Fifth Bi-monthly Monetary Policy Statement, 2019-20

December 05, 2019

Policy Actions

Kept the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 5.15 percent.

The MPC also decided to continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

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

Since the MPC's last meeting in October 2019, global economic activity has remained subdued, though some signs of resilience are becoming visible. Among the advanced economies (Aes), GDP growth in the US picked up in Q3 on strong private investment and personal consumption expenditure. In the Euro area, GDP growth remained stable in Q3 relative to the previous quarter on improved household consumption and government spending, although manufacturing activity continued to struggle with lingering geo-political uncertainties.

Among emerging market economies (EMEs), GDP growth in China decelerated further in Q3, reflecting weak industrial production and declining exports amidst trade tensions with the US. In Russia, GDP growth accelerated in Q3 on the back of an upturn in agricultural output and industrial activity.

Crude oil prices have moved in a narrow range. Gold prices fell on revival of risk appetite eased safe haven demand

Bond yields in the US firmed up in October; however, they softened from mid-November on waning hopes of a near-term resolution of trade disputes. Bond yields in the Euro area remained negative, but expectations that a no-deal Brexit is less likely improved sentiment.

In EMEs, bond yields showed mixed movements, driven initially by optimism on US-China trade talks and country-specific factors. In currency markets, the US dollar weakened against other major currencies, while EME currencies have been trading with an appreciating bias.

On the domestic front, gross domestic product (GDP) growth moderated to 4.5 percent year-on-year (y-o-y) in Q2:2019-20, extending a sequential deceleration to the sixth consecutive quarter. Real GDP growth was weighed down by a sharp slowdown in gross fixed capital formation (GFCF), cushioned by a jump in government final consumption expenditure (GFCE).

Rabi sowing is catching up from the setback caused by delay in kharif harvesting and unseasonal rainfall in October and early November. Storage in major reservoirs, the main source of irrigation during the rabi season, was at 86 per cent of the full reservoir level as on November 28 as compared with 61 percent in the same period a year ago.

High frequency indicators suggest that service sector activity generally remained weak in October. Tractors and motorcycles sales – indicators of rural demand – continued to contract but at a moderated pace; however, passenger vehicle sales – an indicator of urban demand – posted a slender positive growth in October after 11 months of decline, reflecting festival season demand and promotional measures by auto companies. Commercial vehicle sales and railway freight traffic contracted.

Retail inflation, measured by y-o-y changes in the CPI, increased sharply to 4.6 percent in October, propelled by a surge in food prices. Fuel group prices remained in deflation, while inflation in CPI excluding food and fuel moderated further from its level a month ago.

Turning to the drivers of CPI, food inflation spiked to 6.9 percent in October – a 39- month high – pushed up by a sharp increase in prices of vegetables due to heavy unseasonal rains. Prices of onions, in particular, shot up by 45.3 percent in September and further by 19.6 percent in October. Inflation in several other food items such as fruits, milk, pulses and cereals also increased, reflecting diverse factors – the cost push of fodder prices in the case of milk; decline in production and sowing area of pulses; and minimum support price effects.

Overall liquidity in the system remained in surplus in October and November 2019 despite an expansion of currency in circulation due to festival demand. Average daily net absorption under the LAF amounted to ₹1,98,566 crore in October. The Centre availed of ways and means advances (WMA) in the first week and the last three days of the month to fund its expenditure.

Monetary transmission has been full and reasonably swift across various money market segments and the private corporate bond market. As against the cumulative reduction in the policy repo rate by 135 bps during February-October 2019, transmission to various money and corporate debt market segments ranged from 137 bps (overnight call money market) to 218 bps (3-month CPs of non-banking finance companies). Transmission to the government securities market, however, has been partial at 113 bps (5-year government securities) and 89 bps (10-year government securities).

Net foreign direct investment rose to US$ 20.9 billion in H1:2019-20 from US$ 17.0 billion a year ago. Net foreign portfolio investment was of the order of US$ 8.8 billion in April-November 2019 as against net outflows of US$ 14.9 billion in the same period of last year. In addition, net investment by FPIs under the voluntary retention route have amounted to US$ 6.3 billion since March 11, 2019 India's foreign exchange reserves were at US$ 451.7 billion on December 3, 2019..

Outlook

In the fourth bi-monthly resolution of October 2019, CPI inflation was projected at 3.4 percent for Q2:2019-20, 3.5-3.7 percent for H2:2019-20 and 3.6 percent for Q1:2020-21 with risks evenly balanced. The actual inflation outcome for Q2 evolved broadly in line with projections – averaging 3.5 per cent. The inflation print for October, however, was much higher than expected.

The inflation path is shaped by the following factors:

- The upsurge in prices of vegetables is likely to continue in immediate months.
- Incipient price pressures seen in other food items such as milk, pulses, and sugar are likely to be sustained, with implications for the trajectory of food inflation.
- Domestic financial markets have exhibited volatility.
- Domestic demand has slowed down, which is being reflected in the softening of inflation excluding food and fuel.
- crude oil prices are expected to remain range bound, barring any supply disruptions due to geo-political tensions.

Taking into consideration these factors, the CPI inflation projection is revised upwards to 5.1-4.7 percent for H2:2019-20 and 4.0-3.8 percent for H1:2020-21, with risks broadly balanced

GDP growth for Q2:2019-20 turned out to be significantly lower than projected. Various high frequency indicators suggest that domestic and external demand conditions have remained weak. Real GDP growth for 2019-20 is revised downwards from 6.1 percent in the October policy to 5.0 percent – 4.9-5.5 percent in H2 and 5.9-6.3 percent for H1:2020-21.

The MPC notes that economic activity has weakened further and the output gap remains negative. However, several measures already initiated by the Government and the monetary easing undertaken by the Reserve Bank since February 2019 are gradually expected to further feed into the real economy. The need at this juncture is to address impediments, which are holding back investments. The introduction of external benchmarks is expected to strengthen monetary transmission. In this context, there is also a need for greater flexibility in interest rates on small saving schemes. In the judgement of the MPC, inflation is rising in the near-term, but it is likely to moderate below target by Q2:2020-21.

The MPC decided to keep the policy repo rate unchanged and continue with the accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

All members of the MPC voted unanimously in favour of this decision

The next meeting of the MPC is scheduled on February 4-6, 2020.

Statement on Development and Regulatory Policies

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

- RBI would amend certain regulatory guidelines with regard to primary (urban) co-operative banks (UCBs) exposure norms for single and group/interconnected borrowers, promotion of financial inclusion, priority sector lending, etc. These measures are expected to strengthen the resilience and sustainability of UCBs and protect the interest of depositors.
- RBI has decided to bring primary (urban) co-operative banks with assets of ₹500 crores and above under the Central Repository of Information on Large Credits (CRILC) reporting framework.
- RBI will facilitate the setting up of a self-regulatory body (SRB) as a first step towards the development of the secondary market for corporate loans.
- RBI has decided to allow International Financial Service Centre Banking Unit (IBU) to open foreign currency accounts of their corporate borrowers and accept fixed deposit in foreign currency of tenor less than one year from non-bank entities.

Our Views & Conclusion:

The 10 yr G-sec yield was at around 6.65% before the policy announcement which increased to 6.80%as the market expected a repo rate cut and had factored in the same. As inflation is inching up and fears of fiscal slippage are increasing, the yield curve has steepened at the long end. There is a spread of around 150bps in the 1-10 year g-sec spread and is among the highest in recent years. The market is therefore expecting extra borrowing to hit the market in the last quarter (Jan- March 2020). The lower end of the yield curve has priced in the rate cuts on the back of surplus sustaining liquidity of ₹ 2.5 lakh crore for the past 3 months. The Policy stance, however remains accommodative, in view of the weak growth numbers. We could see the yields increase further next quarter for which we are well positioned