Insights – Monetary Policy Review

Monetary Policy Committee maintains status quo on policy rates and neutral policy stance. Inflation remains a key monitorable

February 8, 2018

The Monetary Policy Committee (MPC) maintained status quo on interest rates and decided to watch inflation trajectory, before effecting the next policy move. The policy decision was voted 5-1 in the Monetary Policy Committee (MPC) meeting. With inflation trajectory firming up and surge in inflationary risks, the decision to keep key policy rates unchanged came on the expected lines. The Consumer Price Index (CPI) based headline inflation rose for sixth consecutive month to 5.21% in December'17 versus 1.46% in June'17.

As upside risks to inflation emanated, the committee projected inflation to range between 5.1%-5.6% in first half of FY19 and 4.5%-4.6% on second half of FY19 with risks tilted to the upside. Medium term target for CPI inflation was retained at 4% (within a band of +/- 2%). The policy attributed a combination of factors which are likely to trigger inflation tendencies, including staggered impact of House Rent Allowance (HRA) increases, higher crude oil and commodity prices amid pick-up in global growth, new method of calculating Minimum Support Price (MSP), increase in customs duty on several items in Union Budget, amid others. Moreover, the current year's fiscal slippage and normalization of monetary policy by major advanced economics could also adversely affect the inflation trajectory. Nonetheless, some risks to inflation are expected to be balanced by moderate real wage growth, both ways movement of crude oil prices in recent periods and subdued capacity utilization.

Even as upside risks to inflation prevailed, the growth outlook for FY19 showed improvement. The Gross value added (GVA) growth for FY19 is projected at 7.2% overall, in the range of 7.3%-7.4% in first half and 7.1%-7.2% in second half with risks evenly balanced around it. However, the GVA for FY18 is marginally revised down to 6.6% from the December 2017 projection of 6.7%.

On another front, surplus liquidity in the system gradually moved towards neutrality. During December'17-January'18, there were bouts of liquidity injection by RBI to address the deficit liquidity owing to slow down in government spending and large tax collections. The RBI from time to time also absorbed liquidity to manage liquidity conditions.

From the fixed income market viewpoint, the yields have continued to harden since past several months. The 10-year G-sec yield edged up by 54 basis points to 7.57% as on February 6, 2018 compared to 7.03% as on December 6, 2017 (last policy review). Higher inflation, fiscal stress (the government raised the FY18 fiscal deficit target to 3.5% of GDP from its earlier projection of 3.2% of GDP), steadily firming up oil prices and negative market sentiments on the back of higher government borrowing, trigged sell-off in the bond market leading to higher yields.

Market Outlook

In the backdrop of current policy review and MPC's commitment to keep headline inflation close to 4% on a durable basis, we believe that evolving inflation trajectory will decide the future course of policy rate direction. The present concerns pertaining to high inflation support MPC maintaining its hawkish stance on inflation. We feel the market has started pricing in the few rate hikes, given that the 10-year benchmark is trading at a spread of around 157 bps over the repo rate.

In the given market conditions, we urge investors to be cautious and choose fund duration in line with their investment horizons. We do not expect rate reductions any time soon in the wake of fiscal slippage, but hold on to the argument for a need to have tighter real rates and push for more efficient allocation of capital and savings/investment. 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.

MKTG/Policy Review/0218