
Insights – Monetary Policy Review

No rate action, monetary policy stance remains neutral but sentiment is positive

April 6, 2018

The first policy review of the current financial year was keenly watched given the swiftly evolving global and domestic economic backdrop. The decision of Monetary Policy Committee (MPC) to maintain status quo on interest rates was on expected lines and in response to its neutral stance. The policy decision was voted 5-1 with one member voting for hike in the policy rate by 25 basis points.

Whilst, MPC acknowledged the recent softness in inflation readings and the prognosis for inflation is lowered, the policy rates were left unchanged to control inflationary pressures. In past few years, since the genesis of MPC, the key aspect of monetary policy review has been inflation targeting and MPC has remained committed to achieve the medium-term target for headline inflation of 4% on a durable basis.

With regard to the inflation outlook, the MPC has revised the Consumer Price Index (CPI) based inflation to 4.7%-5.1% in H12018-19 and 4.4% in H22018-19, including the House Rent Allowance (HRA) impact of central government employees, with risks tilted to the upside. In the previous policy statement, CPI inflation was projected at 5.1%-5.6% in H12018-19 and 4.5%-4.6% in H22018-19. As per its assessment, inflation pressure will ease out owing to moderation in food prices, assumption of a normal monsoon and effective supply management by the government which will help keep food prices in check. However, risks to inflation may arise from volatile crude oil prices and expectations of strengthening domestic demand. The policy also attributed factors such as revised formula for Minimum Support Price (MSP) and possibilities of any further fiscal slippage from the Union Budget, which could trigger some inflation tendencies.

Notably, since its previous policy review, inflation has moderated to 5.07% in January '18 and further to 4.44% in February '18, largely led by a decline in vegetable prices. In another positive development, the RBI's assessment of growth forecasts also came higher amid expected pick-up in economic activity. The Gross Domestic Product (GDP) growth is projected to strengthen from 6.6% in 2017-18 to 7.4% in 2018-19, i.e. in the range of 7.3%-7.4% in first half and 7.3%-7.6% in second half, with risks evenly balanced.

Elsewhere, liquidity in the system moved between surplus and deficit during February-March'18. The liquidity moved into deficit amid slowdown in government spending & large tax collections as well due to quarterly advance tax outflows. At the same time, additional liquidity of Rs. 1 trillion came into the system through redemption of Treasury Bills issued

under the Market Stabilization Scheme (MSS) in April and May 2017. On the whole, the RBI injected Rs. 60 billion and Rs. 213 billion on a net daily average basis in February and March 2018 respectively.

Looking from the fixed income market perspective, bond yields which had shot up significantly in past few months, came off sharply by end-March following the announcement of reduction in market borrowing by the government. As such occurrences, have not been common, wherein typically the government frontload its borrowing program in the first half of the year, the decision to lower market borrowing cheered market participants and led to surge in demand for long duration bonds. In fact, by lowering its borrowing program, the government has suitably addressed the mismatch in the demand and supply of government securities. Consequently, the 10-year benchmark yield moved lower by about 65bps to 7.13% as on April 5, 2018, compared to a high of 7.78% seen in early March '18.

Market Outlook

The current policy has augmented the positive sentiments with no surprises and lowered inflation expectations. In an environment, where fears of rate hike had triggered the sell-off in the bond market, such speculations have been put to rest for the time being amid declining inflation and positive assessment by MPC. As for the near-term, i.e. the policy review in June '18, the rate hike decision is ascribed lower probability and may be mainly influenced by the onset and the progress of the monsoon and appreciating crude oil prices.

The 10 year benchmark is presently trading little over 110bps over the repo rate (compared to 80bps average). The sharp drop in the bond yields in the last one week was to price in diminished chances of a repo rate hike. In this environment while there is still some room for bond yields to decline and revert to the mean, the drop of the next 30bps will be interspersed by several variabilities. Hence, we request investors to be cautious and pick fund duration aligned to their investment horizons. However, we are at an interesting juncture where there is also a possibility of RBI turning dovish in the coming months post the current policy review reinforcing the same. In fact, in the event of some softening in repo rates (as RBI acknowledges lower CPI in the second half of the calendar year and feels the need to contract the real rates) in the second half of the CY, there will be newer opportunities for investors on long duration and investors may then initiate some strategic investments.

The market, in due course, is expected to move in sync with the MPC's rate decision, which is expected to take cognizance of developing inflation and growth dynamics. Going forward, the market will also await an announcement from the RBI regarding enhancement of investment limits for foreign investors in the domestic market; the occurrence of which may be positive for the gilts and bonds.

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