

Insights – Monetary Policy Review

Second consecutive rate cut in a span of 2 months, policy stance remains neutral

April 4, 2019

With market abuzz on rate cut expectations given low headline inflation and weakening economic activity and our views affirming the same, the second such rate reduction in a span of 2 months is a welcome move. A large section of market even expected that Monetary Policy Committee (MPC) will either front load the interest rate cut with 50 basis point reduction in repo rate or will dilute its policy stance to 'accommodative' in a bid to revive investments and boost economic growth. Though there was a scope for the larger rate cut, the MPC undertook a calibrated approach. With this rate cut of 25 basis points, the repo rate now stands at 6% which is at the same level as it was in August 2017- June 2018. The decision to reduce policy repo rate was voted 4-2 with two members voting for status quo on policy rates. However, decision to maintain the monetary policy stance was voted 5-1 with one member voting for change in stance from neutral to accommodative

As the headline Consumer Price Index (CPI) based inflation remained benign (at 2.57% in February) and within MPC's target of 4% since past several months, it provided MPC the plausible room for monetary easing. The persistent decline in food inflation and a sharp fall in fuel inflation explains the reasons for low CPI inflation. In view of lower CPI prints and benign inflation outlook in the near term, the MPC has revised inflation projections downward. The CPI inflation is revised down to 2.4% in Q4 2018-19, 2.9% - 3.0% in H1 2019-20 and 3.5%-3.8% in H2 2019-20, with risk broadly balanced. The medium-term target remains at 4% within a band of +/- 2%. However, policy statement cited various factors which could cloud the inflation outlook beyond the near term. These include abrupt reversal in vegetable prices due to probability of El Niño¹ effects, sustainability of lower inflation in fuel items, elevated inflation excluding food and fuel, volatility in financial markets amid global growth and trade uncertainty, fiscal situation etc.

Whilst, MPC noted any spiraling of inflation is unlikely in near term, it also remained cognizant of slowing domestic economic growth and the need to address growth challenges by spurring private investment. The Gross Domestic Product (GDP) growth for 2019-20 is projected lower at 7.2%, in the range of 6.8%-7.1% in H1 2019-20 and 7.3%-7.4% in H2, with risks evenly balanced.

Meanwhile, the RBI continued to infuse durable liquidity into the market through purchases under Open Market Operations (OMOs) till March'19. Liquidity injected under the Liquidity Adjustment Facility (LAF) was Rs. 950 billion in February on an average daily net basis and Rs. 570 billion in March. However, due to build-up of government cash balances, systemic liquidity moved into deficit during February 7 - March 31 compared to net average surplus of Rs. 279 billion during February 1-6, 2019. The total durable liquidity injected through OMOs has aggregated Rs. 2.98 trillion for 2018-19.

Market Outlook

The rate cut has been in line with the expectations and policy makers appeared to be calibrated in their approach in order to monitor the progress of transmission of rates. As two important parameters, growth and inflation remain top of the mind concern for policymakers, we feel that policy is likely to remain accommodative going forward. Since economic growth is weakening and real interest rates are high, we feel that MPC will likely cut rates in order to push through lower rates into the economy. On inflation front, our view is that headline CPI inflation for CY20 should be comfortably well within 4%.

However, drop in repo rates will not lead to lower borrowing cost if rate cut transmission remains weak. Thus, we feel that RBI will remain proactive to infuse liquidity so as to bring down the deposit rates of the banks so that they can eventually price their loans cheaper. Additionally, certain public sector banks which were under prompt corrective action (PCA framework) have now been remediated and should be able to lend thereby improving availability of credit. Further, RBI has allowed banks to use an additional 2% from Statutory liquidity ratio (SLR) bucket for purpose of Liquidity Coverage Ratio (LCR). This is expected to release additional liquidity into the system.

Given various positive factors such as benign inflation, accommodative monetary policy, likely continuation of FPI flows in debt market (with some swings around the general election period) and prudent liquidity management by RBI will auger well for the bond markets. Therefore, we think that path is set for yields and credit spreads to compress, albeit with bouts of volatility.

In the given market conditions, we urge investors to start selecting funds in alignment with their investment horizon and selectively longer on duration depending on their individual risk appetite. We feel that additional duration over the investment horizon may work in favour as the risk return matrix is tilted in favour of lower rates. The risks to this view emanate from

higher government borrowing calendar of FY20, geopolitical risks, uncertainty over election outcome, weak monsoon etc.

¹El Niño is a climate cycle in the Pacific Ocean with a global impact on weather patterns.

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