

Insights – Monetary Policy Review

Monetary Policy Committee raises repo rate by 25 bps to 6.25%; maintains neutral stance

June 6, 2018

Hardening crude oil prices, the top of the mind concern for the market since past few weeks, played heavily on the minds of the members of the Monetary Policy Committee (MPC) too, who deliberated its upside risks to inflation in the latest round of its marathon 3-day meet.

The MPC; taking due cognizance of the uncertainty to inflation outlook, due to sharp and rather swift rise in crude oil prices from US\$ 66 a barrel in early April '18 to US\$ 74 a barrel, together with increase in other global commodity prices and recent developments in the global financial market; unanimously agreed to a 25-basis point hike in the repo rate to 6.25%, after a hiatus of nearly 4.5 years. However, contrasting the consensus expectations for a hawkish stance, the MPC continued to maintain its neutral stance on the monetary policy, which came in as a pleasant surprise.

Since its previous monetary policy review in April '18, there has been firming up of input cost pressures, led by sporadic rise in crude oil prices, resulting in pick-up in the momentum of inflation (excluding food and fuel). Food inflation, in fact, has remained muted over the past few months and the usual seasonal pick-up in prices is delayed. However, taking into account the broader upside risks to inflation due to crude oil prices, that has been volatile off-late and imparts considerable uncertainty to inflation outlook, the MPC revised upwards its CPI inflation projection for 2018-19 to 4.8% - 4.9% for the first half of FY '19 and to 4.7% for the second half of FY '19 (including HRA impact for central government employees), with a bias for upside risk.

Having said that, MPC continues to reinstate its objective of achieving its medium-term CPI inflation of 4%, within a band of +/-2%, while supporting growth. In fact, its upholding of neutral monetary policy stance can be attributed to country's domestic economic activity that has exhibited sustained revival in recent quarters and to the fact that the output gap has almost closed.

The MPC has noted that investment activity, in particular, is recovering well and could receive a further boost from swift resolution of distressed sectors of the economy under the Insolvency and Bankruptcy Code (IBC). With improving capacity utilization and credit

offtake, investment activity is expected to remain robust despite there being some tightening of financing conditions in recent months. Besides, a buoyant global demand is expected to encourage exports and provide a further thrust to investment.

India Meteorological Department (IMD's) forecast of a normal south-west monsoon rainfall for the country also augurs well for the economy and for the healthy consumption demand, both urban and rural, which is expected to strengthen further. Given this backdrop, the RBI has retained its GDP forecast for 2018-19 at 7.4% - suggesting a range of 7.5% - 7.6% for the first half of FY '19 and a range of 7.3% - 7.4% for the second half of FY '19, with risks evenly balanced out.

Meanwhile, the liquidity in the system was largely in surplus during April – May '18, with the RBI absorbing the surplus liquidity of Rs 496 billion on a daily net average basis due to increased government spending. Reflecting easy liquidity conditions, the weighted average call rate (WACR) softened to 5.89% in April '18 from 5.96% in March '18 and further to 5.88% in May '18.

So far as the fixed income markets are concerned, the volatility in the bond prices continues to persist, largely fueled by the upside risks to inflation due to rising crude oil prices, a volatile domestic currency and also because of foreign portfolio investors (FPIs) turning net sellers of Indian bonds. FPIs have sold ~Rs 15,000 crore in April '18 and ~Rs 17,000 crore in May '18 despite the government reporting 7.7% GDP growth for the Jan – Mar '18 quarter. The bond yields traded close to around 7.9% through the month of May '18, having already priced in the interest rate hike by the RBI.

Market Outlook

Despite the rate hike, the latest monetary policy surprised on the positive by maintaining a neutral stance that bodes well for the overall growth of the economy. However, the upside risks to inflation due to rising crude oil prices, a muted pass-through to output prices and staggered impact of HRA revisions by various state governments could continue to dampen sentiments unless substantially compensated by normal monsoon rains, as predicted, that could help keep the food inflation benign.

The hardening bond yields have already priced in much of the potential second round of rate hike by the RBI and we expect the bond yields to eventually tread lower as the upside risks to inflation gradually subside. Overall, we are positive on the bond market and expect the

real rates to contract from over 300 bps (average of 110 bps) and move in line with the broad macro data.

Meanwhile, the credit environment is currently showing signs of slowdown but steps are being taken to revive the economy. While we may not see an immediate visible turnaround in the overall scenario, a revival in the current economic scenario is expected in the medium term.

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