Insights – Monetary Policy Review

RBI adopts wait and watch stance to monitor trajectory of key variables!

February 2016

The Reserve Bank of India (RBI), left its key rates unchanged in the second consecutive policy review, as it paused to measure the trajectory of key variables such as inflation, fiscal consolidation roadmap and economic growth. Even as, the RBI chose to closely watch inflation and fiscal containment measures, it emphasized that it will remain accommodative in its monetary policy stance and more room could open up for monetary policy to support growth, if these key variables remain supportive.

The policy move of maintaining status quo on interest rates was on expected lines given the fact that RBI would need confidence in fiscal roadmap to be presented in the Union Budget by the end of the month. There is a realization that government may have limited fiscal space as it looks to boost growth by capital spending, and thus, may find it difficult to stick to its stated fiscal consolidation path. The government, in the Union Budget 2015, had delayed its fiscal consolidation programme by a year, revising its fiscal deficit target to 3.9% of the GDP from 3.6% in the FY16. The target for FY17, as laid out in the fiscal consolidation roadmap, is 3.5% of GDP.

Whilst, RBI clearly stated its intent of remaining observant of stated fiscal path of the government, it indicated that sustaining disinflation will remain the key aspect of the monetary policy. It took the comfort from the moderating inflation that has evolved closely along the trajectory set by the monetary policy stance, and is of view that Jan'16 target of 6% CPI inflation should be achievable (last count of CPI recorded at 5.6% for Dec'15). The RBI has projected inflation to be around 5% by the end of FY17 based on the assumption of a normal monsoon and current level of international crude oil prices & exchange rates. The RBI said that it has not factored in the impact of VII central pay commission award, which may exert some upward pressure on inflation over a period of one to two years. It also remained cognizant about the impact of adverse geo-political events on commodity prices and financial markets, which may add uncertainty to its inflation target.

The policy statement also sounded optimistic about current economic conditions and said that Indian economy is currently seen as beacon of stability due to steady disinflation, modest current account deficit and commitment to fiscal rectitude. The Gross Value Added (GVA) growth for 2015-16 remained unchanged at 7.4% with a mild downside bias, whereas it projected GVA growth for 2016-17 at 7.6% based on an assessment of the balance of risks.

On liquidity, the RBI remains committed to monitor liquidity on a continuous basis and said that it will deploy gamut of policy tools such as term repos, Open Market Operations (OMOs) to manage liquidity in the system. Of late, liquidity conditions had tightened due to advance tax outflows and pick-up in demand for currency post selling by foreign investors. The RBI looks to maintain money market rates close to the policy rates.

In another move, the RBI had announced the new methodology for determining the base rate according to the marginal cost of funds in its December policy review. The new regime would be effective from April 1 and will help in better transmission of policy rates.

Outlook

We feel that the liquidity enhancing measures like term repo auctions and continuous OMOs will lead to liquidity built-up at the shorter end of the curve, and will benefit yields at the shorter end of the curve. Consequently, yield curve is expected to steepen out due to the outperformance of bonds upto 5 years maturity.

Further, the government borrowing coming to an end by this week, absence of supply is expected to help the sovereign prices to appreciate and outperform till new borrowing calendar is announced for the next financial year.

The Open Market Operations (OMOs), lower FRBM (Fiscal Responsibility and Budget Management) and marginal deposit cost based lending rates is expected to induce lower interest rates over 2016, along with swift and efficient transmission of policy rates.