Signs and signals of the coming rate cut

Policy moves. Given the benign inflation outlook and robust growth projects, the time is ripe for a 25 bps rate cut

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The Monetary Policy Committee (MPC) of the RBI will announce its bi-monthly monetary policy resolution on October 9. The upcoming meeting will have a new set of external committee members.

We have now seen 10 resolutions since February 8, 2023 with the policy rate unchanged at 6.5 per cent. Simultaneously, the MPC by a majority vote has also gone in for withdrawal of accommodation in the monetary policy stance, prioritising inflation management over growth.

The inflation-targeting framework for the monetary policy has over the years seen the transformation of the policy rate (which is essentially the repurchase, or repo rate) to a short term (overnight) signalling rate of the monetary policy stance. This implies that any increase in the rate is a tightening stance primarily to control inflation and to anchor inflation expectations and any reduction in the policy rate is an accommodative stance essentially to stimulate economic growth.

Growth projections

The RBI August 2024 monthly bulletin has forecast the 2024-25 real growth rate at 7.3 per cent (measured in terms of GDP at constant prices, base 2012=100) while the inflation rate is at 4.6 per cent (measured in terms of CPI combined, base 2012=100). For 2025-26, the RBI forecast that the real growth rate and inflation rate will be 6.7 per cent and 3.9 per cent, respectively.

The quarterly forecast by RBI for the inflation rate beginning Q3 of 2024-25 and ending Q4 of 2025-26 ranges from 3.6 per cent (Q3 of 2025-26) to 4.6 per cent (Q4 of 2024-25). The real growth rate forecast during the same period varies within the range of 6.6 per cent (Q4 of 2024-25) and 8.4 per cent (Q3 of 2024-25).

The forecast gives a benign inflation rate which is well within the range of the inflation target – a CPI-Combined inflation rate of 4 per cent in the band of 2 to 6 per cent, coupled with a real growth rate at a reasonable level. Given this, should the MPC break the long period status quo of keeping policy rate at 6.50 per cent?

The answers depend on six key factors.

The first is the quality of inflation forecasting. The actual inflation rate for 2023-24 based on the National Statistical Office (NSO) data is 5.36 per cent against the RBI rate of 5.4 per cent (February 2024).

Furthermore, RBI's estimate for Q1 of 2024-25 for the inflation rate was 4.9 per cent (April 2024) and the NSO actual data worked out to 4.9 per cent in Q1 of 2024-25. This analysis reflects the happy sync of RBI's inflation forecast and NSO's actual published data. Thus, the forecast published in the RBI's August bulletin may not have large scale deviations from the actual data.

Second, as it may be seen in the growth and inflation forecasts, there is by and large a trade off in growth and inflation, meaning that when the inflation is estimated at a lower rate, growth has also been estimated lower, technically referred to as the dis-inflation glide path. But the dis-inflation glide path as has emerged in the management of the inflation rate and the growth outcome remains largely benign.

Third, the study published in the RBI bulletin of July 2024 concluded that for Q4 of 2023-24, the natural interest rate for the Indian economy was within the range of 1.4 and 1.9 per cent as against the range of 0.8 and 1.0 in Q3 of 2021-22.

Seen with the 4.6 per cent projected inflation rate by RBI for 2024-25, the policy rate should be in the range of 6 per cent (1.4 per cent plus 4.6 per cent) and 6.50 per cent (1.9 per cent plus 4.6 per cent). Based on the RBI estimates of an inflation rate of 3.9 per cent in 2025-26 and the same natural interest rate as above, the policy repo rate should vary in the range of 5.3 per cent (1.4 per cent plus 3.9 per cent) and 5.8 per cent (1.9 per cent plus 3.9 per cent) in 2025-26, if there are no shocks to the macroeconomic environment.

Fourth, there have been recent policy rate cuts in advanced economies. The US Fed Reserve reduced the policy rate by 50 basis points and the Fed fund rate is within the range 4.75 per cent and 5.0 per cent; the Bank of England cut the rate on July 31 by 25 basis points while the European Central Bank (ECB) is expected to cut the rate in October 2024. A lower interest rate in advanced economies has implications for the monetary policy in terms of capital flow movement and absorption of surplus liquidity.

Liquidity absorption

Already there has been a large-scale absorption of liquidity by RBI. For example, as on October 1, 2024, the liquidity absorption by RBI in the Standing Deposit Facility (SDF) was to the tune of ₹1,88,048 crore.

Further fuelling will have an adverse implication on the RBI balance sheet as the net interest outgo to the banks will be higher through the monetary policy absorption via SDF.

Fifth, the monetary policy transmission mechanism in the interest channel has been working successfully with the External Bench Mark Lending Rate or EBLR (linking the bank lending rate to policy repo rate). Note that during the easing phase (February 2019- March 2022), the policy repo rate was reduced by 250 basis points and bank lending rate reduced by 250 basis points.

Similarly, during the tightening phase (May 2022 to July 2024), the increase in policy rate was 250 basis points and the bank lending rate increased by 250 basis points. Thus, the interest rate transmission channel is working smoothly.

Sixth, the credit offtake on Y-o-Y basis has picked up. The September issue of RBI's Bulletin notes that non-food credit has increased by 13.7 per cent in July 2024. Pick up of non-food credit is an encouraging signal for a rate cut.

To conclude, the economic environment in terms of a benign inflation outlook and encouraging growth outlook as estimated by RBI augurs well for a rate cut. Besides, monetary policy transmission and credit uptake has worked reasonably well. It is now time for MPC to opt for a rate reduction cycle and consider a reduction of 25 basis points in its monetary policy resolution of October 9, 2024.

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There is a happy syncing of RBI's inflation projection and the NSO's published data, which will have a crucial bearing on the MPC's decision on rates