Insights – Monetary Policy Review

A Ray of hope!

September 2015

The Reserve Bank of India (RBI) slashed the repo rates by 50bps today, bringing it down to 6.75%, after having kept the rates on hold in the previous policy while it awaited the out-turn of the complete monsoon cycle and the Federal Reserve move on the US interest rates.

The tone of the commentary and guidance today was more balanced than the previous three occasions this year when the RBI had cut the repo rate. RBI's commentary this time clearly reflected its changed mind-set, outlining a dovish guidance and explicitly stating that, its stance will, in all likelihood, continue to be accommodative.

This shows a tacit shift in its policy approach towards growth amid acknowledgement that concerns on inflation may be easing faster than anticipated.

Today's move in fact positively surprised the market, which was expecting a rather modest repo rate cut of 25 bps and a somewhat hawkish statement that would have limited the scope for further policy easing.

It was being expected that the policy statement this time round would shift the focus from domestic conditions to the risks emanating from global disinflation amid weak global growth prospects, especially those emanating from the emerging markets such as the Chinese currency devaluation, capital outflows from emerging markets and weaker currencies.

The RBI today also did not sound much worried about the pressure on food prices due to a deficient monsoon given the comfort it has derived from the deft management of the situation by the Government. Moderate increase in Minimum Support Prices (MSP) and relatively better prospects for food production following the increase in area under cultivation along with deflation in global food prices should help cap the momentum in food inflation in near future. It also does not see any demand led pressure on prices emanating from the rural segment of the economy given the weak conditions prevalent there. With the weakening of global activity, the RBI expects the commodity prices to stay put at the current levels for the time being which should also aid in keeping inflation in check.

The recent volatility in financial markets in India, amid continued weakness in external demand, has probably made the RBI shift its focus on creating enabling conditions for growth to recover and encourage a stronger investment response which it felt could be best achieved by way of a front loaded policy rate cut of 50 bps.

While continuing to remain accommodative, the focus of monetary policy hereon is likely to shift to working with the government in removing the impediments in the transmission of the policy easing since the banks have so far transmitted just about a part of the previous '75 bps' reduction in rates. The transmission should not be difficult now given that there has already been a significant easing in deposit rates of banks.

In tune with what the Governor had indicated earlier, after the previous policy announcements, the RBI today also announced a much larger than expected expansion of limits for foreign investment in Indian bonds. This would be increased in phases to 5% of the outstanding G-Sec by March 2018 and would give FPIs the room to invest an additional Rs 1,200 billion in central government securities.

FPI limits in debt securities –

- The limits will henceforth be announced/ fixed in rupee terms.
- The limits for FPI investment in the central government securities will be increased in phases to 5% of the outstanding stock by March 2018 – this provides an additional room of Rs 1,200 billion over and above the existing limit of Rs 1,535 billion for all G-sec.
- A separate limit for investment in the State Development Loans (SDLs), to be increased in phases to reach 2% of the outstanding stock by March 2018 – this will amount to an additional limit of about Rs 500 billion by March 2018.
- Limits increases will be announced every half year in March and September and released every quarter.
- Limits for the residual period of the current financial year will be increased in two tranches from October 12, 2015 and January 1, 2016.

Future direction of rates

Given the sharp rate reduction in the September policy, it will probably be expected that the RBI may not effect another rate reduction before the beginning of the next financial year.

We reserve our outlook on the same, but feel positive on further rate reductions given the change in RBI's attitude and its focus on demand revival and comfort on inflation. Given the continued external headwinds from weak global growth, which may possibly intensify in the coming months and which could also pull retail inflation below the central bank's forecast, we believe that further monetary easing cannot be ruled out and more policy rate cuts could follow.

While in the immediate term, we see the G-Sec market to be range bound, we continue to remain positive on the medium term outlook of long term bonds and gilts.