Shobhana edit

Despite the huge fiscal stimulus of Rs 1.45 lakh crore unleashed by the government in the form of a sharp cut in the corporation tax rate and some measures for the capital markets, the Monetary Policy Committee (MPC) will not really be on the horns of a dilemma this week as it deliberates on whether or not to cut the repo. Consensus suggests a 25 basis points cut, to 5.15%, primarily because inflation is expected to stay benign given there are few signs growth is going to revive meaningfully. To be sure, there is some momentum in core inflation, but as some economists have pointed out, the pace of food inflation could be higher than core inflation by Q4FY20. Also, while prices of crude oil do spike every now and then, for various reasons, the broad view appears to be that these will hold steady due to slowing global growth.

The central bank, therefore, is expected to bat for growth. Indeed, the shocking GDP growth reading of 5% for the economy in Q1FY20 has left economists paring their forecasts. Almost everyone agrees the cuts in corporation tax are a supply-side measure and aimed at attracting investment, and that this will play out in the medium term. Consequently, no immediate capacity addition that could create jobs is expected. Therefore, there is no expectation of a big pick-up in demand in the near term.

Despite an estimated fiscal slippage due to the tax cuts—0.35% of GDP, since the central government will pass on less taxes to the states—the repo will surely be trimmed. Having pushed banks to benchmark their loan rates to an external benchmark—such as the repo or treasury bill— RBI should be able to ensure transmission. The new system kicked in on October 1. While there is no guarantee that lower interest rates will trigger demand for loans, at this point, the government and RBI want to do everything it takes to kickstart growth.

The central bank will also ensure there is adequate liquidity support to support to aid transmission—the banking system has been in a liquidity surplus for a few months now. But, as economists have cautioned, RBI also needs to be watchful and calibrate liquidity as and when the rate cycle turns. The bond markets rallied on Tuesday, reassured by the government's gross borrowing programme in H2FY20, of Rs 2.68 lakh crore (Rs 1.33 lakh crore in net terms), staying at budgeted levels. Although the supply of paper is light, bond yields have stayed in the region of 6.6-6.7% probably because investors feel that the scope for cuts in the repo is now less because of the stimulus. They probably believe that after the 35 bps cut in August and the expected 25 bps in October, the repo could remain at 5.15% or at best go down to 5%, but not below that.

The markets will listen carefully to gauge how much RBI is likely to cut in the future; some of the information will come from RBI's growth forecast for FY20. The consensus pegs the GDP growth at around 6%, which assumes an upward momentum for the rest of the year. If RBI's projection is close to 6% and the tone on inflation is dovish, the market would probably pencil in more cuts, but if it is closer to 6.5%, it may not.