

Economy faces its worst test ever

The monetary policy panel has its task cut out, given rising inflation, growth contraction and worsening macro indicators

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When the Monetary Policy Committee (MPC) had last met in August 2020, the latest available CPI inflation figure was for the month of June. This had printed at an unpleasant 6.1 per cent, and has since been revised higher to 6.2 per cent. Citing its primary mandate of ensuring that the CPI inflation remains within a band of 4 per cent +/-2 per cent, the Committee had decided to leave the repo rate unchanged.

However, the Indian economy was struggling to shake off the torpor induced by the lockdowns that were necessitated by the Covid-19 pandemic. Given the latter, the MPC had retained the accommodative monetary policy stance, stating that supporting a recovery assumes primacy in the conduct of monetary policy.

Soaring up

Since the August meeting, inflation has climbed to an even more discomfiting 6.7 per cent each in July-August, with localised lockdowns and bouts of heavy rainfall creating supply disruptions and higher taxes on some items pushing up retail prices. The CPI inflation may well harden further in September, before exhibiting a base-effect related retreat over the subsequent quarter.

Given this trajectory, the foregone conclusion is of a pause, not only in the upcoming policy review on October 1, but also in the subsequent review meeting in December, based on the MPC's reiteration

of its primary inflation fighting mandate.

At the same time, the worst fears for the state of economic activity in Q1 FY21 have crystallised, with the pace of GDP contraction in that quarter being pegged by the National Statistical Office (NSO) at 23.9 per cent, broadly mirroring our expectation.

However, the situation is expected to be less dire going forward, with a fragmented recovery taking hold in Q2 FY21, even as the number of Covid-19 infections in India remains elevated.

Disaggregated data for July-August paints an uneven picture. While the improvement in industry had gathered speed in July, the momentum of the recovery in the services sector stalled that month. Moreover, government expenditure, a key driver of economic activity in Q1, reported a volatile trend in July; the Central Government's revenue expenditure growth stood at a substantial 18.6 per cent in that month, while its capital expenditure contracted by 47.1 per cent.

The high frequency lead indicators for August indicate that the subsequent recovery remains patchy. On the one hand, the output of Coal India, motorcycles, and rail freight traffic posted a turnaround to a YoY expansion in August, after having displayed a contraction in the previous month.

Moreover, the pace of contraction in the production of scooters and passenger vehicles, domestic airlines' passenger traffic, port cargo traffic, GST e-way bills, and the consumption of ATF and petrol,



Weak pulse A healthy recovery is not in sight yet

narrowed at a varying rate in August. At the same time, the YoY performance of diesel consumption, thermal and hydroelectricity generation, and non-oil merchandise exports actually worsened in August 2020 compared to July 2020, serving as a reminder that the road to a full recovery will not be smooth.

On a positive note, benefiting from favourable rainfall, the entire 2019 kharif acreage level has now been exceeded by nearly 5 per cent and the harvest of most crops is expected to be bountiful.

Moreover, with ample rainfall in most regions, reservoir storage has retraced to the healthy year-ago levels, which should support the timely sowing of the upcoming rabi crops. Such factors portend

that agricultural growth, and the farm sector's sentiment and consumption may remain bolstered in H2 FY21.

Season fall

Based on the available indicators, ICRA expects the overall GDP to continue to shrink in Q2 FY21, but by a narrower 11-13 per cent. However, with fresh Covid-19 infections in India remaining elevated, even at the tail-end of Q2 FY21, and the health and economic challenges this continues to pose, the outlook for H2 FY21 is hazy.

In its upcoming October meeting, the MPC may choose to extend the accommodative stance, as a balm towards the recession that is under way. This may mollify the market to an extent, even though

the inflation trajectory ahead is unsavoury, with the average CPI inflation expected to barely dip below 4 per cent in H2 FY21.

In this context, some commentary on the threshold of inflation, below which a rate cut will be possible, may be needed to make hopes of rate cut in the February 2021 meeting stay alive. This would add heft to the credibility of an extension of the accommodative stance.

Guidance on the MPC's inflation and GDP forecasts for FY21 is also keenly awaited. This, in conjunction with the calendar for Central and State government borrowings in H2 FY21 and Q3 FY21, respectively, will crucially guide the direction of bond yields over the next quarter.

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