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Analysis of RBI Monetary Policy (December 2019)

Pump-priming measures needed for economic growth- Dr. Manoranjan Sharma-BL

The RBI may have hit pause on monetary easing for fears of inflation, but the issue of delayed and inadequate transmission of the rate cuts into the credit market also needs greater attention The macro-economic slowdown has manifested in the 25-quarter low GDP growth of 4.5% in July-September 2019; the 4.3% growth in gross value added (GVA) in Q2 of 2019-20, vis-à-vis 4.9% in Q1 and 6.9% in Q2 last year; and the slow exports and contraction across sectors, including a weak service sector. Manufacturing sector's contraction by 1% in Q2 (6.9% last year) — on top of an almost flat Q1, 68.9% industry capacity utilisation in July-September (73.6% in April-June) — and the contraction in output in eight core industries in October, for the second consecutive month, cause concern. In H1, the manufacturing sector contracted by 0.2% as against 9.4% last year.

Gross fixed capital formation grew only 1.02% in Q2 (4.04% growth in Q1 and 11.8% in Q2 last year). Extensive blocking of investments in housing — especially the residential segment — as well as roads and telecommunications, together with tapering off and decelerating investment in power and railways have exacerbated the situation.

Inflation mandate

Given the triple whammy of contraction in manufacturing, weak investment, and lower consumption demand, there was room for a sixth successive cut by 25 bps. But the Monetary Policy Committee unanimously voted for status quo on the repo rate at 5.15% because of rising inflation in next two months, and ambiguity about magnitude and proportion of fiscal deficit this year and expenditure stance of the government next year. Monetary Policy Committee unanimously voted for status quo on the repo rate at 5.15% because of rising inflation in next two months, and ambiguity about magnitude and proportion of fiscal deficit this year and expenditure stance of the government next year.

The RBI's retail inflation mandate is based on 4% level (give or take 2%). Retail inflation surged to a 16-month high of 4.62% in October (3.99% in September) largely because of a spike in food prices, which are expected to soften by February 2020. Incipient price pressures are in other food items, like milk, pulses and sugar. The inflation forecast was raised to 5.1-4.7% for H2 2019-20 and 4.0- 3.8% "with risk evenly balanced" for H1 2020-21. In October, CPI inflation was projected at 3.5-3.7% for H2 2019-20 and 3.6% for Q1 2020-21.

Simultaneously, India's GDP growth deceleration for the sixth successive quarter to 4.5% in Q2, which makes RBI's task difficult. This year's growth forecast was steeply lowered from 6.1% projected in October policy to 5%. A delayed demand revival, further slowdown in global

economic activity and geo-political tensions necessitate the removal of impediments holding back investments. With slashing of the corporate tax, cutting GST tax rates to boost consumer demand is difficult, because of the burgeoning fiscal deficit.

Problems in transmission

The RBI continued with its “accommodative” stance but the issue of delayed and inadequate transmission of cumulatively 135 bps rate cuts into the credit market, specifically bank lending rates, needs greater attention. The one-year median MCLR has declined by 49 bps post-February, whereas market-determined interest rates such as the yield on the 10-year benchmark government security fell more than 100 bps in this period. The weighted average lending rate (WALR) on fresh rupee loans sanctioned by banks declined by 44 bps, while the WALR on outstanding rupee loans increased by 2 bps during this period. The transmission mechanism is, however, fraught with several difficulties, such as cost and yield of banks, asset-liability mismatch, modest fall of less than 50 bps in deposit rates, rate of interest in competing saving instruments (for instance, a five-year small savings deposit yields 7.7% whereas a bank deposit with similar maturity yields 6.3% on average), tweaked MCLR rate, etc. There are also issues of debilitated position of NBFCs and stickiness in bank lending rates caused by weaker domestic demand and banks’ caution in lending, because of mounting NPAs and the consequent risk aversion and high cost of funds.

The RBI’s direction to banks to link their lending rates to an external benchmark, which is different from the customary practice of basing lending rates on conditions endogenous to banks, is likely to improve transmission. Improved monetary transmission and a quick resolution of global trade tensions could work as growth tailwinds. Of late, the government has initiated several measures — massively slashing corporate tax rates, easing automobile sector issues and setting up a last mile fund for real estate sector to revive the flagging economy. While the downward interest rate scenario is likely to continue, there is a need to provide fiscal impetus to the growth and investment process — what JM Keynes famously called ‘pump-priming’.