
Insights – Monetary Policy Review

Monetary policy committee adopts wait and watch approach, while retaining accommodative stance

December 8, 2016

In the wake of 'Demonetization' by the government, the last monetary policy review of the calendar year was closely watched. The rate reduction in October (after a pause of 6 months), followed by demonetization in November and expectations of interest rate cut in December's policy review had triggered a rally in the bond market.

At a time when market was bracing for a rate cut given the fact that RBI will likely take a growth supportive stance to offset risks due to demonetization, the RBI unexpectedly maintained status quo on interest rate. Notably, the monetary policy decision should be looked in conjunction with the evolving market scenario and recent supply disruptions due to currency replacement. The policy indicated that it should be seen as a transitory phenomenon and in the backdrop of prevailing uncertainty, it will be prudent to wait and watch, while retaining the accommodative monetary policy stance to support growth.

The policy highlighted uncertain outlook on domestic inflation, likelihood of interest rate hike by US Federal Reserve and short term turbulence due to government's decision to scrap the old Rs. 500 and Rs. 1000 notes as legal tender, as key reasons to keep interest rates on hold.

On inflation, RBI indicated upside risks to inflation (though inflation continued on downward trajectory for the third consecutive month in October) due to possibilities of re-emergence of price pressure in food items & volatility in crude oil prices, and reversal of favorable base effect. The RBI's stated intent is to achieve Consumer Price Index (CPI) inflation at 5% by Q4 of FY17 and the medium term target of 4% within a band of +/- 2%.

Whilst, it is clear that inflation has taken a precedence in the monetary policy decision, the policy has also taken cognizance of possibilities of downturn in economic growth. Accordingly, the outlook for Gross Value Added (GVA) projection for 2016-17 has been revised down from 7.6% to 7.1% (down by 50 bps or 0.5%), with risks evenly balanced around it. The committee expects growth will be hit due to unexpected loss of momentum in Q2 and the effects of withdrawal of Specified Bank Notes (SBNs).

Apart from growth-inflation dynamics, one more crucial aspect of the monetary policy is liquidity management, which has taken center stage in recent days. It will be prudent to take note of few important measures undertaken by RBI recently in order to drain excess liquidity amid deluge of deposits with banks following the currency replacement drive (which began on November 9, 2016). According to RBI, banks have so far received around Rs. 11.5 lakh crore in discontinued currency since the government decided to abolish Rs. 500 and Rs. 1000 notes as legal tender.

Following are the measures announced by RBI post demonetization:

- Incremental Cash Reserve Ratio (CRR) – The RBI had announced an incremental CRR at 100% of the deposits accrued between September 16 and November 11, effective from the fortnight beginning November 26, 2016. An increase in CRR meant banks will have to set aside more money as CRR leading to absorption of some surplus liquidity with the banks. In the current policy review, RBI decided to withdraw it from December 10.
- Market Stabilization Scheme (MSS) - In another liquidity absorption measure, the RBI had earlier revised the ceiling for issuance of securities under the MSS to Rs. 6 trillion compared to Rs. 0.2 trillion earlier. Under this, so far RBI has issued Cash Management Bills (CMBs) amounting to Rs. 1.4 trillion (till December 6, 2016).

Taking cognizance of these measures and monetary policy guidance, let us now assess the implications of monetary policy on fixed income market:

We feel that inflation-growth tradeoff has the potential to lead to lower interest rates over the long term, given weakening economic prospects and committee's intent to maintain accommodative stance to support growth. Further, ample liquidity and likelihood of inflation remaining near RBI's target of 5% for FY17 is expected to drive interest rates lower over following quarters.

However, in near term, we feel that markets will remain volatile as expectations of rate reduction unwind. As the entire drop of 175 bps repo rate reduction from early January 2015 has been transmitted into lower bond yields and till the time clarity emerges on inflation trajectory, US Federal Reserve's decision on interest rates and abatement of short term disruptions due to currency replacement, the 10-year benchmark yield is expected to trade within a range of 20-30 bps and the yield curve may steepen.

In the current backdrop, investors who have long investment horizon and can handle volatility in rates are urged to stay invested in funds with portfolio duration longer than their investment horizon amidst higher probability of rates remaining benign in long term. Other investors are encouraged to choose fixed income funds in line with their investment horizon and risk appetite.

Disclaimer: This document alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy. It should not be construed as investment advice to any party. All figures and data included in this document are as on date and are subject to change without notice. The statements contained herein may include statements of future expectations and other forward looking statements that are based on prevailing market conditions / various other factors and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. The data used in this document is obtained by Invesco Asset Management (India) Private Limited (IAMI) from the sources which it considers reliable. While utmost care has been exercised while preparing this document, IAMI does not warrant the completeness or accuracy of the information and disclaims all liabilities, losses and damages arising out of the use of this information. The content of this document is intended solely for the use of the addressee. If you are not the addressee or the person responsible for delivering it to the addressee, any disclosure, copying, distribution or any action taken or omitted to be taken in reliance on it is prohibited and may be unlawful. The readers should exercise due caution and/or seek appropriate professional advice before making any decision or entering into any financial obligation based on information, statement or opinion which is expressed herein.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.