Insights – Monetary Policy Review

Monetary policy committee maintains status quo on policy rates, accommodative stance changes to neutral

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The monetary policy committee maintained a status quo on policy rates for the second time in a row. In a unanimous decision, the committee decided to keep the rates unchanged with a view to assess the transitory effects of demonetization on inflation given its intent to bring the headline inflation to close to 4% on a durable basis. Contrary to the broader market expectations of 25 basis point reduction in repo rate, the move came as a surprise, and at a time when headline inflation trajectory was easing and the government maintained its resolve to contain fiscal deficit (fiscal deficit targeted at 3% of GDP for FY19).

Nevertheless, the monetary policy decision should be looked in conjunction with the committee's assessment of evolving market scenario and particularly in the wake of large overhang of liquidity consequent to the demonetization and its effect on inflation. The policy highlighted that though headline inflation has been easing, the stickiness in inflation (excluding food and fuel) and the possibilities of uptick in food inflation given the potential rebound in vegetable prices as the effects of demonetization diminishes, can limit the further downward movement in headline inflation. Further, any hardening in international crude oil price can also have negative effects on inflation. Given the upside risks to inflation, the committee chose to hold the repo rate steady in line with its objective of achieving Consumer Price Index (CPI) inflation at 5% by Q4FY17. Accordingly, it changed the monetary policy stance from 'Accommodative' to 'Neutral' and projected CPI in the range of 4.0% to 4.5% for first half of FY18 and 4.5% to 5.0% for second half of FY18. The medium term target for CPI remained unchanged at 4% within a band of +/- 2%.

Whilst, achieving inflation target has been the mainstay of the monetary policy decision, the policy also noted the possibilities of recovery in economic growth in FY18 due to pick-up in consumer demand, lower cost of capital on the back of transmission of previous policy rate reductions & ease in bank's funding conditions and government's efforts to revive growth. The Gross Value Added (GVA) for 2017-18 has been projected at 7.4% (6.9% for 2016-17).

On the liquidity front, RBI indicated that it will continue with its stance of liquidity management framework, which progressively aims to bring the system-level ex ante[1] liquidity deficit to close to neutrality.

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

Market Outlook

Fixed Income market will undergo yield adjustment as the policy stance changes to neutral from accommodative. Since the market was surprised in the last two monetary policy reviews, market participants will remain unsure about the next rate action even if headline inflation trends lower. The market sentiment is expected to remain weak and trading volumes to remain low in this environment. This would steepen the shape of the yield curve.

Since Dr. Urjit Patel looked at core inflation (trading around 5%), he refrained to acknowledge the decline in headline inflation and kept the repo rate unchanged. Some portion of the inflation basket will remain outside 'effectiveness' ambit of the monetary policy tools and eventually may impact the consumption demand. Hence, we feel that both headline inflation and growth will undershoot RBI's forecast.

It also appears that RBI has altered the real rate from 100-125bps to 175bps since average FY18 headline forecast is around 4.50% and repo rate is maintained at 6.25%. Yields may harden initially, but prudent liquidity management and surplus liquidity due to demonetization would keep the yields in check.

The trend on inflation so far has been a big positive and our assessment suggests that inflation is on a structural decline. We feel that inflation on an average will remain below 4% in calendar year 2017. In addition, comfortable liquidity conditions and liquidity management by RBI would support lower interest rate environment. Notably, the Union Budget 2017-18 has also been well received by the fixed income market, with contained fiscal deficit target and government borrowing adding to the optimism. Accordingly, we expect interest rates to remain benign. Further, we expect around Rs. 6-7 lakh crores of surplus liquidity due to demonetization lying in Cash Management Bills (CMBs) and reverse repo to be redeployed in corporate bonds, government securities, other assets and loans. The lower interest rates concurrently will also bode well for credit environment. However, risks to our base case view of lower interest rates can emerge from any surprise run-up in crude oil price (above $55-$65 per barrel), which can have a negative effect on Current Account Deficit (CAD). Further, trade orders due to new administration in U.S. can push inefficiencies in pricing. This in turn may cause higher inflationary trend in general and higher uncertainty in financial markets.

Since immediate rate reductions are not expected unless inflation and growth drops significantly, investors who have long investment horizon and can handle volatility in rates are urged to stay put. 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. Investors should invest in low to moderate duration products like short term fund, ultra-short term fund, medium term fund and bank debt fund.

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