Fourth Bi-monthly Monetary Policy Statement, 2016-17

October 04, 2016

Policy Actions

- Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 6.5 per cent to 6.25 per cent with immediate effect.
- Consequently, the reverse repo rate under the LAF stands adjusted to 5.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate to 6.75 per cent

Policy Assessment

Global growth has been slowing more than anticipated through 2016 so far, with weak investment and trade damping aggregate demand. Meanwhile, risks in the form of Brexit, banking stress in Europe, rebalancing of debt-fueled growth in China, rising protectionism and diminishing confidence in monetary policy have slanted the outlook to the downside.

On the domestic front, the outlook for agricultural activity has brightened considerably. The south west monsoon ended the season with a cumulative deficit of only 3 per cent below the long period average, with 85 per cent of the country's geographical area having received normal to excess precipitation. Kharif sowing has surpassed last year's acreage, barring cotton, sugarcane and jute and mesta. Accordingly, the first advance estimates of kharif food grains production for 2016-17 by the Ministry of Agriculture have been placed at a record level, and higher than the target set for the year. The industrial sector, by contrast, suffered a manufacturing-driven contraction in early fiscal year Q2, after a sequential deceleration in gross value added in Q1.

In the services sector, the acceleration in the pace of activity in Q1 appears to have been sustained. An increasing number of high frequency indicators are moving into positive territory, construction is boosted by policy initiatives, and public administration, defense and other services will be supported by the pay commission award.

Retail inflation measured by the headline CPI had been elevated by a sharp pick-up in the momentum of food inflation overwhelming favorable base effects during April-July. In August, however, the momentum of food inflation turned negative and surprised expectations; consequently, base effects in that month came into full play and pulled down headline inflation to an intra-year low. Fuel inflation has moderated steadily through the year so far. Inflation excluding food and fuel (including petrol and diesel embedded in transportation) has been sticky around 5 per cent, mainly in respect to education, medical and personal care services.

Liquidity conditions have remained comfortable in Q3, with the Reserve Bank absorbing liquidity on a net basis through variable rate reverse repo auctions of varying tenors. Liquidity was injected through open market purchases of INR 200 billion in line with the system's requirements.

In the external sector, merchandise exports contracted in the first two months of Q2. Subdued domestic demand was, however, reflected in a faster contraction in imports. Moreover, the still soft crude prices pared off a fifth of the oil import bill and gold import volume slumped to a fifth of its volume a year ago. Consequently, the merchandise trade deficit narrowed by US$ 10 billion in April-August on a year-on-year basis. These developments are likely to have contained the current account deficit in Q2 at its level in Q1, although the decline in remittances and the flattening of software earnings warrants monitoring.

Outlook

The Monetary Policy Committee (MPC) expects that the strong improvement in sowing, along with supply management measures, will improve the food inflation outlook. It notes that the sharp drop in inflation reflects a downward shift in the momentum of food inflation – which holds the key to future inflation outcomes – rather than merely the statistical effects of a favorable base effect

The easy liquidity conditions engendered by the Reserve Bank's operations should also enable the smooth transmission of the policy action through various market segments.

Furthermore, banks should find added impetus for better transmission by the recent downward adjustment in small savings rates. The Committee took note of potential cost push pressures that may emerge, including the 7th pay commission award on house rent allowances, and the increase in minimum wages with possible spillovers through minimum support prices. The fuller play of these factors will need vigilance to prevent a generalized cost spiral from taking root. On balance, the Committee envisages a trajectory taking headline CPI inflation towards a central tendency of 5 per cent by March 2017, with risks tilted to the upside albeit lower than in the second and third bimonthly monetary policy statements of June and August respectively

The momentum of growth is expected to quicken with a normal monsoon raising agricultural growth and rural demand, as well as by the stimulus to the urban consumption spending from the pay commission's award. The accommodative stance of monetary policy and comfortable liquidity conditions should support a revival of credit to the productive sectors.

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

Next bi-monthly monetary policy statement for fiscal year 2016-17 (Fifth Policy Statement) is slotted for December 6-7, 2016.

Our Views & Conclusion:

The RBI has maintained an accommodative stance on the back of good monsoon and negative interest rates around the world. There has been a softening of rates in the debt market due to the excess liquidity in the system – there has been a 30 bps rally since the last RBI policy. The RBI has also said that they are keeping the inflation at 5 percent with upside risk. The 10 year benchmark g-sec is at 6.89 percent currently. Market will see a mild rally with 10-Year G.Sec rates coming down further by 25 to 30 bps, on the expectation / market talk of that there could be one more 25 bps cut. We do not subscribe to any further cut in this interest rate cycle.

We therefore think that the interest rates may not soften further significantly. At this juncture, it would be prudent to be cautious as the softening of yields is on the back of excess liquidity and low credit offtake. There are two major events in this quarter- Fed might increase rates and the FCNR outflow which will be taking place in Oct- Nov 2016, apart from the Indo- Pak tensions at the border.

We would be cautious and may look for an opportune moment to lower the average duration to much lower levels. We would not play anything above 10 years maturity.

The year ahead of us will see a low interest rate regime (at least for one year) and hence the return expectations based on current yields and coupon earnings should be kept very low.