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Short take

Economy seems prepared for a rate cut

K Srinivasa Rao

Consumer price inflation was at 3.7 per cent in August, only a notch higher from 3.6 per cent in July maintaining below the 4 per cent mark. Food inflation increased to 10 per cent in August, up from 6.8 per cent in July, exposing its vulnerability to climate factors. Core inflation is satisfactory at 3.4 per cent. The inflation outlook of ICRA for September is at 4.8 per cent pin-pointing upside risks. Such continued vulnerability to food inflation dynamics makes it difficult to stay firmly targeted at the 4 per cent inflation benchmark on a durable basis.

However, with international Brent crude prices dropping to $71 per barrel during the week, the lowest since December 2021, there could be some drop in retail prices of auto fuels if the diminishing trend in global crude prices sustains. It could hasten inflation control.

The single-point focus on the 4 per cent inflation target led to prolonged high interest rates aided by the monetary policy stance – 'withdrawal of accommodation'. There are strong arguments that it has hurt growth. GDP growth was down to 6.7 per cent in Q1 of FY25 – a 15-month low down from 7.8 per cent in Q4 of FY24. It is also lower than the RBI estimate of 7.1 per cent. The average GDP growth during FY24 was 8.2 per cent and is showing imminent signs of slowdown in FY25.

The economy may have reached a tipping point where monetary policy shift is warranted.

Government expenditure is rebounding to support growth, leading to surplus liquidity in the banking sector as the Centre injects cash into the system. The RBI's tolerance of this surplus suggests a potential shift toward a softer monetary policy.

In continuing to align monetary policy direction to domestic priorities, it will be equally important to keep a close watch on the external sector.

With US inflation steadily moving towards the 2 per cent mark and year-over-year (YOY) inflation moderated to 2.5 per cent in August, the probability of the US Federal Reserve beginning to cut its policy rate in the next FOMC meeting during September 17-18, looks firm. ECB and Bank of England have already started their policy rate descent. Under positive interest rate sentiments, the global stock markets are upbeat.

Against this backdrop, RBI may have to evaluate its options to unleash the full growth potential of the economy while pursuing its inflation-easing target. The monetary policy committee may change the stance of the policy to 'neutral' and hint at rate cuts in December.

The writer is an Adjunct Professor, the Institute of Insurance and Risk Management – IIRM, Hyderabad. Views expressed are personal