
Insights – Monetary Policy Review

Monetary Policy Committee slashes repo rate, while maintaining neutral policy stance

August 3, 2017

We first communicated the rate decline view 3 years back. We have been constantly apprising our investors the case for a decline in interest rates through our communiqués. In our latest update on 'CPI Inflation' and insights on last 'Monetary Policy Review', we firmly outlined our view of further rate cuts by the Monetary Policy Committee (MPC).

As expected, the MPC slashed the repo rate and reverse repo rate by 25 bps each to 6% and 5.75% respectively, in its August'17 monetary policy review. With the headline Consumer Price Index (CPI) inflation plunging to a record low of 1.54% in June 2017 (which is well below RBI's neutral level of 4% target for CPI inflation in the medium term), the case for monetary easing was stronger in order to reduce the excessive real rates within the system and improve the investment climate.

Accordingly, acknowledging the latest data trend and projections, the committee in a calibrated policy decision, chose to opt for the rate cut. It has further lowered the FY18 end CPI forecast to a little above 4.00% from 4.50% (which was already revised down in its last policy meeting).

However, in a contrasting view, the committee retained its neutral policy stance citing uncertainties surrounding inflation. The policy statement highlighted several upside risks to inflation. It cited that implementation of farm loan waiver by States may lead to fiscal slippages, while impact of price revisions due to Goods and Services Tax (GST), effect of higher House Rent Allowance (HRA) on inflation and receding base effect may exert the upward pressure on inflation, even as second successive normal monsoon will help keep prices under check. Given, the possibilities of inflation edging up, the policy statement indicated that CPI could rise by an additional estimated 100 bps above the baseline over 18-24 months in case all the states adopt the central's HRA recommendation this financial year. The MPC also stated its intent of monitoring movements in inflation to ascertain if recent soft readings on inflation are transient or if a more durable disinflation is underway.

Whilst, this policy review was keenly watched for MPC's view on future direction of interest rates and assessment of inflation, the evolving trajectory of inflation and macro-economic environment appears to set the stage for benign interest rate environment.

Market Outlook

We reiterate our view of some additional repo rate reductions of 25-50 bps in the FY18. Our opinion is that the drop in headline inflation is a sustained shift and present levels of inflation will remain subdued over the next few months supported by good monsoon as well as low credit growth from the banking sector which will keep price rise under check.

We also expect reductions in the Savings and Fixed Deposit (FD) interest rates of banks in an environment of surplus cash and lower credit demand.

As we expect the 2017 average inflation to be around 3% (approximately 200 bps lower than 2016), we feel that in order to push some demand revival, monetary policy tool might be used by MPC once again.

In our opinion, prospects of lower rates supported by softening inflation and surplus liquidity augers well for the fixed income market. The credit outlook is also expected to improve on the back of economic recovery. The increased monetary policy transmission will also help lending rates to go down, leading to improvement in the balance sheets of highly leveraged companies. Further, stable to appreciating rupee, stable macro-economic fundamentals and higher forex reserves are bringing in foreign investors in the capital market and demand for Indian bonds are increasing rapidly.

In this environment, we encourage investors who have over 2 year investment horizon to invest in funds with fund duration longer than their investment horizon, given the higher probability of interest rates remaining lower in the medium term. Investors with a horizon of less than 2 years can consider short term funds. Short horizon investors can also consider credit focused funds to benefit from potential improvement in credit environment and in line with individual risk appetite.

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