Insights – Monetary Policy Review

RBI paves the way for quicker transmission of lower rates with rate cut and greater focus on liquidity management

April 5, 2016

The Reserve Bank of India (RBI), maintained its dovish stance, effecting a repo rate reduction of 25bps, the first rate reduction since September 2015. The Repo rate, now stands at 6.5%, its lowest level in 5 years. The key aspect of today's monetary policy review has been to pave the way for benign interest rates and quicker transmission of rate cuts, by creating a structured framework for liquidity management.

Key policy rates at a glance:-

	Before	Now
Repo Rate	6.75%	6.50%
Reverse Repo Rate	5.75%	6.00%
Marginal Standing facility (MSF)	7.75%	7.00%
Cash Reserve Ratio (CRR)	4.00%	4.00%

The move of narrowing the policy rate corridor from +/- 100 bps to +/- 50 bps is a step in that direction and aims to align the policy rate with overnight rates. This may eventually help the banks to fund at interest rates closer to policy rates and will bring down the lending cost. The recent reduction in small savings rate in March and the introduction of the Marginal Cost of Funds based Lending rate (MCLR) have been few other measure to enable lower interest rate environment over a period and amplify the effects of previous rate cuts.

The RBI has also taken several other measures to address liquidity shortage, and progressively aims to lower the average *ex ante*[1] liquidity deficit in the system from 1% of Net Demand and Time Liabilities (NDTL) to close to **neutral**. In that backdrop, RBI now looks to separate durable liquidity infusion from temporary/short term liquidity infusion. The RBI will continue to supply incremental liquidity whenever needed, but will focus first on maintaining adequate durable liquidity, irrespective of short term seasonal fluctuations. The move assumes significance as RBI looks to remove structural constraints with regard to liquidity and help banks to pass the rate cut benefit to end consumers, given the fact that banks were not transmitting the rate cuts citing tight liquidity conditions. The RBI has also relaxed the daily balance of Cash Reserve Ratio (CRR) from 95% of the requirement to 90% with effect from the fortnight beginning April 16, 2016. This will help ease liquidity management for banks.

Whilst, RBI in its policy review focussed on the measures to facilitate better transmission of rate cuts, it continued to remain vigilant on inflation. Drawing comfort from the moderating inflation that has evolved closely along the trajectory set by the monetary policy stance, and met the target of 6% by Januray'16. Going forward, the RBI has projected that Consumer Price Inflation (CPI) inflation will remain around 5% during 2016-17. On the growth front, the Gross Value Added (GVA) growth projection for 2016-17 has been retained at 7.6% with risks evenly balanced around it.

[1] means based on estimates rather than actual results.

Outlook

As mentioned by RBI, the focus is now on the pace of monetary transmission. The RBI is expected to move quickly and increase the pace of durable liquidity infusion. Such liquidity can be infused through either purchase of foreign currency inflows or domestic bonds.

We expect continued Open market Operations (OMOs) bond purchases over the following months in order to increase durable liquidity infusion. Such liquidity should bring down the overnight rates over time, in the range of 6% -6.5%. Hence, short maturity money market securities and bonds should witness the some price appreciation in the process.

The RBI’s decision to infuse permanent liquidity is a signal about his comfort around inflation. This stance of RBI along with OMO bond purchases of medium to long maturity securities will remain supportive if bond prices. The entire yield curve may initially steepen from short to mid segment, but eventually the mid-long end of the curve should also witness softening of yields as liquidity infusion should bring about lower rates and pick-up in demand.

In our opinion, it is a policy shift from RBIs’ standpoint as it becomes comfortable on inflation and does not hesitate anymore from liquidity infusion, while maintaining the room open for further rate reduction. The liquidity easing measures will find its way through lower lending rates and higher bond prices over the months. We expect to witness the rate reduction of RBI started in 2015 to eventually be reflected in bond yields.

Investors are encouraged to pick fund duration longer than their investment horizon as yields are expected to move swiftly with the pace of durable liquidity infusion.

MKTG/Policy Review/0416/C003232