
Insights – Monetary Policy Review

Monetary Policy Committee starts with reduction in repo rate, policy stance changes to support growth

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- **Our 'Viewpoint, India - Case for Further Monetary Easing'** (released in the month of September '16), firmly expressed our view of further rate cuts by the RBI.
- Our view has been held true with the newly constituted Monetary Policy Committee (MPC) slashing the repo rate by 25 bps; notwithstanding the industry consensus for a status quo in MPC's maiden monetary policy review.
- The Repo rate now stands at 6.25%.
- With the RBI continuing its accommodative stance on interest rates, we maintain our **'Viewpoint'** for the repo rates to eventually drop down to 5 - 5.5% over 2 years' time frame.
- Further, we had opined the average G-Sec spread (vis-à-vis the Repo Rate) to eventually trade closer to 25 bps (close to the historic average). The spread has now dropped lower to about 46 bps from the average of 66 bps for January '15 – August '16 period.

Monetary policy review- Key takeaways

The first policy review by the new RBI Governor Dr. Urjit Patel and the newly constituted Monetary Policy Committee (MPC) members, gave a unanimous decision of 25 basis cut in repo rate. It is an attempt by the MPC at bolstering the domestic drivers of growth when global economic growth is not supportive. It noted that a good monsoon and various supply management measures have helped improve the food inflation outlook, which in turn has opened up room for policy easing.

Over the next two quarters, the policy committee will have to weigh the domestic inflation outlook against global risk factors, while looking out for potential cost-push pressure which may arise due to pay commission awards on house rent allowance, increase in minimum wages and hike in minimum support prices. Even as the RBI expects 5% CPI target to be met by March 2017, with some upside risks the MPC saw the magnitude of such risks having reduced over the last few months.

The near-term growth-inflation mix would support a continuation of the RBI's accommodative stance in the coming months, making room for more policy interest rate cuts. Growth momentum is also unlikely to improve sufficiently in the near-term to warrant caution about demand-pull inflation. A positive inflation path, however, needs to be weighed with global uncertainties ahead. These mainly include banking sector stress in

Europe, US Presidential elections in November, Organization of the Petroleum Exporting Countries (OPEC) meeting later in November and the likelihood of US Fed rate normalization in December.

The central bank also pointed out that since global potential growth and neutral interest rates had been falling, it is willing to work with a lower real interest rate (around 1.25%) than was preferred earlier (1.5%-2.0%). This may support further monetary easing in ensuing months.

Structurally, the government too has been playing its part to keep inflation stable. Having met its fiscal target for the previous financial year, the government is targeting a smaller deficit this year. Pay commission hikes have been partially implemented, which will smoothen the impact on the fiscal front and inflation. It has also cut the interest rates on small savings schemes, albeit in a small measure, to demonstrate its commitment to make these rates in line with interest rates in the financial system.

While there has been a heightened level of volatility due to the actions of the various central banks globally, the comfortable forex reserves of USD 370.77 billion (as on September 23, 2016) should help insulate the economy from external shocks, if any.

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. To this end it would continue to focus on the infusion of liquidity through Open Market Operations (OMOs) and intervention in forex market of which it has already done around Rs. 160 billion which helped to bring the system-level ex ante¹ liquidity deficit to close to neutrality (albeit without seasonal adjustment).

¹means based on estimates rather than actual results.

Outlook

We expect inflation to moderate over the next two quarters. From an average 5.6% in April 16-August 16, it is expected that CPI inflation will average 4.5% in the quarter ended December 2016, before inching up to 5% in the quarter ended March 2017. Hence, full-year inflation is expected not to be far from the 5% target for FY17.

Given the expectations of inflation to hover near the RBI's target and central bank's commitment to maintain adequate liquidity, we feel that RBI will have the elbow room to continue accommodative stance and cut interest rates in order to support economic growth.

Accordingly, we are of view that favorable liquidity conditions and prospects of lower rates supported by moderate inflation puts the fixed income market in a sweet spot.

The credit market also retains encouraging outlook on the back of economic recovery. In a recent note by CRISIL, it highlighted that 'For the first time in the last 10-semi-annual periods the debt²-weighted credit ratio rose above 1 which underscores value of debt upgraded is more than those downgraded, and surged to 2 times in the first half of FY17 compared with 0.2 times in the second half of FY16. The credit ratio (number of upgrades to downgrades) came in at 1.2 times compared with 0.8 times'. This is also for the first time in the last 10 semi-annual periods that both these ratios have been above 1 simultaneously.

Further, the increased monetary policy transmission will also help lending rates to go down, leading to improvement in the balance sheets of highly leveraged companies.

In the backdrop of 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.

²debt outstanding on the books of the firms, excludes financial sector players. Source: CRISIL.

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