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Talking Point

Extended pause on repo rate likely

Volatility in monthly CPI inflation gives cautious bias to monetary policy

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With inflation rising from the temporary lows seen in mid-2017, the Monetary Policy Committee (MPC) stayed on hold in the recent Policy review, as was expected. Moreover, the Indian economy charted a moderate sequential recovery in growth in Q2 FY2018, relative to the destocking-hit Q1 FY2018.

This uptrend is expected to continue in the remainder of FY2018. However, a sustainable investment recovery remains elusive. Furthermore, the outlook for the rate cuts appears dim, given the lingering inflationary concerns.

Inflation risks related to commodities and perishables have escalated over the last two months and there are persisting concerns related to the fiscal balances of the Central and state governments. While the MPC retained the neutral stance of the Monetary Policy, it mildly increased its inflation projection for H2 FY2018 to 4.3-4.7 per cent, from 4.2-4.6 per cent, which suggests a low likelihood of rate cuts in the remainder of this fiscal.

Our baseline expectation, heading into 2018, is of an extended pause for the Repo rate. The CPI is heavily weighted towards food items, the prices of which tend to be quite sensitive to small changes in supply-demand dynamics. Therefore, volatility in the monthly CPI inflation readings will continue, imparting a cautious bias to the Monetary Policy setting in India.

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The MPC retained the growth forecast for FY2018 at 6.7 per cent, with risks evenly balanced, which is predicated on a sharp pick-up in economic expansion in the latter half of the year.

The committee based this optimism on the expected positive impact of various factors on the economic growth momentum — including the revival in fundraising through the primary capital markets, which will boost de-

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mand; the improvement in the ease of doing business that will attract FDI; the ongoing process of resolution of distressed borrowers; and recapitalisation of public sector banks. While these factors will indeed boost growth over time, their efficacy at reviving the economy substantially over the next few months is somewhat uncertain.

The recent GDP release indicates that growth of gross fixed capital formation improved to 4.7 per cent in Q2 FY2018 from the low 1.6 per cent in Q1 FY2018. However, other data and company announcements do not signal the commencement of a broad-based investment recovery.

Moderate capacity utilisation, high leverage levels, and availability of brownfield distressed assets in some sectors are likely to constrain fresh investment for a few quarters.

Many companies in the Indian corporate sector remain highly leveraged. Over the recent months, the corporate sector has benefited from lower interest rates.

While the metals segment has benefited from rising prices and the resulting improvement in cash flows, many corporates in the stressed sectors still need to address balance sheet issues. Moreover, there are sector-specific issues impacting recovery in some cases, such as competitive intensity in telecom or slack demand in real estate.

Additionally, uncertainty regarding the buoyancy of indirect tax collections, post-GST, and the continued fiscal consolidation forecast by the rolling targets may limit the fiscal space available with the Government of India (GoI) to augment infrastructure investment in the near term. Moreover, state government expenditure on crop loan waivers, pay revision and the UDAY debt servicing will reduce the space for capital spending.

Another constraint is the ability of the public sector banks (PSBs) to be able to fund an investment recovery, given the stress in their balance sheets. The GoI has recently announced a plan to recapitalise PSBs with capital of ₹2.11 trillion during FY2018 and FY2019.

ICRA expects at least ₹850 billion of recapitalisation bonds are required during FY2018 to help the PSBs offset the credit provisions and meet the regulatory norms. It is welcome that the capital infusion will have a differentiated approach across PSBs, including front-loading for the better-managed banks. The ability of individual banks to raise capital from the markets during FY2019 will be critical for their own growth, as well as their participation in the much-awaited investment revival.

To conclude, interest rates are likely to remain sticky in the near term. While lower rates will certainly help, they are unlikely to prove sufficient to jumpstart investment activity in the light of the aforesaid constraints.

The writer is Managing Director and Group CEO, ICRA

Investment curbs

- Moderate capacity utilisation
- High leverage levels
- Brownfield distressed assets in some sectors

Less wiggle room

State government expenditure on crop loan waivers, pay revision and UDAY debt servicing will reduce the space for capital spending