Our Views

Expectations from the upcoming Monetary Policy by RBI on Oct 1st

The Monetary Policy Committee of the RBI will meet next week and announce its decision on Oct 1st.

In the previous meeting held on August 6, 2020, the RBI MPC has unanimously voted to maintain status quo on policy rates. RBI Governor maintained that the MPC will remain watchful with respect to inflation dynamics to further use space available on the monetary side when appropriate. In this note, we will elaborate if the time is appropriate for further monetary action.

To put this in perspective, we will look at the current fiscal situation, liquidity position in the system, latest data on inflation and the exchange rate. The current policy repo rate is at 4% which is after cumulative reductions of 115 basis points since the onslaught of the Pandemic in March 2020. The bond yields have eased off by 70-130 bps across maturity ranges. Currently, the yield on 10-year Government security is at 6.0% while the yield on AAA rated corporate bonds of similar maturity is at 6.8%. Apart from policy rate cuts, the RBI has taken other measures such as Operation Twist, Targeted Long-Term Repo Operations (TLTRO) and increase in Held-To-Maturity (HTM) limits to soften the bond yields and to put in much required liquidity in the system.

Inflation – The current inflation data is still not very comforting. August print for CPI was 6.69% although slightly lower than July of 6.73% but still higher than the comfort zone of RBI of 4% plus/minus 2%.

Liquidity – Bankers will tell us that at this time there is absolutely no issue of liquidity. Surplus liquidity is being put back under reverse Repo to RBI. Average reverse repo in the last 6 months is approximately USD 80 bn plus. Further the private credit demand is also low. This has ensured that government bond auctions have remained well subscribed in the first half of FY21. The Central Government has raised close to USD 98 bn (INR 7.4 lakh crore) so far this year, which is over 60% of its revised gross borrowing target of USD 160 bn (INR 12 lakh crore). The State Governments have together raised 30% of the gross borrowing target of USD 120-130 bn (INR 9-10 lakh crore) for the year. So far, the Government's borrowing programme in the first half of the year has gone through in a non-disruptive manner.

Fiscal – The net tax collection for the first 6 months fell by approximately 25% which is broadly in line with expectations given the slowdown in the economic activities. The positive part is that the tax collection is improving sequentially therefore the full year shortfall is expected to be ~12-15% against the previous year. The revenue shortfall on account of tax collections (both direct and indirect) is likely to be approximately USD 69 bn for the year while the shortfall in disinvestment receipts is expected at approximately USD 21 bn. This would mean that the government borrowing program may get revised upwards in the second half.

Exchange rate – The INR has gained about 4% against the USD from its low of 76.8 in mid-April to 73.6 currently. On Aug 31, 2020, RBI had quoted in a note titled `Measures to Foster Orderly Market Conditions' that "the recent appreciation of the rupee is working towards containing imported inflationary pressures". This gives the indication that considering the limitations on raising interest rates amidst the ongoing pandemic, the RBI has found a tool in currency operations to control inflation. This appreciation in currency rate can also be attributed to foreign direct investment of around USD 22 bn into India during the pandemic and the current account surplus driven by sharper contraction in imports by 26% year on year as against a de-growth of 13% year on year in exports. The overall trade surplus for the period from Apr-20 to Aug-20 is estimated at USD 14.2 bn as compared to the deficit of c.USD 45.1 bn in the same period last year.

Given an inflation level that is somewhat outside the comfort zone, the widening fiscal deficit that would require additional borrowing by the Government and the importance of a stable currency, we believe that MPCI should continue with its *status quo* stance like the previous time.

In the last 6 months RBI has used the opportunity to focus on some structural reforms such as the cooperative bank and NBFC reforms. This time RBI can focus on progressive reforms in the banking sector. The last significant steps towards this was attempted in 2015 when several new types of banking licenses were issues such as Payments Bank and Small Finance Bank. I think RBI can now refocus on the pending agenda of regulatory enablement towards setting up a truly digital banking landscape which is the future of banking.

Sunil Sanghai
Founder & CEO
NovaDhruva Capital Pvt. Ltd

NovaDhruva