

## Repo rate cut expected

**T**he Credit rating agency ICRA has anticipated that the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) would reduce the repo rate by 25 basis points (bps) in the upcoming policy review of August 2017. However, this will be a difficult decision for the Monetary Policy Committee (MPC), from the perspective of guiding the forward path of inflation, which will be the focus of all deliberations. The causes of the unanticipated drop over the past three months will have to be evaluated to form the basis of the trajectory for the next year and in the medium term. The year-on-year (YoY) CPI inflation declined to a series low of 1.5 per cent in June 2017, from 2.2 per cent in May 2017, led primarily by a deeper disinflation in food items (to -1.2 per cent from -0.2 per cent). The monsoon dynamics have been reasonably favourable so far, which has boosted sowing of most crops. Moreover, prices of a number of food items such as pulses, vegetables (barring tomatoes) and oils remain weak on a seasonally adjusted basis so far this month. However, a reversal of the favourable base effect could result in food and headline inflation rising sharply to exceed four per cent during H2 FY2017. The final impact of the GST on inflation will become clearer with a lag, as businesses would observe the impact of this tax on costs over a period of time, prior to raising prices. Although the revision in house rent allowance (HRA) of Central government employees with effect from July 1, 2017, is likely to push up housing inflation, its impact would be staggered over FY2018 and the first quarter of FY2019. Despite measures taken by the RBI to absorb liquidity through instruments such as cash management bills, treasury bills issued under the market stabilisation scheme and the recent open market sales of G-sec, a substantial Rs. 3.4 trillion is being absorbed on an average through overnight and term reverse repos in July 2017. A portion of the continuing surplus in systemic liquidity is structural and not frictional in nature, warranting permanent measures of absorption, such as sales of the RBI's holdings of G-sec, to supplement the absorption of surplus liquidity through other short term tools. In this environment, the MPC will have to consider the prospects of the trajectory falling even further than expected. This has happened in the past, particularly on food inflation. And this has been a gap not just in the RBI's inflation projections, but also in the median of the responses of the Survey of Professional Forecasters (SPF). Another important factor in a rate-cut decision will be the objectives achieved by lowering interest rates. But, a million-dollar question remains - how much would these measures help in reducing the output gap?