Second Bi-monthly Monetary Policy Statement, 2019-20

June 6, 2019

Policy Actions

Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 6.00 percent to 5.75 percent with immediate effect

Consequently, the reverse repo rate under the LAF stands adjusted to 5.50 percent, and the marginal standing facility (MSF) rate and the Bank Rate to 6.0 percent

The MPC also decided to change the stance of monetary policy from neutral to accommodative.

These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 percent within a band of +/- 2 percent, while supporting growth.

Policy Assessment

Global economic activity has been losing pace after a somewhat improved performance in Q1:2019, reflecting further slowdown in trade and manufacturing activity. Among advanced economies (AEs), economic activity in the US strengthened in Q1, supported by higher government spending, increase in private investment and a lower trade deficit. Economic activity in the Euro area has remained weak due to muted industrial activity and weak business confidence. Leading indicators point to a further slowdown in the Euro area in Q2. The Japanese economy accelerated in Q1 on net exports gains and increased public investment.

Economic activity has slowed in many emerging market economies (EMEs). In Q1:2019, the Chinese economy grew at the same pace as in the previous quarter, though slightly above consensus expectations. The Russian economy, which had shown some signs of recovery in Q4:2018, weakened in Q1 on muted domestic activity and trade.

Crude oil prices remained volatile, reflecting evolving demand-supply conditions underpinned by the production stance of the OPEC plus, rising shale output, weakening global demand and geopolitical concerns. The strengthening of the US dollar had weakened gold prices. Inflation remains below target in several economies, though it has shown an uptick since March.

Financial markets have been driven by uncertainties surrounding US-China trade negotiations and Brexit. In the US, the equity market has experienced some selling pressures since early May on escalation of trade tensions with China and recently, with Mexico. Bond yields in the US picked up in April on better GDP data for Q1, but declined in May on subdued economic data and expectations of a dovish monetary policy stance. Bond yields in Germany slipped into negative territory on weak economic data; in Japan, they remained negative on indications of sustained accommodation. In many EMEs, bond yields have been falling with central banks adopting accommodative monetary policy to boost economic growth.

GDP growth for 2018-19 has been estimated at 6.8 percent year-on-year (y-o-y), down by 20 basis points from the second advance estimates released on February 28, pulled down by a downward revision in private final consumption expenditure (PFCE) and moderation in exports. Quarterly data show that domestic economic activity decelerated sharply to 5.8 percent in Q4:2018-19 from 6.6 percent in Q3.

Agriculture and allied activities contracted, albeit marginally, in Q4:2018- 19 due to a decline in rabi production. Foodgrains stocks at 72.6 million tonnes as on May 16, 2019 were 3.4 times the prescribed buffer norms. Growth in manufacturing activity weakened sharply to 3.1 percent from 6.4 per cent in the previous quarter. Construction activity slowed down markedly.

India Meteorological Department (IMD) has predicted that south-west monsoon rainfall (June to September) is likely to be normal at 96 percent of the long period average (LPA). The current weak El Niño conditions over the Pacific are likely to continue during the monsoon.

Growth in eight core industries decelerated sharply in April, pulled down largely by coal, crude oil, fertilisers and cement. Credit flows from banks to large industries strengthened, though they remained muted for micro, small and medium industries. High frequency indicators suggest moderation in activity in the service sector. Sales of commercial vehicles, tractors, passenger cars, and three and two wheelers contracted in April. Railway freight traffic growth decelerated. Domestic air passenger traffic growth contracted in March, but turned around modestly in April. Two key indicators of construction activity, viz., cement production and steel consumption, slowed down in April.

Retail inflation, measured by y-o-y change in CPI, remained unchanged in April, at its March level of 2.9 percent, with higher inflation in food and fuel groups being offset by lower inflation in items excluding food and fuel. The April food inflation print showed an increase to 1.4 percent from 0.7 percent in March. Input price pressures eased in both agricultural and industrial raw materials.

Liquidity in the system turned into an average daily surplus of ₹66,000 crore (₹660 billion) in early June after remaining in deficit during April and most of May due to restrained government spending. The Reserve Bank injected liquidity of ₹70,000 crore (₹700 billion) in April and ₹33,400 crore (₹334 billion) in May on a daily net average basis under the LAF. The Reserve Bank has announced that it would conduct an OMO purchase auction of ₹15,000 crore (₹150 billion) on June 13, 2019.

Transmission of the cumulative reduction of 50 bps in the policy repo rate in February and April 2019 was 21 bps to the weighted average lending rate (WALR) on fresh rupee loans.

After a sharp recovery in March 2019, net foreign portfolio inflows were relatively modest at US$ 2.3 billion in 2019-20 in April-May. While the equity segment received net inflows during this period, the debt segment witnessed net outflows. India's foreign exchange reserves were at US$ 421.9 billion on May 31, 2019.

Outlook

In the bi-monthly monetary policy resolution of April 2019, CPI inflation was projected at 2.4 percent for Q4:2018-19, 2.9-3.0 percent for H1:2019-20 and 3.5-3.8 per cent for H2:2019-20, with risks broadly balanced. The headline inflation outcome in Q4 at 2.5 percent was largely in alignment with the April policy projections

The inflation path is shaped by the following factors:

- The summer pick-up in vegetable prices has been sharper than expected, though this may be accompanied by a correspondingly larger reversal during autumn and winter.
- A significant weakening of domestic and external demand conditions appear to have led to a sharp broad-based decline of 60 bps in inflation excluding food and fuel in April.
- Crude prices have continued to be volatile. However, its impact on CPI inflation has been muted so far due to incomplete pass-through.
- Near-term inflation expectations of households have continued to moderate

Taking into consideration these factors, the impact of recent policy rate cuts and expectations of a normal monsoon in 2019, the path of CPI inflation is revised to 3.0-3.1 per cent for H1:2019-20 and to 3.4-3.7 per cent for H2:2019-20, with risks broadly balanced

GDP growth for 2019-20 is revised downwards from 7.2 percent in the April policy to 7.0 percent – in the range of 6.4-6.7 percent for H1:2019-20 and 7.2-7.5 percent for H2 – with risks evenly balanced.

The MPC notes that a sharp slowdown in investment activity along with a continuing moderation in private consumption growth is a matter of concern. The headline inflation trajectory remains below the target mandated to the MPC even after taking into account the expected transmission of the past two policy rate cuts. Hence, there is scope for the MPC to accommodate growth concerns by supporting efforts to boost aggregate demand.

The MPC decided to reduce the policy repo rate by 25 basis points and change the stance of monetary policy from neutral to accommodative.

All members of the MPC voted in favour of the monetary policy decision

The next meeting of the MPC is scheduled on August 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.

On Tap Licensing of Small Finance Banks: To enhance credit access to small borrowers and encourage competition within small finance banks, RBI has proposed to issue draft Guidelines for 'on tap' Licensing of Small Finance Banks by the end of August 2019.

Regulatory and Supervisory Framework for Core Investment Companies (CICs): In light of recent developments, there is a need to strengthen the corporate governance framework of CICs. Accordingly, it has been decided to set up a Working Group to review the regulatory guidelines and supervisory framework applicable to CICs.

Internal Working Group to Review Liquidity Management Framework: It has been decided to constitute an Internal Working Group to review comprehensively the existing liquidity management framework and suggest measures, among others, to (i) simplify the current liquidity management framework; and (ii) clearly communicate the objectives, quantitative measures and toolkit of liquidity management by the Reserve Bank. The Group is expected to submit its report by mid-July 2019.

Foreign Exchange Trading Platform for Retail Participants: With a view to creating market infrastructure that would ensure fair and transparent pricing for users of foreign exchange, the Reserve Bank in October 2017, had issued a discussion paper proposing to set up a foreign exchange trading platform. The trading platform has now been developed by the Clearing Corporation of India (CCIL) and is being tested by users. The platform will be available to users for transactions from early August 2019.

Review of Charges for RBI-operated Payment Systems: In order to provide an impetus to digital funds movement, RBI has been decided to waive off any charges on transactions processed through RTGS and NEFT systems and the benefits of the same should be passed on to the consumers.

Our Views & Conclusion:

The 10 yr G-sec yield was at 6.99% before the Policy and softened to 6.89%. RBI changed its monetary policy stance from neutral to accommodative providing room for further rate cuts. We believe RBI future action will largely depend on how the growth outlook evolves, even as RBI's targeted inflation trajectory is expected to remain comfortable. We expect 10year g-sec yield to be in the range of 6.75 - 7.15 considering volatility in the crude oil prices, upcoming budget and timely monsoon.