

Insights – Monetary Policy Review

First rate cut in 18 months, policy stance changes from calibrated tightening to neutral

February 12, 2019

The Monetary Policy Committee (MPC) responded to benign inflation & inflationary expectations and initiated the first repo rate reduction after a gap of 18 months. The repo rate has been reduced by 25 basis points to 6.25% and was accompanied by change in policy stance from 'calibrated tightening' to 'neutral'. The decision to change the monetary policy stance was unanimous, however, reduction in policy repo rate was voted 4-2 with two members voting for status quo on policy rates.

Even as market participants were expecting dovish policy and change in stance, the rate cut came as a surprise and faster than expected move. The rate cut decision was attributed to declining inflation, benign inflation outlook, moderation in household expectations and the need to support economic growth.

Clearly, drop in inflation has been significant over past few months, with inflation largely staying under 3% for the last few months and under 4% for several quarters. The latest CPI inflation (as of December'18) came in at 2.19%, the lowest in the last eighteen months. The persistent deflation in food items, a sharp fall in fuel inflation and some edging down of inflation excluding food & fuel has led to the decline in headline inflation.

Consequently, the MPC taking cognizance from softer CPI data and benign food inflation outlook, revised its inflation forecast downward. The CPI inflation is revised lower to 2.8% in Q4 2018-19, 3.2%-3.4% in H1 2019-20 (previously 3.8%-4.2% in H1 2019-20 as per December policy review) and 3.9% in Q3 2019-20, with risk broadly balanced around the central trajectory. However, it enumerated the reversal in vegetable prices, hazy oil price outlook, rising trade tensions & geo-political uncertainty, unusual spike in the prices of health and education, volatility in financial markets, any temporal variation in rainfall (although monsoon outcome is assumed to be normal) and the impact of various budget announcements as key upside risks to CPI inflation. Meanwhile, the policy statement, reaffirmed to achieve its medium-term inflation target of 4% on a durable basis.

On the economic growth front, the Gross Domestic Product (GDP) growth for 2019-20 is projected at 7.4%, in the range of 7.2%-7.4% in H1, and 7.5% in Q3, with risks evenly balanced. The committee revised downward growth projections for H1 FY20 amid rising trade tensions and geo-political risks that could impact global growth.

Elsewhere, the RBI primarily infused liquidity into the market in a targeted manner through purchases under Open Market Operations (OMOs). Liquidity injected under the Liquidity Adjustment Facility (LAF) was Rs. 996 billion in December on an average daily net basis and Rs. 329 billion in January. However, in February, the average daily liquidity position turned into surplus with an average absorption of Rs. 279 billion. The total durable liquidity injected through OMOs has aggregated Rs. 2.36 trillion during 2018-19 so far.

Market Outlook

In the policy document, the RBI Governor noted that the path of inflation has moved downward significantly, and over the period of the next one year, headline inflation is expected to remain contained below or at the target of 4%. He has put to rest all opinions around the rise in core inflation and said that only headline CPI mattered and additionally will look forward to reviving growth if the inflation target has been achieved. This has opened up space for policy action. Further, shift in the stance of monetary policy from calibrated tightening to neutral has given flexibility to address challenges to sustained economic growth, as long as long as the inflation outlook remains benign.

Taking cues from last two monetary policy reviews and aided by inflation prints & outlook, we are increasingly becoming bullish on interest rates and hold on to our stance for a need for tighter real rates and endorse efficient allocation of capital and savings/investment.

Undeniably, the decision of the MPC in this regard will be data driven and in consonance with the primary objective of monetary policy to maintain price stability while keeping in mind the objective of growth, we feel that positive flow of data is on the side of rate reduction side, over the coming months or quarters.

In the given market conditions, our sense is that once again it is the time for duration funds with the rate reduction cycle possibly unfolding over 2019. We would encourage investors to look at durations funds and choose them appropriately & judiciously assessing their investment cycle. We would urge investors to select duration funds slightly longer than the investment cycle so as to overcome the reinvestment risk at this point. The risks to view of

softening in interest rates, however, emanate from the adverse movement in inflation, borrowing calendar of FY20 and geo-political risks.

Moreover, the OMOs have started to increase the liquidity in the hands of the banks. It is expected that the excess liquidity in the hands of the banks will get onward lent to the corporates including NBFCs and HFCs. However, in the absence of commensurate risk appetite, the flow of liquidity into the affected sector is ebbing, and the credit spreads have widened in the last few months. We feel that if this kind of positive data flow continues and sentiment improves, investors may consider funds offering higher credit spread currently, as eventually spreads may contract amid possible waning of risk aversion. The recent announcement of recalibrating the risk weights on bank loans to Non-Banking Financial Companies (NBFCs) to their credit rating is a welcome step and expected to increase the flow of credit from banks to NBFCs.

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