Invesco Mutual Fund

Insights – Monetary Policy Review

MPC takes a first pause in rate easing cycle, but maintains accommodative policy stance

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Throughout the calendar year, the policy moves focussed on addressing growth challenges faced by the economy. The continuing slump in GDP growth, which further slipped to 4.5% in September quarter, its slowest pace since March 2013, had instilled the expectations of another rate cut among a large section of market participants. Until this policy review, the Monetary Policy Committee (MPC) has been reducing repo rate in every policy review (beginning from February'19) to support the decelerating economic growth, taking the cumulative rate reductions to 135 basis points (bps) during the calendar year.

It appears, that although, growth has been a major challenge, the policy space for further rate cut was restrained in order to wait out for more time to see the effects of previous rate cuts. Accordingly, the MPC maintained status quo on the interest rates in its latest policy review. In doing so, the MPC retained its 'accommodative' stance acknowledging the need to revive growth, while ensuring that inflation remains within its target. The six-member MPC unanimously voted for keeping the repo rate unchanged and maintaining the policy stance at accommodative.

Inflation has quickened in past few months with October'19 print exceeding 4%, for the first time since July 2018. The Consumer Price Index (CPI) inflation was recorded at 4.62% in October 2019. Inflation is expected to stay elevated given surge in food prices due to unseasonal rains and rise in inflation expectations. The MPC revised its inflation estimate upwards to 5.1%-4.7% for H2 2019-20 and 4.0%-3.8% per cent for H12020-21, with risks broadly balanced. The medium-term target remained at 4% within a band of +/- 2%. However, alongside core inflation has softened from 4.2% in September to 3.4% in October.

Whilst, the MPC turned cautious to evolving inflation dynamics, it also took a note of weakening domestic and external demand conditions. It marked down its growth forecast fourth time during the year. In its latest estimate, the real Gross Domestic Product (GDP) growth for 2019-20 is revised downward from 6.1% in October policy to 5.0%, 4.9%-5.5% in H2 and 5.9%-6.3% for H12020-21.

Even as growth concerns remained high, another key economic parameter i.e. liquidity in the system remained in surplus in October'19 and November'19 despite an expansion of currency in circulation due to festival demand. The average daily net absorption under the Liquidity Adjustment Facility (LAF) amounted to Rs. 1,98,566 crores in October'19 and Rs. 2,40,566 crores in November'19.

On the positive side, the MPC also noted full and swift monetary transmission across various money market segments and the private corporate bond market. However, the MPC said that credit market transmission remains delayed but is gathering pace. Going forward, it expects the rate transmission to improve as share of base rate loans decline in favour of loans linked to the external benchmarks.

In a separate move, with a view to expand peer to peer (P2P) lending platform business, the RBI raised aggregate lending limit by five times to Rs. 50 lakh for such lenders. Further, it will also facilitate the setting up of a self-regulatory body (SRB) as a first step towards the development of the secondary market for corporate loans.

Market Outlook

We reason that the slowing domestic growth is a function of both slowing global growth and slowing domestic consumption. The average headline inflation, after remaining benign for past few months, has risen due to the rise in food prices attributed to unseasonal rains. However, we think that average headline CPI for FY20 may remain in check due to drop in core inflation.

While, slowing growth and accommodative monetary policy stance gives room for further rate reduction, we think that further policy actions will be guided by evolving growth-inflation dynamics.

Amid mix of positives (mainly accommodative monetary policy stance & surplus liquidity) and negatives (mainly due to rising inflation & fears of fiscal slippage), we feel that benchmark yields are expected to remain rangebound.

Since majority of the market investors were expecting a rate reduction of a minimum 25 bps, a status quo may see some unwinding in the near term. Over the month, the market direction will be dictated by RBI's actions to infuse durable liquidity and government's decision on the steps to meet the potential fiscal slippage.

Any upward revision in borrowing calendar of Government for FY20 may also pose upward pressure on yields.

Data Source: Monetary Policy Statement- RBI, Bloomberg, Internal.