Insights – Monetary Policy Review

No change in policy rates, neutral policy stance continues

December 7, 2017

In the latest monetary policy review, the Monetary Policy Committee (MPC) held the policy rates steady. The policy decision was voted 5-1 in the Monetary Policy Committee (MPC) meeting. As expected, there were no surprises in the policy review and it sounded less hawkish than the previous one. In a cautious, yet more calibrated approach, the MPC chose to maintain the neutral policy stance, balancing a slight uptick in its inflation projection with a close vigilance on output gap dynamics and evolving inflation trajectory. The committee revised upward its inflation projection for the second half of FY18 to range between 4.3%-4.7% from 4.2%-4.6% in the previous policy.

The headline inflation, a key determinant of MPC's policy decision, has continued to move northward in the past few months. The Consumer Price Index (CPI) based inflation rose for the fourth consecutive month to 3.58% in October (a seven-month high). Although, CPI inflation has moved higher, it remained well within the MPC's medium-term forecasts of 4% (within a band of +/- 2%).

The policy statement highlighted that inflation expectations are firming up and going forward inflation trajectory will be influenced by several factors such as reversal in moderation of inflation (excluding food and fuel), impact of House Rent Allowance (HRA) increases on housing inflation and recent rise in international crude oil prices. However, it also noted that these adverse risks to inflation are expected to be reduced by some seasonal moderation in food prices on the back of arrival of winter crops, and revision in Goods and Services Tax (GST) rates for several retail goods and services to lower tax rates, resulting in lower retail prices, going forward.

On the growth front, the MPC retained its forecast. The Gross value added (GVA) projection for 2017-18 was held steady at 6.7%, with risks evenly balanced around it. Since economic growth target for the year-end remains unchanged, the growth for remaining two quarters need to move substantially higher, clearly indicating that risks to economic growth persists.

Meanwhile, surplus liquidity in the system declined during October'17 and November'17. The RBI from time to time conducted Open Market Operations (OMOs) to balance liquidity conditions. The RBI conducted open market sales of Rs. 300 billion in October-November 2017, taking the total absorption of durable liquidity during the financial year so far to Rs. 1.9 trillion, comprising Rs. 900 billion in the form of open market sales and Rs. 1 trillion of long-term treasury bills under the Market Stabilization Scheme (MSS). Further, MPC indicated that liquidity will remain in surplus for the rest of the financial year.

From the fixed income market standpoint, the yields have moved higher in past few months. The 10-year G-sec yield shot up by 33 basis points to 7.03% as on December 6, 2017, compared to 6.70% on October 4, 2017 (last policy review). The hardening in yield was attributed to negative market sentiment amid rising inflation, hawkish undertone in the October's monetary policy commentary and fears of fiscal slippage. The rise in yield was briefly arrested by three positive important developments, (i) India's rating upgrade by Moody's Investor Service (after more than a decade) from Baa3 to Baa2. Later on, S&P retained its existing sovereign credit rating on India at BBB- (ii) Finance Minister's assertion on sticking to the glide path of fiscal consolidation (iii) Government's announcement of a recapitalization package for the PSU banks.

Market Outlook

In the wake of current policy review and continuance of MPC's neutral policy stance, we believe that the factors playing into the inflation dynamics will decide the future trajectory of interest rates. As real rate i.e. differential between repo rate and inflation remains high, it makes us believe that it will give the MPC elbow room to hold the policy rates in subsequent periods.

At the same time, we attach a very low probability of inflation going up given tepid credit demand amid tight monetary conditions. Broadly, monetary conditions have tightened due to declining liquidity surplus and higher terms spreads on bonds. With credit growth and M3 remaining in single digit, we feel that inflation will remain within the MPC's medium term target of 4% (within a band of +/- 2%). In such a scenario, taking cognizance of benign inflation, there could be a possibility of rate reduction in medium term, in order to address slower economic activity and slowdown in money growth. In the near term, the market seems to have formed an immediate top in yields at 7.08% levels and investors should invest in order to benefit from the mean reversion in yield.

In the given market conditions, long term investors are urged to stay invested in fixed income funds with fund duration longer than their investment horizon with there being a higher probability of rates moving in a narrow band or remaining lower in the medium term. Investors with a short investment horizon may consider credit focused funds to benefit from potential improvement in credit environment and in line with individual risk appetite.

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