MPC minutes: dovish tone with concerns on inflation

The key takeaway from the June 2021, Monetary Policy Committee (MPC) minutes is that the committee is inclined to support growth while acknowledging the underlying inflationary pressures. Most of the members sounded dovish with some flagging concerns on building inflationary pressures within the economy.

Other key highlights of the policy statement included: 1) concerns on growth with the emerging risks of mutation in the virus, leading to a possibility of a third wave, 2) rising inflationary pressures amid elevated global fuel and commodity prices and supply side disruptions, 3) a significant dent in consumer confidence and rise in household inflation expectations, 4) increasing risk of capital outflows induced by taper tantrums due to asymmetrical recoveries across EMs and DMs, and 5) poor credit offtake. However, MPC members noted some positive triggers in the economy that include strong export performances due to an improvement in the overall demand conditions, improving Capex spending of the government and resilient agricultural growth amid favourable monsoon expectations. However, all MPC members acknowledged that a higher pace of vaccination will remain key for avoiding a third wave of infections.

We expect MPC to continue with its accommodative stance till the economic recovery is on a firm footing. At the same time, the next rate action will be dependent on the movement of the inflation trajectory, and MPC members will keep a close watch for it. Persistent high inflation could force RBI to introduce liquidity control measures such as variable rate reverse repo auctions and a possible reverse repo rate hike, by the end of this year.

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Key takeaways from MPC members:

Dr. Shashanka Bhide: sent across a dovish signal. Dr Bhide sounded concerned over the dent in growth prospects following the rise in the second wave of infections, as the spread of the disease was large, as compared to the first wave, and also because rural areas were not insulated this time as compared to the first wave. He pointed out that both consumer confidence and the manufacturing outlook have taken a hit during the second wave as indicated by the recent surveys of RBI. While acknowledging that the short-term growth uncertainties have increased; he pointed towards positive triggers in terms of improved global demand, improving capital expenditure and resilient agriculture growth on the back of a favourable monsoon. He advocated for the acceleration in vaccination program for improvements in the confidence of consumers, workers and producers. On the inflation front, he remained concerned about the pass-through of elevated commodity prices and supply side disruption in the core inflation. On the policy front, we think Dr Bhide will remain in support of continuing with the accommodative stance for as long as necessary, to revive and sustain growth on a durable basis.

Dr. Ashima Goyal: sent across a very dovish signal. Dr Goyal thinks that headline inflation will largely remain within the RBI's tolerance limit, even though some seasonal and lockdown induced spikes may occur. While acknowledging that there are several upside risks to inflation arising from elevated global commodity prices, supply chain disruptions, and a low base effect; in her view, the global price pressures are temporary and the pass-through of WPI to CPI is low and lagged. She also said that a rise in household inflation expectations is outlier and inconsistent because the survey was conducted from 29th April to 11th May when Covid cases peaked; this period facing the highest fear and uncertainty may have affected consumer responses. Since the output gap has widened and short-term real interest rates are close to equilibrium, she thinks additional liquidity through targeted schemes will be key in stimulating demand. According to her, the risk of excess money fuelling inflation is limited since banks are parking excess durable liquidity in reverse repo amid a low credit growth. She also said that there is some room for a limited counter-cyclical rise in the government deficit. On the external front, she believes that where on one hand the recovering global growth will support Indian exports, on the other, asymmetric global recovery poses the risk of taper tantrum induced outflows. However, according to her views, India's reserves will give some independence in terms of the local interest rate policy and through that process, limiting the need to follow the US cycle.

Prof. Jayanth R Varma: firmly believes that the economic impact of the second wave was less severe than the first wave, although he states that the "high level of precautionary savings during the pandemic" could lead to demand depression over several quarters and hence emphasises on the need to support the economic recovery. While raising concerns on the reliability of "nowcasts and forecasts of economic growth" during the pandemic, Prof. Varma highlighted MPC's need to remain data driven, so as to "respond rapidly and adequately" to evolving circumstances in the future, in order to maintain and enhance their credibility. About inflation, Prof. Varma mentioned that although the inflation numbers and future forecasts are currently higher than the "tolerance zone", it appears to be more likely from supply-side factors (higher input costs, higher commodity prices etc.) and not due to domestic demand. This gives some comfort to MPC, despite the presumed risk that the situation could change with demand-revival, as the economy opens up and inflation expectations could become "entrenched" if the inflation remains elevated for too long. He concluded by saying that the "balance of risk and reward" continues to be in favour of maintaining "monetary accommodation" in order to support growth.

Dr. Mridul K. Saggar: opined that given the epidemiological models, the wave would be flattened by June end and economic recovery is likely to ensue. He also commented on the possibility of an increased pass-through from global inflation. As the budget for the year aims to shift, spending further from consumption to investment, this augurs well for growth from a multi-year perspective. Inflation is expected to stay within the tolerance band, though above target, closer to the upper tolerance levels and may reduce post August "if Kharif crops shape well and the global commodity price pressures subside by then". "Clear signs of generalisation in CPI inflation setting in could be a tipping point where growth-inflation dynamics could alter". Prices may be contained by fiscal or supply side responses. He argued that the "uncertainties ahead provide a rationale to avert any time-based guidance" and that we need to "consider the policy trade-off between leaving the policy rate unchanged and correcting it at some point for the negative real rates that have persisted for a spectrum of interest rates, thus taxing savers." He commented on the multiplier effects of increase in demand as well and opined that "retail inflation is not yet predominantly demand-driven and to accept that output sacrifice at this stage may not be the best policy choice" and that "withdrawing support to growth at this stage might be premature, as it may dampen second-round effects".

Dr. Patra: also voiced his concerns on the stalling of economic recovery and dented aggregate demand due to the second wave and believes it to depend on factors, including vaccination induced demand revival, higher commodity prices etc. He believes that the price pressures within the food category would remain benign, while core inflation could remain elevated, given the high input pressures. Although the pass-through to retail prices (services) would be delayed due to the absence of demand, despite the persisting "demand-supply imbalances". On the other hand, the upside risk from energy inflation remains, due to the uncertainty of "reflation of global demand to pre-pandemic level". He therefore recommends the same to be closely monitored so that "countervailing actions" could be taken accordingly, as and when required. While acknowledging MPC's role in creating necessary conditions for supporting growth, he believes that the onus is on RBI to operationalise MPC's guidance on an ongoing basis and ensure "congenial financial conditions", across the system. He feels that the Central Bank is engaging both market-based and off-market channels of financing and is proactively engaged in operations that convey the stance directly across the term structure of interest rates. He therefore believes that MPC would create the space for further easing of financial conditions by keeping the stance and policy rates at status quo.

Shri. Shaktikanta Das: mentioned that the lockdown restrictions to curb the spread of Covid infections has taken a toll on the economy; activities across the country are expected to normalise from the beginning of July. All the indicators have been suggesting a normalising of economic activity by Q4FY2021, which was disrupted by the second wave, though to a lesser extent than the previous year. The central government capex is expected to reignite the investment cycle once the curbs are eased and that vaccination holds the key for a rebound of high-contact intensive services. While domestic, monetary and financial conditions remain highly accommodative, it is expected to continue to be so in view of the MPC's forward guidance, and economic activity is expected to recover from the second quarter and gather pace in the second half of the financial year. He commented that "the fragile demand conditions could help limit the pass-through of input cost pressures across manufacturing and services to output prices" and recommended keeping a close watch on the evolving trajectory of the same. The Governor emphasised on the need to continue with an "accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward" and that **the Central Bank remains committed to undertaking pro-active conventional and unconventional measures and to effectively channeling the systemic liquidity to alleviate the stress of critical sectors that have borne the brunt of the second wave.**

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