1. Whatever it takes

Context:

- The Monetary Policy Committee (MPC) cut the repo rate again, the fifth time since February 2019 by 0.25 percentage points, based on the views of the MPC members on current and projected economic conditions.

What is Monetary Policy Committee?

- The Monetary Policy Committee would be entrusted with th**e task of fixing the benchmark policy rate (repo rate) required to contain inflation** within the specified target level. The meetings of the Monetary Policy **Committee shall be held at least 4 times a year** and it shall publish its decisions after each such meeting

Composition:

- The MPC will have **six members** – the RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and the remaining three members would represent the Government of India.

Objective of MPC:

- The primary objective of monetary policy is **to maintain price stability while keeping in mind the objective of growth.** Price stability is a necessary precondition for sustainable growth.
- **To maintain price stability, inflation needs to be controlled.** The government of India sets an inflation target for every five years. RBI has an important role in the consultation process regarding inflation targeting. The current inflation targeting framework in India is flexible in nature.

Why RBI reduce the Interest Rate?

- The MPC action was in line with the series of cuts by almost all major central banks across the globe, as counter-cyclical policy responses to the global slowdown. The reason for this strong signal showed up in the steep reduction in RBI's FY20 GDP growth projection, from to 6.9 per cent in August down to 6.1 per cent.
- High frequency indicators of economic activity remain weak, with a flat core infrastructure index growth, continuing weak automobile sales and a sharply lower services sector purchasing managers index (PMI) showing a deep contraction in September. Rural demand, proxied by sales of two-wheelers and tractors, contracted.

If growth is so weak, why not cut rates More Aggressively?

- One has to consider the roots of India's economic slowdown, if the slowdown was essentially because of the high cost of money holding back investment, then cutting interest rates makes a lot of sense. But that is not the case.
- **The main problem with the economy is the collapse in consumption, which in turn has been due to a collapse in incomes and jobs.**
- Yet, given the stage of India's economy and the fact that the government has just cut corporate tax rates, it makes sense to cut interest rates and incentivise new investments.
- But there are two more hurdles here. One is the issue of transmission of rate cuts. Of the 110 basis points of the repo rate cut, only 29 basis points were transmitted by the banking system to the final borrower. This weak transmission begs the question: whether it is wise to cut rates without first fixing the transmission.
- Two, and very importantly, is the issue of inflation. At present, most inflation indicators are well within RBI's comfort zone. But they are trending up. This means people expect inflation to rise and RBI must not cut rates to such a level that it unleashes another monster – that of high inflation.

What should be next in the Policy Response?

- The government, RBI and other agencies have already announced a coordinated set of counter-cyclical stimulus measures to revive consumption, investment and growth.
- The government is expediting the implementation of the multiple measures it has announced. Moral suasion will probably induce some project capex, particularly by public sector enterprises. Upfront recapitalisation payments to public sector banks might gradually fill loan pipelines, hopefully to MSMEs, which will be critical for the recovery.
- The efficacy of these measures over the near to medium term will be determined by the nature of the slowdown. RBI analytics suggest that the slowdown is largely cyclical, and in macroeconomic terms, this is probably correct.
- However, many sectors have large structural components contributing to slowing growth, including changing consumer preferences, wage growth and income uncertainty.
- In the meantime, a combination of relatively easy systemic liquidity and a shift of some loan products to market benchmarks will begin to lower borrowing costs.
- To support credit flows to sectors which are particularly constrained for funds, the RBI has relaxed some micro-prudential restrictions to cautiously incentivise credit and fund flows to solvent but liquidity constrained financial intermediaries and sectors.