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# Insights - India Fixed Income Market

## Goldilocks' Monetary Policy for India

June 2015

In its latest monetary policy review, the RBI, as expected, reduced the repo rate by another 25 bps to 7.25%. The Governor Mr. Raghuram Rajan summarized the policy as a **Goldilocks' Policy** where monetary policy is neither overly conservative nor aggressive. As during previous policy rate cuts, the RBI's decision has been influenced by the incoming macro-economic data and has strongly hinted that any further easing in interest rates will also be based on the same.

The RBI's most recent rate cut is clearly an outcome of the comfort the Central Bank seems to have derived from the manner in which some of the variables, to which it lends credence to, have behaved. These being; passing on the benefits of the previous two rate cuts (through reduction in lending rates) by commercial banks to their customers, headline inflation moving along the projected path, the impact of unseasonal rains seen in the previous quarter being moderate, administered price increases continue to remain muted, and the normalization of US monetary policy not being an immediate threat. The RBI has also taken into consideration the low domestic capacity utilization, and also the subdued investments and credit growth.

While it initiated its third rate cut this year, the RBI has also categorically highlighted the estimated below normal south west monsoons and its impact on food inflation as a key risk. Taking cognizance of the same, it has carefully chosen to be somewhat conservative going forward and would rather wait to assess the impact of the same on inflation before taking further calls on interest rates.

**Future direction of rates**

In the immediate term while the RBI is expected to be accommodative, keeping in mind that it needs to be supportive if the economy has to reach its optimal growth trajectory, its future rate actions will depend upon a host of variables, which would impact inflation and inflation expectations. With the central bank's primary mandate of keeping inflation contained to create macroeconomic conditions that are supportive of growth, it will continue to monitor how global energy prices behave; food stock management by the government - in the event of a sub-par monsoon to mitigate possible inflationary effects; the stance of the government on administered food prices (minimum support price); transmission of previous rate cuts by commercial banks and also the behaviour of international crude oil prices.

With central banks, globally, maintaining an easing monetary stance to support their economies, the rupee has been appreciating against many major currencies so far in the year. RBI will also be mindful of the same in the light of nominal policy rates in India being higher than those of other countries with similar macro-dynamics. In the medium term, proactive efforts from the government on supply, response towards key inputs and the path that the US monetary policy takes will decide the interest rate trajectory.

Recent data shows the government has spent 8.7% of its budgetary allocation in the month of April compared with 6.7% in the previous year. Total spending in April was Rs 1.55 lakh crore, of which 17% was on the capital account compared with 10.3% of the total last year. The front loading of government capital spending is encouraging which if supplemented with an early award of fresh projects in various sectors with all clearances in place would help in investment recovery. Sustained revival of coal output also augurs well for electricity generation and mining. There is also some optimism on gas pricing and its availability. While all these augur well for the economy, in the medium term, in the absence of productivity improvements, our exports could be rendered incrementally uncompetitive due to the

strong rupee and therefore the government would need to take measures to unclog stalled investment projects and encourage fresh capex by private firms.

**What should investors do?**

Emphasis on upside risks to inflation has tempered future rate expectations and dented market sentiments. Given a weaker visibility on continuation of the accommodation cycle, we expect the market to take cues from evolving liquidity and demand-supply dynamics.

A prolonged pause on policy rate now appears as a distinct possibility, since the incoming macro-economic data will provide clarity only in the course of the coming quarter. Contingent on inflation undershooting RBI's projected path, room for another 25 bps easing may open up only towards the end of year. Until then, we believe the policy rates are close to neutral level. In the near term, the benchmark 10Y is likely to stay in range of 7.65% - 7.80%.

While global issues like muted growth, low inflation, weak manufacturing activities, easing measures by the central banks and concerns over Greece's exit from euro zone will continue to have their ripple effects on our markets, we believe that the RBI and the economy is well placed to weather any storm.

The next few months will also provide more confirmation on government's food policy. If this aids RBI's endeavor to take CPI to 4% by 2018, then it is imperative that rates have to be much lower. On the other hand, if food stock management goes the other way, then on its own this is likely to be a hurdle. However, the global backdrop provides another dimension to India's fixed income story. While potential for disruption from the Fed can never be ruled out, an equal if not larger challenge is the possibility of more aggressive easing from our peer nations, if growth and inflation impulses don't stop deteriorating soon.

The decision to invest in the fixed income market cannot depend upon just one variable, such as the state of the monsoon. Instead one has to look at the whole framework and then assess whether the environment seems positive for rates or not. In our view, there is still reason to be optimistic for medium term bond investors as the environment seems positive and therefore, we would recommend that investors continue to participate in fixed income.

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