Insights – Monetary Policy Review

No change in repo rate and policy stance, but revises inflation projection downward

December 6, 2018

The Monetary Policy Committee (MPC) has been following a regime of inflation targeting and with inflation staying well within its target range, status quo on key policy rates came as no surprise. The policy statement sounded less hawkish than previous one, however, MPC, maintained its stance of 'calibrated tightening'. The decision to keep policy rate unchanged was unanimous, however, one member voted for change in monetary policy stance to 'neutral'.

The MPC had shifted its stance from 'neutral 'to 'calibrated tightening' in its October policy review signaling upside risks to inflation amid hardening of oil prices and sharp depreciation of rupee in previous months. Clearly, with key macro-economic variables, such as oil prices and rupee now at a benign trajectory, the market was hopeful that there was a case for change in stance. The market participants were also expecting that MPC members will take cognizance of evolving dynamics and may revise their inflation prognosis. International oil prices have plummeted by 30% from the peak, while rupee has recovered about 5% (currently at around 70.60) after seeing a historic low of 74.39 per USD.

Accordingly, MPC did acknowledge the softer Consumer Price Index (CPI) prints (latest CPI at 3.31% in October) and benign inflation outlook. The CPI inflation is now projected at 2.7%-3.2% in H2 2018-19 and 3.8%-4.2% in H1 2019-20 with risks tilted to the upside. It flagged various risks which could weigh on the outlook of inflation, namely, reversal in food prices which have been unexpectedly benign in recent months, exact impact of Minimum Support Price (MSP) on inflation, uncertain medium-term outlook of crude oil prices, elevated future inflation expectations, fiscal slippage center/state level if any and staggered impact of House Rent Allowance (HRA) revision on inflation. The policy statement, however, reaffirmed to achieve its medium-term inflation target of 4% on a durable basis.

Whilst, near term inflation projection was revised down, economic growth forecast remained unchanged. MPC retained GDP growth forecast for 2018-19 at 7.4%, with risks somewhat to the downside. The committee noted that while supporting growth, domestic macro-economic fundamentals need to be strengthened with focus on fiscal discipline.

Even as repo rate was unlikely to see any action, the market was eyeing for additional measures to address liquidity woes. Ever since the default by a major NBFC and ensuing liquidity crunch, the government had desired that RBI would infuse liquidity into the markets in a targeted manner for the NBFCs and HFCs. However, so far, RBI has infused liquidity through the Open Market Operations (OMOs) by buying gilts. It has undertaken OMOs of Rs. 36,000 crores in October'18, Rs. 40,000 crores in November'18 and Rs. 40,000 crores in December'18. As banking system was running a deficit of average Rs. 84,899 crores in November, infusing liquidity through OMOs was not seen enough. The Statutory Liquidity Ratio (SLR) cut is expected to result in increased liquidity with the banks thereby leading to higher lending. The SLR will be reduced by 25 basis points every calendar quarter until it reaches 18% of Net Demand and Time Liabilities (NDTL) in order to align it with Liquidity Coverage Ratio (LCR). The first reduction of 25 basis points will take effect in the quarter commencing January 2019. Presently, SLR is at 19.5% of NDTL.

In another development, the RBI has asked banks to link all floating rate loans such as home loan, car loan etc. to external benchmark rates viz. RBI's policy rates, Treasury Bill yield, etc. instead of current practice of linking it to internal benchmarks (Prime Lending Rate, Base Rate, Marginal Cost of Funds based Lending Rate etc.). The move is expected to improve transparency in loan pricing. The final guidelines are expected this month and will be effective from April 1, 2019.

Market Outlook

The fixed income market has seen rally in bond prices since mid-October. The 10-year benchmark yield came off sharply from an intra-day high of 8.22% in October to around 7.46% as on December 5, 2018. The yields have primarily declined on lower inflation, stabilization of rupee versus dollar and euro and market neutralizing fears of additional round of rate hike on improving macro fundamentals. We feel that yields are expected to remain lower or range bound given benign inflation projections, improving liquidity conditions in December and expectations of pause in hike in policy rates during the rest of financial year. Overall, we are positive on the bond market and do hold on to our stance of a need for tighter real rates and endorse efficient allocation of capital and savings/investment. However, we do not expect any rate cut in immediate months as change in stance to 'calibrated tightening' has tied RBI's hands.

In the given market conditions, we urge investors to pick fund duration aligned to their investment horizons and risk appetite.

Invesco Mutual Fund

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