Fifth Bi-monthly Monetary Policy Statement, 2018-19

December 5, 2018

Policy Actions

Keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.50 percent.

Consequently, the reverse repo rate under the LAF remains at 6.25 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 6.75 per cent.

The decision of the MPC is consistent with the stance of calibrated tightening of monetary policy in consonance with the objective of achieving the medium term target for consumer price index (CPI) inflation at 4 per cent with in a band of +/- 2 per cent, while supporting growth.

Policy Assessment

Since the last MPC meeting in October 2018, global economic activity has shown increasing signs of weakness on rising trade tensions. Among advanced economies (Aes), economic activity appears to be slowing in the US in Q4:2018, after a buoyant Q3. The Euro area growth lost pace in Q3, impacted by weaker trade growth and new vehicle emission standards.

Economic activity also decelerated in major emerging market economies (EMEs) in Q3. In China, growth slowed down on weak domestic demand. The ongoing trade tensions and the possible cooling of the housing market pose major risks to growth in China. The Russian economy lost some traction, pulled down largely by a weak agriculture harvest, though the growth was buttressed by strong performance of the energy sector.

Crude oil prices have declined sharply, reflecting higher supplies and easing of geopolitical tensions. Base metal prices have continued to decline on selling pressure following weak demand from major economies. Gold price has risen underpinned by safe haven demand triggered by political uncertainty in some geographies, though a strong dollar may stem the rise. The inflation scenario has remained broadly unchanged in the US and the Euro area.

Global financial markets have been driven mainly by rising policy rates in the US, volatile crude oil prices and expectations of a slowdown compared with earlier projections. EM stock markets have corrected on shrinking global liquidity, weak economic data in some key EMEs, and lingering trade tensions. The 10-year yield in the US, which surged on robust economic data at the beginning of October, softened subsequently on the unchanged Fed stance. In currency markets, the US dollar, which was strengthening on a widening growth differential with its peers, eased in the second half of November.

On the domestic front, gross domestic product (GDP) growth slowed down to 7.1 per cent year-on-year (y-o-y) in Q2:2018-19, after four consecutive quarters of acceleration. Private consumption slowed down possibly on account of moderation in rural demand, subdued growth in kharif output, depressed prices of agricultural commodities and sluggish growth in rural wages.

On the supply side, growth of gross value added (GVA) at basic prices decelerated to 6.9 per cent in Q2, reflecting moderation in agricultural and industrial activities. Slowdown in agricultural GVA was largely the outcome of tepid growth in kharif production. Within industry, growth in manufacturing decelerated due to lower profitability of manufacturing firms, pulled down largely by a rise in input costs, while that in mining and quarrying turned negative, caused by a contraction in output of crude oil and natural gas. Growth in electricity, gas, water supply and other utility services strengthened.

Looking beyond Q2, rabi sowing so far (up to end-November) has been 8.3 per cent lower as compared with the same period last year due mainly to lower soil moisture levels resulting from a deficient monsoon and a delayed kharif harvest across states. Storage in major reservoirs, the main source of irrigation during the rabi season, was at 61 per cent of the full reservoir level as on November 29.

Growth in the index of industrial production (IIP) slowed down to 4.5 per cent in September 2018. The growth in core industries recovered in October on the back of double-digit expansion in coal, cement and electricity. The purchasing managers' index (PMI) for manufacturing touched an eleven-month high of 54.0 in November, supported by an expansion in output, and domestic and export orders.

High frequency indicators of service sector activity showed a mixed picture in September-October. Growth in tractors sales – an indicator of rural demand – turned negative in September. Growth in two-wheeler sales, another indicator of rural demand, rebounded in October, supported by a base effect. Railway freight traffic improved markedly in October to touch a five-year high growth. While domestic air passenger traffic sustained robust growth, international passenger traffic contracted.

Retail inflation, measured by y-o-y change in CPI, declined from 3.7 per cent in September to 3.3 per cent in October. A large fall in food prices pushed food group into deflation and more than offset the increase in inflation in items excluding food and fuel. Adjusting for the estimated impact of an increase in house rent allowance (HRA) for central government employees, headline inflation was 3.1 per cent in October.

Inflation in the fuel and light group remained elevated, driven by liquefied petroleum gas prices in October, tracking international petroleum product prices. Kerosene prices also edged up, reflecting the calibrated increase in their administered price. Inflation in rural fuel items such as firewood and chips and dung cake also moderated.

CPI inflation excluding food and fuel accelerated to 6.1 per cent in October; adjusted for the estimated HRA impact, it was 5.9 per cent. Transport and communication registered a marked increase, pulled up by higher petroleum product prices, transportation fares and prices of automobiles.

The Reserve Bank injected durable liquidity amounting to ₹360 billion in October and ₹500 billion in November through open market purchase operations, bringing total durable liquidity injection to ₹1.36 trillion for 2018-19. Liquidity injected under the LAF, on an average daily net basis, was ₹560 billion in October, ₹806 billion in November and ₹105 billion in December (up to December 4).

On the financing side, net FDI flows moderated in April-September 2018. Portfolio flows turned positive in November on account of a sharp decline in oil prices, indications of a less hawkish stance by the US Fed and a softer US dollar. However, during the year, there were net portfolio outflows of US$ 14.8 billion (up to November 30). India's foreign exchange reserves were at US$ 393.7 billion on November 30, 2018.

Outlook

In the fourth bi-monthly resolution of October 2018, CPI inflation was projected at 4.0 per cent in Q2:2018-19, 3.9-4.5 per cent in H2 and 4.8 per cent in Q1:2019-20, with risks somewhat to the upside.The actual inflation outcome in Q2 at 3.9 per cent was marginally lower than the projection of 4.0 per cent. However, the October inflation print at 3.3 per cent turned out to be unexpectedly low.

The headline inflation outlook is driven by the following effects:

- The broad-based weakening of food prices imparts downward bias to the headline inflation trajectory, going forward.
- In contrast to the food group, there has been a broad-based increase in inflation in non-food groups.
- International crude oil prices have declined sharply since the last policy; the price of Indian crude basket collapsed to below US$ 60 a barrel by end-November after touching US$ 85 a barrel in early October.
- Global financial markets have continued to be volatile with EME currencies showing a somewhat appreciating bias in the last one month
- The effect of the 7th Central Pay Commission's HRA increase has continued to wane along expected lines.

GDP growth in H1 has been broadly along the line in the April policy when for the year as a whole GDP growth was projected at 7.4 per cent.

Going forward, lower rabi sowing may adversely affect agriculture and hence rural demand. Financial market volatility, slowing global demand and rising trade tensions pose negative risk to exports. However, on the positive side, the decline in crude oil prices is expected to boost India's growth prospects by improving corporate earnings and raising private consumption through higher disposable incomes.

Credit offtake from the banking sector has continued to strengthen even as global financial conditions have tightened. FDI flows could also increase with the improving prospects of the external sector.

Inflation projections have been revised downwards significantly and some of the risks pointed out in the last resolution have been mitigated, especially of crude oil prices, several uncertainties still cloud the inflation outlook:

- The prices of several food items are at unusually low levels and there is a risk of sudden reversal, especially of volatile perishable items.
- Uncertainty continues about the exact impact of MSP on inflation, going forward.
- The medium-term outlook for crude oil prices is still uncertain due to global demand conditions, geo-political tensions and decision of OPEC which could impinge on supplies.
- Global financial markets continue to be volatile.
- Fiscal slippages, if any, at the centre/state levels, will influence the inflation outlook, heighten market volatility and crowd out private investment.
- The staggered impact of HRA revision by State Governments may push up headline inflation.

The MPC decided to keep the policy repo rate on hold and maintain the stance of calibrated tightening. The MPC reiterates its commitment to achieving the medium-term target for headline inflation of 4 per cent on a durable basis.

The MPC noted that the benign outlook for headline inflation is driven mainly by the unexpected softening of food inflation and collapse in oil prices in a relatively short period of time. The acceleration in investment activity also bodes well for the medium-term growth potential of the economy. The time is apposite to further strengthen domestic macroeconomic fundamentals.

The decision on keeping the policy rate unchanged was unanimous. Regarding the stance Dr. Ravindra H. Dholakia (voted to change the stance to neutral).

The next meeting of the MPC is scheduled on February 5 to 7, 2019.

Statement on Development and Regulatory Policies

This Statement sets out various developmental and regulatory policy measures for developing and strengthening financial markets.

- Mandatory Loan Component in Working Capital Finance: With a view to promoting greater credit discipline among working capital borrowers, it was proposed that a minimum level of 'loan component' in fund-based working capital finance for larger borrowers.
- Aligning Statutory Liquidity Ratio with Liquidity Coverage Ratio: In order to align the SLR with the LCR requirement, it is proposed to reduce the SLR by 25 basis points every calendar quarter until the SLR reaches 18 per cent of NDTL. The first reduction of 25 basis points will take effect in the quarter commencing January 2019.
- Measures to Improve Liquidity Management by Banks: The Reserve Bank will provide information on daily CRR balance of the banking system to market participants on the very next day.
- External Benchmarking of New Floating Rate Loans by Banks

Our Views & Conclusion:

The 10 yr G-sec yield was at 7.56% before the Policy and softened to 7.45%. Sharp correction in oil prices since the last MPC meet in October, softening of inflation expectations, and easing of depreciation pressures for the rupee are the main factors that led the RBI to keep the policy rate unchanged. The MPC highlighted the risk of "sudden reversal" in food prices, uncertainty regarding the impact of new MSP policy (around 24% hike announced by the government for the current Kharif season), volatility in oil prices and global financial markets as the main reasons to keep its stance unchanged.

The lower than expected inflation trajectory, continued OMO purchases from the RBI, gradual return of FPI investments into the Indian debt market, and more importantly, the inversion of the US yield curve are some of the factors which are likely to support bonds in the short term.

We had increased modified duration in the last 2 months to around 4 years and will maintain the same for this month.