NSE

Macro Preview

December 02, 2019 | Vol. 1, Issue. 21

Monetary Policy: Weak Q2 GDP growth calls for another 25bps rate cut

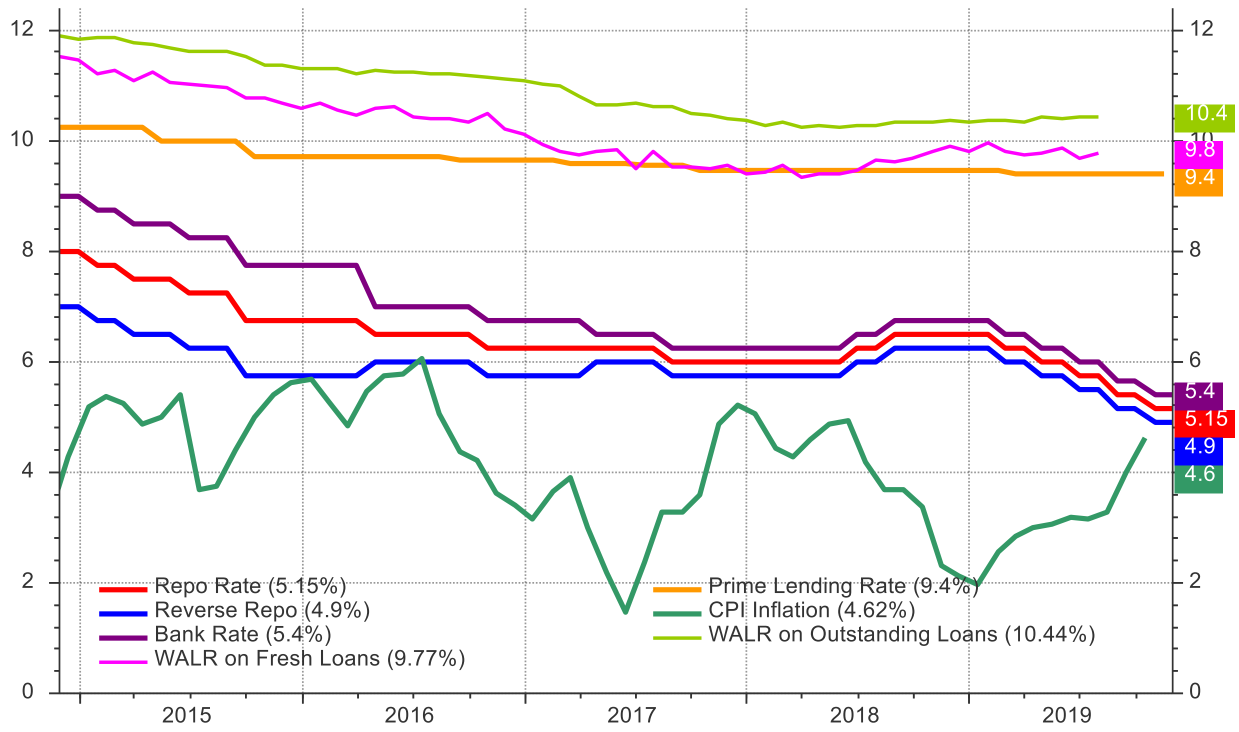
We expect the RBI's Monetary Policy Committee (MPC) to cut policy rates by another 25bps on December 5th, 2019, marking the longest streak of consecutive rate cuts in the last two decades, thanks to a protracted economic slowdown. GDP growth fell to six-and-a-half year low of 4.5% in Q2FY20 led by a sharp deterioration in investment activity—a consequence of weak business confidence, low risk appetite and low capacity utilisation. The third quarter is also not looking meaningfully better as signalled from several high frequency indicators such as industrial production, merchandise trade performance, fuel consumption, amongst others. Fiscal spending, the only saviour last quarter, is unexpected to sustain in the second half, with October already witnessing some moderation, even as a low base may provide a statistical bump-up to GDP print. Inflation, on the other hand, has been moving up, but it has been mainly due to a transitory spike in food inflation, even as core inflation has continued to trend lower, signalling weak domestic demand.

While an unfavourable base may keep the headline inflation above the RBI's 4% target in the near-term, we expect the RBI to look through the base effect and remain focused on reviving growth and continue with monetary easing. Transmission to the real economy, however, is expected to be gradual amid tight financial conditions.

- **Expect another 25bps rate cut accompanied by retention of an accommodative stance**: The RBI's Monetary Policy Committee, in its fifth bi-monthly policy review meeting of this fiscal scheduled for December 5th, 2019, is expected to reduce the policy rates by another 25bps (repo rate to be reduced from 5.15% to 4.9%—just 15bps shy of the post-crisis lows of 2009). This would take the total quantum of rate cuts in 2019 thus far to 160bps—the highest seen in any year over the last two decades, except for 2009. The MPC is expected to retain its monetary policy stance to 'accommodative', as it continues to remain focused on reversing growth slowdown, accompanied with a reduction/increase in growth/inflation forecasts.
- **Growth impulses remain weak**: The Q2FY20 GDP print, if not for fiscal spending, would have come in at 3.1%, signalling a broad-based slowdown. The third quarter has also started on a weak note as also witnessed from several high frequency indicators—1) India's import bill in October declined at the steepest pace in 39 months, while exports growth has also remained negative for the third consecutive month. 2) Domestic passenger car sales have declined for the 12th consecutive month with growth in the fiscal thus far (Apr-October 2019) at -27%, even as the decline came off last month. 3) Output of India's eight-core infrastructure sectors contracted for the second consecutive month in October, falling by 5.8%—the steepest pace of decline in the new series.
- **Spike in inflation to be transitory in nature**: A surge in recent inflation prints has largely been a consequence of higher food inflation (vegetables)—thanks to delayed harvesting following an excessive and prolonged monsoon and consequent supply disruptions—and is expected to be transitory in nature. On the positive side, a prolonged Southwest monsoon has increased soil moisture and reservoir levels, which augers well for the *Rabi* season. Excluding vegetables, headline inflation declined by 10bps MoM to 3.1% in October. Core inflation (ex food and fuel), on the other hand, has been trending downwards and is currently at the lowest level since the start of the new series, signalling weak demand environment. This, in turn, is expected to keep the headline inflation under check, even as an unfavourable base effect may impart upside pressure in the near-term.
- **Weak growth underscores the need for further monetary easing:** While inflation is expected to remain elevated in the near-term owing to higher, albeit transitory, food inflation and an unfavourable base, any recovery in growth is expected to be quite shallow and prolonged. Moreover, with fiscal pressures mounting for the Centre as well as states, Government spending is unlikely to support growth for long, making it imperative for the Central Bank to cut rates further. We expect another 25bps cut in the policy rates in the forthcoming monetary policy review on December 5th. However, monetary transmission thus far has been weak (weighted average lending rate on fresh loans down by 20bps by July 2019), and is likely to be so until financial conditions remain tight, and supply of funds from weak economic growth and falling household savings are effectively balanced by fiscal demands. Surplus liquidity and linking of floating rate loans with an external benchmark should result in a gradual transmission of lower policy rates into the real economy.

Figure 1: Policy rates reduced by 135bps since start of 2019; expect another 25bps cut on December 5th

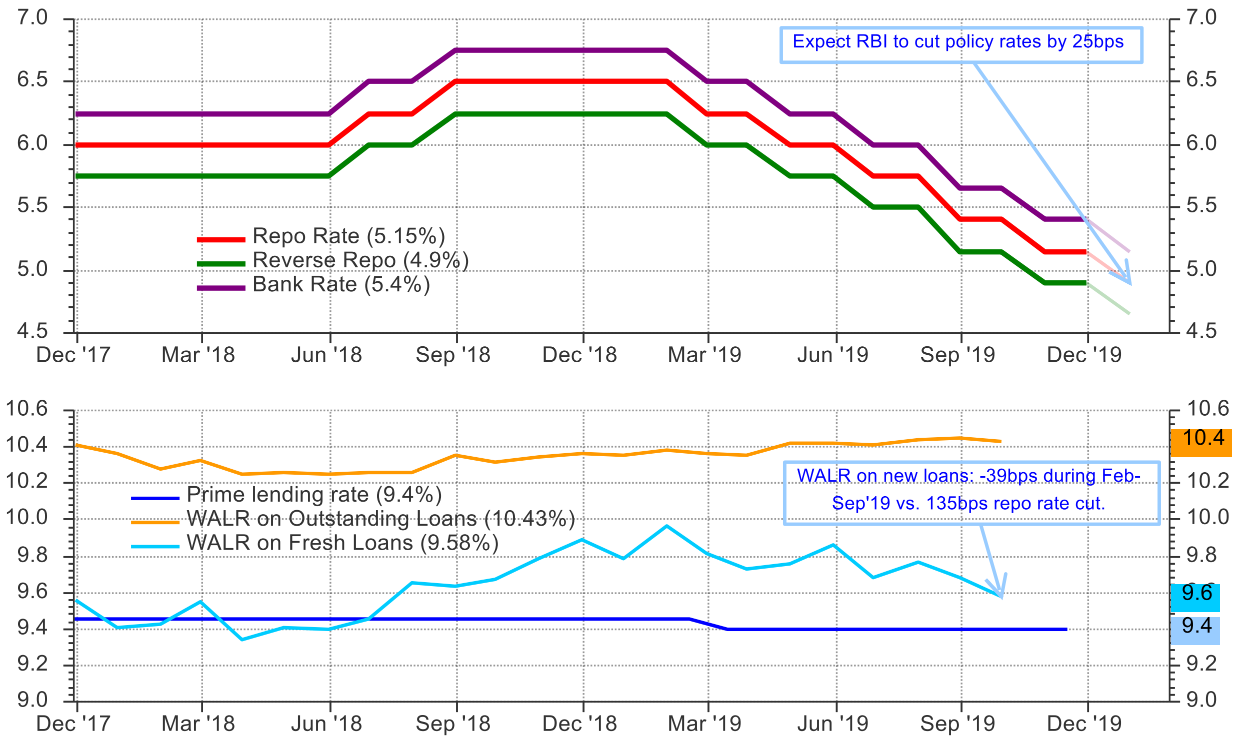
India policy rate, inflation, lending rate (%)



Source: RBI, Refinitiv Datastream. WALR: Weighted Average Lending Rate

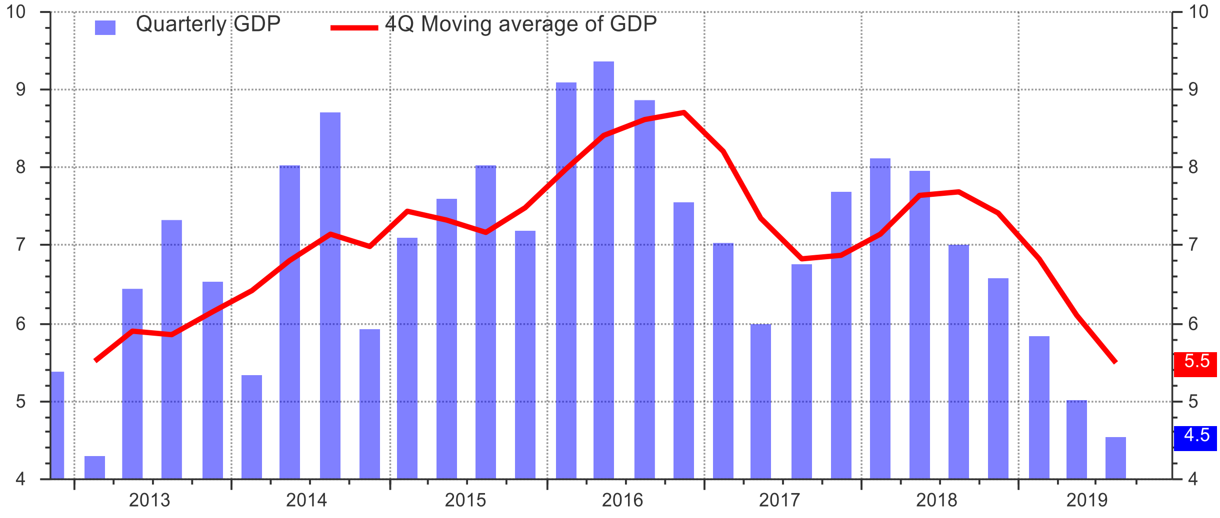
Figure 2: Whither Transmission? Repo -135bps; 'New loan' WALR -39bps, 'Old loan' WALR +5bps

Policy rate and lending rates (%)



Source: RBI, Refinitiv Datastream. WALR: Weighted Average Lending Rate

Figure 3: Q1FY20 GDP growth came in at a six-year low



Source: RBI, Refinitiv Datastream

Economic Policy & Research

Tirthankar Patnaik, PhD	tpatnaik@nse.co.in	+91-22-26598149
Prerna Singhvi, CFA	psinghvi@nse.co.in	+91-22-26598316
Ashiana Salian	asalian@nse.co.in	+91-22-26598163
Runu Bhakta, PhD	rbhakta@nse.co.in	+91-22-26598163

Marketing

Rajesh Jaiswal	rjaiswal@nse.co.in	+91-22-26598380