
Insights – Monetary Policy Review

Accommodative stance to continue with focus on inflation

December 2015

The Reserve Bank of India (RBI), in its last monetary policy review of the year, maintained status quo on interest rates, after reducing repo rates by cumulative 125 bps in the Calendar Year 2015. The RBI sounded optimistic in the policy review and reiterated that accommodative stance will continue whenever room opens up, but at the same time will remain vigilant about inflation with focus on achieving inflation target of 5% by March 2017.

As has been the case in earlier policy reviews, the RBI underscored its intent of keeping the economy on the disinflationary path, and is of view that inflation target of 6% for January 2016 is within reach. The Consumer Price Index (CPI) has been trending below 6% since September 2014 with latest (October 2015) CPI being recorded at 5%.

Given that RBI had front-loaded the rate cuts in response to weak domestic and global demand, today's policy move was on expected lines. In fact, today's policy statement also appeared well balanced and outlined the roadmap for future rate moves.

In a positive move, to facilitate quicker transmission of rate cuts, the RBI said that it will shortly finalize the methodology for determining the base rate according to the marginal cost of funds. This will give banks the flexibility to move much more quickly and react to market competition. The policy commentary also said the government is contemplating to link small savings rate to market interest rates. These moves should further help transmission of policy rates into lending rates. In addition, the on-going clean-up of bank balance sheets will also help create room for fresh lending. The median base lending rate so far has declined only by 60 bps, out of the policy repo rate reduction of 125 bps this year.

Whilst, RBI clearly looks to remove impediments for better transmission of interest rates and anchor inflationary expectations, it also said that focus would be to ensure consistent sustainable growth. According to the policy statement, economy is in the early stages of a recovery, though with some areas of continued weakness. The RBI's growth projection for 2015-16 has accordingly been kept unchanged at 7.4% with a mild downside bias.

Future direction of rates

Further rate moves would be guided by inflation, quality and quantum of fiscal consolidation and transmission by banks. On the external front, monetary policy actions by other central banks, remain an important data point that RBI may ponder upon, before deciding the next course on interest rates.

We remain positive on possibilities of further drop in monetary rates and secondary market yields, given RBI's intent of further accommodation in monetary policy, and contained inflation.

While in the immediate term, we see the G-Sec market to be range bound, we continue to remain positive on the medium term outlook of long term bonds and gilts. We expect the 10-year benchmark yield to drop closer to 7.25% (+/- 10 bps) over the last quarter of FY16.

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