First Bi-monthly Monetary Policy Statement, 2018-19

August 1, 2018

Policy Actions

Increase the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points to 6.50 percent.

Consequently, the reverse repo rate under the LAF stands adjusted to 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 a **neutral** stance 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 MPC's last meeting in June 2018, global economic activity has continued to maintain steam; however, global growth has become uneven and risks to the outlook have increased with rising trade tensions. Among advanced economies (Aes), the US economy rebounded strongly in Q2, after modest growth in Q1, on the back of rising personal consumption expenditures and exports. In Japan, recent data on retail sales, consumer confidence and business sentiment point to moderation in growth.

Economic activity in major emerging market economies (EMEs) has slowed somewhat on volatile and elevated oil prices, mounting trade tensions and tightening of financial conditions. The Chinese economy lost some pace in Q2, pulled down by efforts to contain debt. The Russian economy picked up in Q1; recent data on employment, industrial production and exports indicate that the economy has gained further momentum.

Global trade lost some traction due to intensification of trade wars and uncertainty stemming from Brexit negotiations. Crude oil prices, which remained volatile and elevated in May-June on a delicate demand-supply balance, eased modestly in the second half of July on higher. Base metal prices have fallen on the general risk-off sentiment triggered by fears of an intensification of trade wars. Gold prices have softened on a stronger dollar.

Investors' appetite for EME assets has waned on increases in interest rates by the US Fed. The 10-year sovereign yield in the US has moderated somewhat from its peak on May 17 on safe-haven demand, spurred by escalating trade conflicts. Yields have softened in other key AEs as well. In most EMEs, however, movements in yields have varied reflecting domestic macroeconomic fundamentals and tightening global liquidity. Capital flows to EMEs declined in anticipation of monetary policy tightening in Aes.

On the domestic front, the cumulative rainfall up to July 31, 2018 was 6 per cent below the long-period average. The total sown area of kharif crops as on July 27 was 7.5 per cent lower than that a year ago. The live storage in major reservoirs as on July 26 was at 41 per cent of the full reservoir level compared with 36 per cent a year ago, which portends well for the rabi sowing season.

Industrial growth, measured by the index of industrial production (IIP), strengthened in April-May 2018 on a y-o-y basis. Growth in the infrastructure/construction sector accelerated sharply, reflecting the government's thrust on national highways and rural housing, while the growth of consumer non-durables decelerated significantly. The output of eight core industries accelerated in June due to higher production in petroleum refinery products, steel, coal and cement. Capacity utilisation in the manufacturing sector remains robust.

Commercial vehicle sales growth remained robust despite some deceleration. Domestic air passenger traffic – another indicator of urban demand – maintained double-digit growth. Construction activity indicators also improved with cement production sustaining double digit growth for the eighth consecutive month in June. Steel consumption also accelerated in May.

Retail inflation, measured by the year-on-year change in the CPI, rose from 4.9 per cent in May to 5 per cent in June, driven by an uptick in inflation in fuel and in items other than food and fuel.Fuel and light group inflation rose sharply, pulled up by liquefied petroleum gas and kerosene. Inflation in firewood and chips ticked up, while electricity inflation remained low.

In June, the Reserve Bank absorbed surplus liquidity of around Rs. 140 billion on a daily net average basis under the LAF even as the system migrated from net surplus to a net deficit mode in the second half of the month due to advance tax outflows. Systemic liquidity moved back into surplus mode in early July with increased government spending but turned into deficit from July 10 onwards; on a daily net average basis, the Reserve Bank injected liquidity under the LAF of Rs. 107 billion in July.

Net foreign direct investment (FDI) flows improved significantly in the first two months of 2018-19. With the tightening of liquidity conditions in AEs, growing geopolitical concerns and with the escalation of protectionist sentiment, net foreign portfolio investment (FPI) outflows from the domestic capital market have continued, albeit at an increasingly slower rate. India's foreign exchange reserves were at US$ 404.2 billion on July 27, 2018.

Outlook

In the second bi-monthly resolution of 2018-19, CPI inflation for 2018-19 was projected at 4.8-4.9 per cent in H1 and 4.7 per cent in H2, including the HRA impact for central government employees, with risks tilted to the upside.

The headline inflation outlook is driven by the following effects:

- The central government has decided to fix the minimum support prices (MSPs) of at least 150 per cent of the cost of production for all kharif crops for the sowing season of 2018-19. This increase in MSPs for kharif crops, which is much larger than the average increase seen in the past few years, will have a direct impact on food inflation.
- The overall performance of the monsoon so far augurs well for food inflation in the medium-term.
- Crude oil prices have moderated slightly, but remain at elevated levels
- The central government has reduced Goods and Services Tax (GST) rates on several goods and services. This will have some direct moderating impact on inflation, provided there is a pass-through of reduced GST rates to retail consumers
- Inflation in items excluding food and fuel has been broad-based and has risen significantly in recent months, reflecting greater pass-through of rising input costs and improving demand conditions

Taking these effects into account, inflation is projected at 4.6 per cent in Q2, 4.8 per cent in H2 of 2018-19 and 5.0 per cent in Q1:2019-20, with risks evenly balanced.

Turning to the growth outlook, the progress of the monsoon so far and a sharper than the usual increase in MSPs of kharif crops are expected to boost rural demand by raising farmers' income. Investment activity remains firm even as there has been some tightening of financing conditions in the recent period. Increased FDI flows in recent months and continued buoyant domestic capital market conditions bode well for investment activity. Rising trade tensions may, however, have an adverse impact on India's exports

GDP growth projection for 2018-19 is retained, as in the June statement, at 7.4 per cent, ranging 7.5-7.6 per cent in H1 and 7.3-7.4 per cent in H2, with risks evenly balanced; GDP growth for Q1:2019-20 is projected at 7.5 per cent.

Crude oil prices continue to be volatile and vulnerable to both upside and downside risks. Geopolitical tensions and supply disruptions remain an upside risk to oil prices, the fall in global demand due to further intensification of protectionist trade policies could pull down oil prices. Several other risks remain:

- Volatility in global financial markets continues to impart uncertainty to the inflation outlook
- Households' inflation expectations, as measured by the Reserve Bank's survey, have risen significantly in the last two rounds, which could influence actual inflation outcomes in the months to come
- Though the monsoon has been normal temporally so far, its regional distribution needs to be carefully monitored in the context of key CPI components such as paddy
- Uncertainty around the full impact of MSP on inflation will only resolve in the next several months once the price support schemes are implemented
- The staggered impact of HRA revision by state governments may push headline inflation up

The MPC decided to increase the policy repo rate by 25 basis points and keep the stance neutral. The MPC reiterates its commitment to achieving the medium-term target for headline inflation of 4 per cent on a durable basis.

The MPC notes that domestic economic activity has continued to sustain momentum and the output gap has virtually closed. Rising trade protectionism poses a grave risk to near-term and long-term global growth prospects by adversely impacting investment, disrupting global supply chains and hampering productivity. Geopolitical tensions and elevated oil prices continue to be the other sources of risk to global growth.

Except for Dr. Ravindra H. Dholakia all the other five members of MPC voted in favour of the monetary policy decision.

The next meeting of the MPC is scheduled on October 3 to 5, 2018.

Statement on Development and Regulatory Policies

This Statement sets out various developmental and regulatory policy measures for strengthening regulation and financial inclusion initiatives; broadening and deepening of the financial markets; and, enhancing customer education and protection.

- Co-origination of loans by Banks and Non-Banking Financial Companies (NBFCs) for lending to the priority sector: It has been decided that all scheduled commercial banks may co-originate loans with Non-Banking Financial Companies - Non-Deposit taking- Systemically Important (NBFC-ND-SIs), for the creation of eligible priority sector assets. It should also involve sharing of risks and rewards between the banks and the NBFCs for ensuring appropriate alignment of respective business objectives, as per their mutual agreement.
- Comprehensive Review of Market Timings: The Reserve Bank of India has been receiving, from time to time, requests for extension of timings for certain market segments such as currency futures, Over-the-Counter (OTC) foreign exchange market, etc. It is, therefore, proposed, to set up an internal group to comprehensively review timings of various markets and the necessary payment infrastructure for supporting the recommended revisions to market timings.
- Investment in Non-SLR Securities by Primary (Urban) Cooperative Banks: In order to bring further efficiency in price discovery mechanism and as a step towards harmonization of regulations for Urban and Rural Co-operative Banks, it has been decided to permit Primary (Urban) Co-operative Banks to undertake eligible transactions for acquisition / sale of non-SLR investment in secondary market with mutual funds, pension / provident funds, and insurance companies.

Our Views & Conclusion:

The 10 yr G-sec yield softened by around 8bps today post the RBI policy on the rate hike announcement. The hike was in response to various upside risks (oil and core prices) that have unfolded since the last monetary policy meeting.

The MPC also revised up its inflation estimate for FY19 from 4.80% to 4.90%. Taking into account the rise in oil prices, marginal depreciation in the rupee, and the expected increase in MSP for the upcoming Kharif season, there could be increase in CPI.

We could still see the bond yields increasing further on the fiscal slippage, lack of appetite from the banks for g-sec and increase in crude oil prices and the liquidity tightening in the system.

However, with 2 rate hikes behind us, the yields will be range bound, with 10 yr gilt yield around 7.85% on an average.

We have already reduced duration since the past 6 months and plan to increase the duration only on dips in the bond prices.