

Why we expect India to cut rates again this week

The balance of risk is tilted towards one more 25 basis point policy rate cut by the Reserve Bank of India this week. This would probably mark the end of the current easing cycle



Reserve Bank of India
Governor Shaktikanta
Das

3.75%

RBI policy rate forecast

25bp cut this week

Loose consensus for an RBI rate cut

The Reserve Bank of India's Monetary Policy Committee is meeting on Thursday, 6 August, to decide the course of the policy. The consensus is skewed towards a further 25 basis point cut to key policy rates; at the time of this writing, 18 out of 29 estimates in the Bloomberg survey favoured a rate cut and the rest no change.

We also think we'll get a 25bp rate cut, bringing the RBI repurchase rate down to 3.75% and the reverse repo rate to 3.10%. These will be marked to be a record low for both rates, after eight cuts

in the repo rate and nine in the reverse repo rate in the current easing cycle that has been underway since early 2019.

We also share the consensus view that the central bank will leave commercial banks' cash reserve ratio unchanged at 3.00%. Nor do we anticipate any change to the accommodative policy bias as growth outweighs inflation as the policy driver. That said, we think we are near the end of this easing cycle.

Nose-diving economy warrants lower rates

The monetary easing expectations stem from prospects of a prolonged economic slump ahead resulting from an un-abating spread of the Covid-19 pandemic. India is the third worst-affected country in the world (after the USA and Brazil) with total infections poised to cross the two-million mark in the coming days.

Clearly, the April-June quarter, the first quarter of the fiscal year 2020-21, recorded its worst economic performance, probably in the living memory. We forecast close to 12% year-on-year GDP contraction in that quarter; the data is due on 31 August.

Supporting this, exports crashed by 37% YoY and imports were worse with a 53% plunge. These dented manufacturing sharply. The statistical office refrained from publishing the industrial production data recently, but the output of key infrastructure sectors (coal, crude oil, natural gas, petroleum products, fertilisers, steel, cement, and electricity) shrank 25% YoY in April-June, suggesting that the headline IP couldn't be any better than this.

The deteriorating fiscal situation also suggests action

Further reinforcing the need for more monetary accommodation are the deteriorating public finances as these are constraining the scope for any more fiscal stimulus.

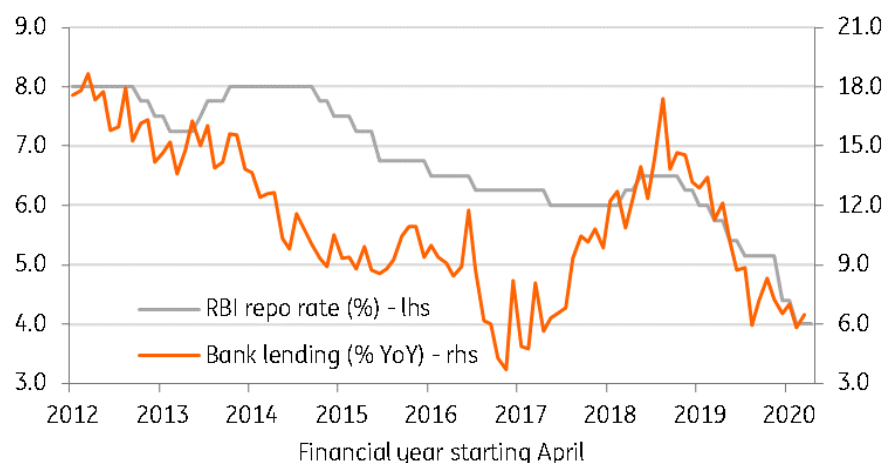
The fiscal deficit is through the roof

The contracting economy has dented government revenue, while stimulatory policy has boosted spending, shooting the fiscal deficit through the roof. The deficit in 1Q FY20-21 surged 53% YoY to INR 6.62 trillion and this was 83% of the official target for the entire fiscal year. This stems from a 47% YoY fall in revenue and a 13% rise in expenditure. Our view of the deficit equivalent to 6.5% of GDP this fiscal year remains at risk of an upside miss.

Record government borrowing to plug the budget gap is another reason why interest rates should fall further to ease the debt servicing burden. Despite aggressive RBI rate cuts so far this year the 10-year government bond yield has been sticky downward, at around 5.8% currently.

Meanwhile, the noise about monetisation of the deficit with direct purchases of government bonds by the central bank has been prevalent. This is despite the RBI dashing such hopes in an [off-cycle policy announcement in April](#), while some of its former policymakers continued to warn against this policy option, calling it as highly inflationary.

Aggressive monetary easing is still failing to stimulate lending



Source: CEIC, ING

Headwinds to lower rates

Talking about inflation, it has risen above the RBI's 2-6% policy range in recent months. Supply disruption and panic buying brought food prices back in play as the key inflation driver. And a recent hike in excise duty and retail fuel prices have pressured utilities and transport costs. We expect inflation to remain above or near the RBI's policy limit for the remainder of the year.

While high inflation explains why some favour a stable rate decision this week, another argument supporting it is a weak currency. The INR has been an underperforming emerging market currency this year with about 5% year-to-date depreciation. Although it gained some ground recently on the back of broad US dollar weakness and one-off inflows in India's telecom sector, we see nothing on the horizon to help it erase underperformance in the rest of the year.

Our end-2020 USD/INR forecast remains at 76.50 (spot 75.05).