
Insights – Monetary Policy Review

Monetary Policy Committee narrows policy rate corridor, future course of policy action to be determined by evolving macro-economic conditions

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In line with its neutral stance, the six-member monetary policy committee in a unanimous decision, retained the repo rate at 6.25%. The change in policy stance to 'Neutral' in preceding policy review curbed the expectations of interest rate cut to almost nil; the only surprise came from the hike in reverse repo by 25 basis points to 6.00%. As a result, the policy rate corridor (differential between repo rate and reverse repo rate) has contracted to 25 basis points (bps), compared to existing 50 bps and 100 bps a year ago. The narrowing policy rate corridor is expected to drain out the excessive liquidity from the banking system given the surge in deposits with banks due to demonetization, which in turn will help the inflation to remain in check. Besides, the policy review has also reduced Marginal Standing Facility (MSF) rate and the Bank Rate by 25 bps to 6.50%. The other implication of reducing the differential between policy rates should be appraised from the central bank's intent of keeping overnight rates anchored to the repo rate, while preventing it to digress in a wide range. This should keep the volatility in rates under check.

Clearly, the monetary policy committee has focused on reducing the liquidity glut and align the operative rates to the repo rate, the underlying objective of achieving the medium-term inflation target through these measures remains the mainstay of the monetary policy decision. Whilst, the committee is of the view that risks are evenly balanced around the inflation trajectory at the current juncture, upside risks to its baseline Consumer Price Index (CPI) inflation can emanate from uncertain monsoon (due to the rising probability of an El Niño¹ event in the latter half of the monsoon season) and its probable implications on food inflation. Other factors that could lead to higher inflationary pressure are recommended increase (if awarded) in house rent allowance under the seventh Central Pay Commission (CPC) and one-off effects of the Goods and Services Tax (GST). The policy also highlighted the stickiness in inflation (excluding food and fuel), which has been significantly above headline inflation since September 2016. Given, the committee's resolve to bring headline inflation closer to 4% on a durable basis and in a calibrated manner, and upside risks to inflation, it chose to hold the repo rate steady. According to RBI's near-term projections, CPI inflation is projected to average 4.5% in the first half of the FY18 and 5% in second half of FY18.

From the perspective of economic growth, the policy remains optimistic and has highlighted the possibilities of recovery in economic growth in FY18. The Gross Value Added (GVA) for 2017-18 has been projected at 7.4% (6.7% for 2016-17).

On the liquidity front, RBI indicated that it will continue to balance liquidity conditions, while resolving banks' stressed assets problems, and create congenial conditions for bank credit to revive and flow to productive sectors of the economy.

Market Outlook

In our view, the policy has been explicit in giving direction to the fixed-term investors. Although, there has been a pause in the interest rate cut cycle and immediate prospects of rate cut have diminished, there are reasons to be optimistic for fixed income investors. Firstly, the move to reduce the policy rate corridor will anchor the overnight rates close to the repo rate and would reduce the volatility in short term rates. Even though, there has been a spike in short term rates in response to increase in reverse repo rate, and yields at the shorter-end may further harden in near term, eventually rates will be less susceptible to market vagaries and will be positive for short term bond investors. Secondly, comfortable liquidity conditions and liquidity management by RBI would continue to auger well for the bond investors. Lastly, it should be noted that resurgence in foreign portfolio inflows, and no major upside risk to inflation would support the yields at the longer end of the yield curve, and would provide opportunities of the capital appreciation to the investors. The appreciation in rupee led by improvements in inflation, drop in Current Account Deficit (CAD) and higher forex reserves is bringing in foreign investors in the capital market and demand for bonds are going higher. Investors who have long investment horizon and can handle volatility in rates are urged to stay invested or incrementally increase their allocation. Other investors are encouraged to choose credit focused funds to benefit from potential improvement in credit environment or other fixed income funds in line with their investment horizon and risk appetite.

¹ an irregularly occurring and complex series of climatic changes affecting the equatorial Pacific region and beyond every few years, characterized by the appearance of unusually warm, nutrient-poor water off northern Peru and Ecuador.

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