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INDIA

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Economy

MPC likely to hold rates amidst rising inflation

The Monetary Policy Committee began its third bi-monthly meeting for FY21 on 4 August. In this policy review, the committee faces a tough choice – while on one hand growth has been faltering due to Covid-19, on the other hand inflation has been rising due to supply disruptions. When it comes to choosing between controlling inflation and boosting growth, we expect the MPC to choose the former. Hence, we expect it to hold rates in the ongoing meeting. Below, we elaborate on the reasons:

- **Rate cut unlikely to boost growth:** As MPC member Dr. Chetan Ghate has been pointing out in the past couple of monetary policy minutes, 'in a demand deficient economy, a large rate cut will be akin to pushing on a string.' We agree with this view– given the slack in demand and bleak outlook, rate cuts are unlikely to boost growth meaningfully. Eg. scheduled commercial banks cut their 1yr MCLR by 50bps during Mar 2020 and June 2020. However, non-food bank credit growth during the said period fell to 6.1% from 6.6%. Hence, even if banks fully pass on policy rate cuts, it is unlikely to lead to higher credit offtake unless outlook improves.

- **High inflation likely weigh on committee's decision:** CPI inflation in India has been printing above 6% since Dec 2019, with the only exception of Mar 2020. In Q4FY20, inflation averaged 6.7% and in Q1FY21 it averaged 6.5%. We expect CPI inflation to print ~6.4% in July 2020 and remain elevated in the short term especially if new supply shocks emerge due to local lockdowns. Hence, inflation could print above 6% in Q2FY21 as well. We believe the current level of inflation and its expected trajectory are likely to prompt the committee to hold rates.

- **Negative real interest rates are disincentivising savings:** In the beginning of Mar 2020, deposit rates on 1yr maturity were between 5.9%-6.4% and inflation rate was 5.8%. Hence, a 1yr fixed deposit carried a real interest rate between 0.1%-0.6%. However, in the next few months banks reduced deposit rates and inflation picked up. Currently, interest rates on 1yr FD range between 5.1%-5.5% while current inflation rate is 6.1%. Hence, a 1yr FD now yields an interest of -0.6% to -1%. Any further reduction in policy rate is likely to lead to lower deposit rates and disincentivize savings further.

- **Financial conditions are significantly better than pre-Covid levels:** Our proprietary 'Financial Conditions Index' shows that financial conditions in the country improved substantially in March 2020 following the RBI's emergency repo rate cut of 75bps to combat Covid-19. In the following two months, financial conditions eased rapidly as the central bank undertook a series of unconventional measures to minimise the impact of Covid-19 on the economy. Although financial conditions have deteriorated moderately since June 2020, they are still significantly better than pre-Covid levels. Hence, there is no pressing worry of real economy stress spilling over into financial market. Also, if financial conditions tighten going ahead, the RBI can use a variety of instruments at its disposal to ease the situation which are outside the MPC's purview.

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