CPI has remained stubbornly higher than 7% with the recent reading consistently surprising forecasters on the upside. While food prices continue to remain the culprit, it is disheartening to note that food inflation seems to have broadened from the volatile vegetables group to high-protein items (pulses, meat and eggs) and oilseeds. Moreover, there is a risk to core inflation from labour shortages, higher prices from services prices (as firms look to mend their balance sheets), rising commodity prices (oil, industrial metals) and higher taxes. In the past few weeks, some vegetable prices appear to have softened and the broader food group should benefit from a strong harvest this year. But even accounting for this disinflation in the coming months, the H2-FY21 (October-March) inflation is expected to average about 75-100 bps above the mid-point of the 5.4-4.5% range offered by RBI in the last Monetary Policy Committee (MPC) meeting. In light of this upside surprise, we could see RBI revising up its inflation projection to 5.5-6.5% in H2-FY21 from the earlier 4.5-5.4%.

> **The upward revision of both growth and inflation may lead the MPC to vote unanimously to remain in a wait-and-watch mode**

The upward revision of both growth and inflation may lead the MPC to vote unanimously to remain in a wait-and-watch mode. We still believe that the MPC will probably wait for more evidence to assess risk to the core inflation from the current state of output-gaps and the second-round effect of higher food inflation on core prices. That said, the persistency of higher inflation well beyond the MPC-targeted band of 2-6% for three consecutive quarters could test the patience of the MPC to maintain their view of 'looking through' the spike in inflation.

Besides deliberation on policy rate and forward-guidance, it would be interesting to see how comfortable the MPC is with respect to domestic liquidity conditions and the persistence of overnight rates remaining well below the 'operating rate'. The deluge of capital inflows has led to surplus core interbank liquidity moving beyond the ₹8-trillion mark. With credit channels still remaining weak, this liquidity deluge has steered a collapse in credit spreads in market-linked instruments and front-end rates. Concerns over these developments, and the need to maintain the sanctity of the operating rate, may have already persuaded RBI to halt its OMO purchases after promising to increase the same in the October policy. Even as we realise that some of this easing is by design as part of the policy framework, there is surely a risk of credit being mispriced in search for yield. This is particularly so, given the recent optimism in the revival of economic activity that seems to be beyond the pent-up demand on account of lockdowns getting lifted and the rebuilding of inventories. So, the key question for this policy is: Will RBI walk the path of sterilising excess liquidity through market stabilisation scheme (MSS), standing deposit facility (SDF), variable rate repos, or an expanded reverse repo window for non-banks such as MFs?

Overall, we expect the MPC to maintain status quo in the upcoming policy. The strong guidance of keeping monetary policy accommodative into the next fiscal year has so far helped keep sovereign yields below 6%. Any early modification of the existing guidance, on rates or on liquidity, will hinder the ongoing transmission of previous rate cuts in the bond market and might throttle the nascent growth recovery. Consequently, notwithstanding the recent optimism on recovery, we still expect them to adopt a cautious tone, flagging uncertainty about the resilience of demand after the festive season and downside risks due to the rising second wave of infection. There is a fine balance that the MPC needs to strike in the current scenario between the growth-inflation trade-off. For the sake of the economy and the growth impulses, we hope that the MPC may err on the side of caution and maintain status quo on both policy rates and forward-guidance in the upcoming policy.