Invesco Mutual Fund

Insights – Monetary Policy Review

No change in repo rate and policy stance. Inflation remains a key monitorable

February 7, 2020

The Monetary Policy Committee (MPC) maintained status quo on interest rates and chose to watch inflation trajectory before deciding the next course of policy action. The MPC held the repo rate unchanged for the second consecutive review.

With sharp uptick in inflation in last two months (the latest Consumer Price Index (CPI) based headline inflation peaked to 7.35% in December'19, highest reading since July 2014) and likely persistence of high inflation tendencies in the near term, the decision to keep key policy rates unchanged came on the expected lines. The six-member MPC unanimously voted for keeping the repo rate steady. In doing so, the MPC also retained its 'accommodative' stance acknowledging the need to revive growth, while ensuring that inflation remains within its target.

As upside risks to inflation remained, the MPC raised its inflation forecasts. The CPI inflation is projected at 6.5% for Q4 2019-20, 5.4%-5.0% for H1 2020-21 and 3.2% for Q3 2020-21, with risks broadly balanced. The medium-term target for CPI inflation was retained at 4% (within a band of +/- 2%).

Whilst, the MPC noted that inflation has surged above the upper tolerance band around the target in December'19, primarily on the back of the unusual spike in onion prices, it acknowledged that onion prices are likely to subside over the months as supply conditions improve. However, the moderation in the food price inflation due to drop in onion prices may get muted due to hardening of prices of other food items, notably those of milk, pulses and proteins. The policy also enumerated couple of other factors that may weigh on inflation outlook in near term, namely, volatile crude oil prices, increase in input costs for services in recent months, volatile financial markets and increase in customs duties on items of retail consumption in the budget. Meanwhile, it noted that base effects would turn favorable during Q3 2020-21.

Even as inflation continued to be a key monitorable, the MPC reiterated that the economy continues to be weak and the output gap remains negative. It noted that, although some high-frequency indicators have turned around and indicated uptick in momentum of economic activity, the sustainability of these trends need to be assessed by incoming data. The MPC projected Gross Domestic Product (GDP) growth for 2020-21 at 6.0%, in the range of 5.5%-6.0% per cent for H1 2020-21 and 6.2% for Q3 2020-21.

Overall, liquidity in the system remained in surplus in December’19 and January’20. The average daily net absorption under the Liquidity Adjustment Facility (LAF) amounted to Rs. 2.61 lakh crores and Rs. 3.18 lakh crores in December’19 and January’20 respectively. The RBI also fine-tuned its existing liquidity management framework to help faster transmission of its rate decisions.

On the positive side, the MPC noted that monetary transmission across various money market segments and the private corporate bond market has been sizeable. It said that credit market transmission remains delayed but is gathering pace. The MPC also took comfort from the fact that higher fiscal deficit in 2019-20 has not resulted in an increase in market borrowings compared to the budget estimates. Accordingly, it noted that these positive developments could strengthen the effects of cumulative policy reductions undertaken by RBI previously and help domestic demand going forward.

Market Outlook

We are broadly in agreement in the direction of the CPI projections of RBI. However, we feel in case the present trend of the vegetable prices normalizes, the actual CPI could be lower than RBI’s forecast by about 20-50 basis points at various points of CY20.

The statement in the policy document about ‘policy space available for future action’ is positive for bonds and opens up potential rate reductions in CY20 given that growth remains weak and CPI headline moves southwards from Q3FY21.

The policy statement also suggests focused attention by RBI towards ensuring transmission of policy rates into the economy. The long-term repo operations (LTRO) for improving monetary transmission is viewed as a much-awaited definite step to finally ensure decent quantum of transmission going forward. In line with the move, the availability of liquidity for a long period of 3 years is likely to help the yields of sovereign bonds and select AAA credit securities to move lower. Over the medium term, a drop in yields could also be witnessed at the longer end of the yield curve as well.

While, the decline in the yields of sovereign bonds and AAA bond yields do not ensure transmission into lower borrowing cost of credits below AAA, but eventually the banks are expected to participate (over the long term) and price loans and borrowings of sub-AAA credits at a lower rate. However, at this stage we expect the transmission of this action (LTRO) to be felt only in sovereign and AAA credits.

In this environment we urge investors to select funds of high credit quality in alignment with their investment horizon and longer depending on their individual risk appetite.