

MAY MPC MINUTES

05 June 2020

Room for another 25bps rate cut

MPC members reduced policy rate by 40bps as the impact of COVID-19 on the domestic economy is far more severe than initially anticipated. Inflation is likely to ebb and fall below RBI's target in H2 due to lower aggregate demand. Normal monsoon and easing of lockdown restrictions will help in reducing food inflation. While members see room for more rate cuts, space is limited if RBI would like to maintain positive real rates. We expect another 25bps reduction in repo rate in the next policy meet.

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KEY HIGHLIGHTS

- Inflation to fall below RBI's target in H2FY21.
- FY21 GDP growth expected to be in the negative territory.
- Space remains for further rate cuts.

Growth to be sharply lower: MPC members agreed that impact of COVID-19 on the domestic economy is far more severe than initially estimated. While RBI has not projected GDP growth for FY21, members believe growth will be negative. Dr Dholakia said nominal GDP growth may also slip into negative zone. Dr Patra believes that India's potential output has been pushed down and it will take years to repair. Dr Janak Raj noted that investment spending will be impacted severely as 1) lower demand will create excess capacity, 2) lower profitability implies firms cant finance investments from own accruals and government spending will be on revenue rather than capital heads.

Inflation to soften in H2: Dr Dholakia believes headline inflation will ease to 3.1-3.2% range in Q4FY21. The decline in inflation will be led by both core and food inflation. While food inflation will ease as supply bottlenecks ease, core inflation will ebb due to lower demand. Dr Patra pointed out that sustained loss of momentum of seasonally adjusted GDP growth over eight consecutive quarters is depressing the underlying momentum of core inflation. This trend is likely to continue as aggregate demand will take time to recover to pre-COVID levels.

Room for more: RBI Governor, Shri Shaktikanta Das, pointed out that sharper loss of growth momentum in near-term has provided policy space to ease financial conditions and stimulate growth. Dr Patra and Dr Dholakia believe that some more policy space may open going forward. We believe inflation will average close to 3.6% in FY21 which gives MPC members room to reduce policy rate by another 25bps. Faster deceleration may open room for 50bps, but is unlikely in our opinion as of now.



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