Insights – Monetary Policy Review

Status quo after two successive rate hikes; stance changes to calibrated tightening

October 8, 2018

At a time when near-term headwinds have clouded the macro economic environment and financial markets, status quo on interest rates in latest monetary policy review is the silver lining. The decision of Monetary Policy Committee (MPC) to retain repo rate at 6.5% came in as a positive surprise and provided the jittery markets some stability. The policy decision was voted 5-1 with five out of six members voting for keeping the repo rate unchanged.

Whilst, the sliding rupee and hardening of oil prices had stoked concerns about inflation and majority of market participants were expecting a rate hike, the MPC did respond to changing dynamics by altering its stance to calibrated tightening from neutral, instead of opting for a repo rate hike. Out of six MPC members, five voted in favour of change in stance to calibrated tightening.

The policy statement reaffirmed its inflation targeting with medium term inflation aimed at 4% within a band of +/- 2%. Given the inflation targeting objective, the MPC highlighted various factors posing risks to inflation. It enumerated various factors such as recent hike in Minimum Support Price (MSP) of Rabi crops, possible upward pressure on oil prices, volatility in global financial market, rise in input costs, staggered impact of House Rent Allowance (HRA) revision and any fiscal slippage at the centre and/or state level, to exert upward pressure on headline inflation. However, benign food prices and recent excise duty cut on petrol and diesel prices will help mitigate some inflationary risks.

And so, while it lowered its inflation projection from August review, it expected the trajectory of inflation to rise above the August 2018 print of 3.69%. The Consumer Price Index (CPI) based inflation for Q2 2018-19 is projected at 4.6%, 4.8% in H2 2018-19 and 5% in Q1 2019-20, including HRA impact of central government employees, with risks evenly balanced.

From macro-economic perspective, it noted that global headwinds in the form of rising trade tensions, erratic & rising oil prices and tightening of global financial conditions pose risks to both inflation and growth outlook. It retained growth forecast for 2018-19 at 7.4%, with risks evenly balanced. However, it marginally lowered Gross Domestic Product (GDP) growth for Q1 2019-20 to 7.4% from 7.5% in August policy review.

Elsewhere, liquidity in the system moved between surplus and deficit during August-September'18 in line with the expansion of currency in circulation, RBI's forex operations and movements in government cash balances. The RBI addressed the prevailing liquidity conditions by doing two open market purchase operations in the second half of September to inject Rs. 200 billion of durable liquidity. The Liquidity Adjustment Facility (LAF) operations absorbed, on a daily net average basis, Rs. 30 billion in August, but injected Rs. 406 billion in September.

The fixed income market which was marred by extreme volatility in recent months, cheered the surprise pause in rate hike following the two consecutive interest rate increases since June. Following the rate decision, the 10-year benchmark yield came off sharply to close at 8.03% on Oct 5, 2018 as against 8.16% on Oct 4, 2018. During August and September, 10-year G-sec yield moved in the range of 7.70% - 8.18%, averaging at 7.95%. The rupee which depreciated significantly and is the worst performing major Asian currency this year (mainly due to concerns about a widening current account deficit, strengthening US dollar and emerging market turmoil) coupled with rising fuel prices led to sharp revision in rate expectations and weighed on the bond prices. Later, recent deduction in excise duty on fuel prices and reduced government borrowing helped calm the market sentiments.

Market Outlook

Overall, we feel that current pause in rate hike will provide near-term stability to the market. The volatility in bond yields are expected to subside with clarity emerging on monetary policy stance. It is important to note that bond yields will be guided by evolving inflation dynamics and MPC may need to tighten rates if upsides risks highlighted with regard to inflation materialize.

In our view, current bond yields offer investment opportunity to lock in at relatively higher yields in accrual funds. Investors are advised to weigh their investment horizons and risk appetite before taking investment calls. We do not expect any rate reductions soon but we do hold on to our stance for a need for tighter real rates and endorse efficient allocation of capital and savings/investment.

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