Insights – Monetary Policy Review

Rate hike with a neutral stance

August 2, 2018

The Monetary Policy Committee (MPC) hiked the repo rate by another 25-basis point in its latest monetary policy review. The policy decision was voted 5-1 with five out of six members voting for hike in the policy rate by 25 basis points. The policy stance remains unchanged at neutral.

Given that medium-term target for inflation remains unchanged at 4% within a band of +/- 2%, the MPC members cited various risks to the inflation. The key factors that could have bearing on inflation are volatile crude oil prices, uncertainty in global financial market, uptick in household's inflation expectation as measured by RBI's survey and regional distribution of monsoon. The policy also attributed factors such as any fiscal slippage at the centre and/or state levels, uncertainty around the full impact of Minimum Support Price (MSP) on inflation and the staggered impact of House Rent Allowance (HRA) revision by state governments, which may push headline inflation higher. Meanwhile, latest CPI inflation was recorded at 5% in June and has been on an uptrend since April.

The Consumer Price Index (CPI) based inflation for Q2 2018-19 is projected at 4.6%, 4.7%-4.8% in H2 2018-19 and 5% in Q1 2019-20, including HRA impact of central government employees, with risks evenly balanced.

With regard to growth outlook, MPC noted that domestic economic activity has strengthened. The investment activity remains firm even as there has been some tightening of financing conditions in the recent period. It retained Gross Domestic Product (GDP) growth forecast at 7.4% for 2018-19 – in the range of 7.5%-7.6% per cent in first half and 7.3%-7.4% per cent in second half with risks evenly balanced. The GDP growth for Q1 2019-20 is projected at 7.5%. However, it also remained vigilant of rising trade tensions between major global economies, which could have its impact on economic growth.

Another key focus area of central bank, i.e. systemic liquidity, generally remained in surplus during June- July 2018. In the second half of June, liquidity turned in deficit due to advance tax outflows. Thereafter, it again moved to surplus in July with increased government spending. Meanwhile, the RBI absorbed surplus liquidity of around Rs. 14,000 crores on a daily net average basis under the Liquidity Adjustment Facility (LAF). Further, in line with its commitment to maintain durable liquidity, RBI conducted two open market operation (OMO) purchase auctions of Rs. 10, 000 crores each on June 21 and July 19, 2018.

Market Outlook

The market expectation was divided on the rate decision, but there was a lot of debate on whether MPC would change its policy stance or not. We feel that with a rate hike and keeping a neutral stance the MPC is hinting at a pause in rate hikes for this calendar year. It is based on the views that MPC has front loaded the hikes, inflation projections have not changed, interest rate transmission takes time and has still maintained a neutral stance. Moreover, we feel that inflation will ease from July to December, and therefore the window for rate hike appears virtually closed for this calendar year.

Overall, we are positive on the bond market and expect the real rates to contract and move in line with the broad macro data. We also feel that the steep yield curve offers opportunities for investors, the volatility in the market may continue, which makes sense for investors to weigh their investment horizons and then take investment calls.

Meanwhile, the credit environment is currently showing signs of slowdown, but steps are being taken to revive the economy. While, we may not see an immediate visible turnaround in the overall scenario, a revival in the current economic scenario is expected in the medium term.

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