Invesco Mutual Fund

Insights – Monetary Policy Review

Status quo on interest rates. Going forward policy framework to be decided by Monetary Policy Committee

August 10, 2016

With all eyes set on the last policy review by current RBI Governor Dr. Raghuram Rajan, the market was not expecting any rate action. The RBI governor who has been credited for inflation targeting through a new monetary policy framework based on Consumer Price Index (CPI), augmenting of foreign exchange reserves, focusing on macro-economic stability and effective liquidity management, this policy review was keenly watched for his assessment of inflation and current economic conditions.

The RBI in its policy statement reiterated upside risks to inflation, even as it highlighted that the accommodative stance of monetary policy would continue and it will continue to monitor macroeconomic and financial developments for possibility of any further policy action. The policy statement also sounded optimistic about the progress of monsoon and effective food management, which would help control inflationary pressure emanating from higher food prices.

The policy stance of maintaining status quo on interest rates for the second consecutive review was on expected lines, and in response to upside risks to inflation before the full effect of monsoon plays out. The risks to inflation will primarily arise from higher food prices, reversal in commodity prices and implementation of the 7th Central Pay Commission awards. With the passage of Goods and Services Tax (GST) bill and its impact on inflation, RBI said that it would be premature to anticipate that it would lead to inflation. It further added that the monetary policy setters would be more concerned about whether it will pass to more generalized inflation or not.

The CPI inflation has been rising since last 3 months, surpassing the RBI target of average 5% inflation by end of FY2017. The latest CPI print in June was recorded at 5.77%. Nevertheless, the RBI retained its forecast of CPI inflation averaging around 5% for FY17 with a possible upward bias. Meanwhile, on the growth front, the Gross Value Added (GVA) growth projection for 2016-17 has been retained at 7.6% with risks evenly balanced around it.

Notably, the government and RBI agreed to continue with the current inflation targeting framework whereby a CPI inflation target of 4%, with a band of plus or minus 2% will be targeted for the period ending FY2021. The inflation targeting is widely practiced in developed nations and with India adopting the same, inflation would continue to take the centrestage in monetary policy moves. In the past few decades, besides inflation, monetary policy has also taken into account other factors such as the government's borrowing needs, the health of the banking sector etc.

Moreover, the government has also notified the formation of a Monetary Policy Committee (MPC) which will take decisions on monetary policy rate setting. The MPC would be a six-member panel that is expected to bring value and transparency to rate-setting decisions. It will feature three members from the RBI- the Governor, a Deputy Governor and another official and three independent members to be selected by the Government. The new MPC regime is expected to take over from the RBI Governor while deciding on the monetary policy. The panel will decide on the direction of policy rates on the basis of a majority vote with the governor having a casting vote.

On the liquidity front, RBI indicated that it will continue its focus on providing adequate liquidity which is helping to improve the pass-through of past rate cuts. The RBI has so far injected liquidity through purchases under Open Market Operations (OMOs), amounting to Rs. 805 billion which helped to bring the system-level ex ante[1] liquidity deficit to close to neutrality (albeit without seasonal adjustment). The RBI also announced an open market operation on August 11, 2016 to frontload liquidity.

[1]means based on estimates rather than actual results.

Outlook

The RBI left policy rates unchanged, in line with expectations, even as it reiterated that accommodative stance of monetary policy will continue. In our view, interest rates are expected to move lower over 6 to 9 months period, due to benign inflation. The risks to inflation, are likely to be offset by the progress of monsoon, efforts of government to address the supply side inefficiencies with limited impact from an uptick in international crude oil prices.

Further, liquidity which plays a significant role in governing the trajectory of rates in the fixed income market, remains favorable on the back of RBI's commitment to provide adequate liquidity. The liquidity conditions eased significantly during June and July, which a few months back (on April 5, 2016) was recorded at Rs. 1 lakh crore in deficit. The liquidity management by RBI through OMOs among other factors has helped ease liquidity conditions.

The commitment to maintain adequate liquidity is expected to bring about further softening of yields at the shorter end. The yield curve has started to witness some flattening out, with comfort growing around attainability of moderate inflation. Given improving liquidity and reduction in volatility, we expect higher demand for short term bonds in the near term.

At the same time, the additional liquidity through purchase of government bonds by OMOs, will also lead to higher demand for government securities, with supply expected to remain constant amid government's intention to contain fiscal deficit. This will eventually translate into lower yields for medium to long term bonds.

In our opinion, favorable liquidity conditions and prospects of lower rates supported by moderate inflation bodes 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.

Given, the favorable outlook of both interest rate and credit market, investors are encouraged to choose across duration and credit funds based on their individual suitability. Investors are urged to select funds with portfolio duration longer than their investment horizon as yields are expected to move lower with the pace of durable liquidity infusion.

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