Third Bi-monthly Monetary Policy Statement, 2019-20

August 07, 2019

Policy Actions

Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 35 basis points from 5.75 percent to 5.40 percent with immediate effect

The MPC also decided to maintain the accommodative stance of monetary policy.

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 slowed down since the meeting of the MPC in June 2019, amidst elevated trade tensions and geo-political uncertainty. In the advanced economies (AEs) like US, UK, Europe and Japan, GDP growth remained muted or decelerated

Economic activity remained weak in major emerging market economies (EMEs), pulled down mainly by slowing external demand like China and Russia

Crude oil prices fell sharply in mid-May on excess supplies from an increase in non-OPEC production, combined with a further weakening of demand. Consequently, extension of OPEC production cuts in early July did not have much impact on prices. Gold prices have risen sharply since the last week of May, propelled by increased safe haven demand amidst rising downside risks to growth and a worsening geo-political situation. Inflation remained benign in major advanced and emerging market economies.

Financial markets were driven by the monetary policy stances of major central banks and intensifying geo-political tensions. In the US, the equity market recovered most of the losses suffered in May, boosted by dovish guidance by the US Fed and some transient respite in trade tensions with China. Bond yields in some more member countries in the Euro area moved into negative territory as expectations of more accommodative monetary policy by the European Central Bank gained traction. In EMEs, bond yields edged lower on more accommodative guidance by systemic central banks. In currency markets, the US dollar weakened against major currencies in June on dovish guidance by the US Fed but appreciated in July.

On the domestic front, the south-west monsoon gained intensity and spread with the cumulative rainfall 6 percent below the long-period average (LPA) up to August 6, 2019. The total area sown under kharif crops was 6.6 percent lower as on August 2 than a year ago. Rainfall during the second half of the season (August-September) has been forecast to be normal by the India Meteorological Department (IMD).

The growth in the index of eight core industries decelerated in June, dragged down by a contraction in petroleum refinery products, crude oil, natural gas and cement. The manufacturing PMI rose to 52.5 in July from 52.1 in June, underpinned by a pickup in production, higher new orders and optimism on demand conditions in the year ahead.

Tractor and motorcycle sales – indicators of rural demand – continued to contract. Amongst 3 indicators of urban demand, passenger vehicle sales contracted for the eighth consecutive month in June; however, domestic air passenger traffic growth turned positive in June. Commercial vehicle sales slowed down. Import of capital goods – a key indicator of investment activity – contracted in June. The services PMI expanded to 53.8 in July from 49.6 in June on increase in new business activity, new export orders and employment.

Retail inflation, measured by y-o-y change in the CPI, edged up to 3.2 percent in June from 3.0 percent in April-May, driven by food inflation, even as fuel inflation and CPI inflation excluding food and fuel moderated. Inflation in the food group rose to 2.4 percent in June caused by a sharp pick up in prices of meat and fish, pulses and vegetables. Inflation in liquified petroleum gas (LPG) and subsidised kerosene prices, however, remained elevated.

CPI inflation excluding food and fuel fell by 50 basis points to 4.1 percent in May from 4.6 percent in April, and remained unchanged in June.

Liquidity in the system was in large surplus in June-July 2019 due to (i) return of currency to the banking system; (ii) drawdown of excess cash reserve ratio (CRR) balances by banks; (iii) open market operation (OMO) purchase auctions; and (iv) the Reserve Bank's foreign exchange market operations. The Reserve Bank absorbed liquidity of ₹ 2,04,921 crore in August on a daily net average basis under the LAF.

The banks reduced their Weighted Average Lending Rates on fresh rupee loans by 29 bps during the current easing phase so far (February-June 2019).

Net foreign direct investment flows moderated to US$ 6.8 billion in April-May 2019 from US$ 7.9 billion a year ago. Net foreign portfolio investment (FPI) flows in the domestic capital market amounted to US$ 2.3 billion during the current financial year so far (up to August 5, 2019) as against net outflows of US$ 8.5 billion in the same period last year. India's foreign exchange reserves were at US$ 429.0 billion on August 2, 2019 – an increase of US$ 16.1 billion over end-March 2019.

Outlook

In the second bi-monthly monetary policy resolution of June 2019, CPI inflation was projected at 3.0-3.1 percent for H1:2019-20 and 3.4-3.7 percent for H2:2019-20, with risks broadly balanced. The actual headline inflation outcome for Q1:2019-20 at 3.1 percent was in alignment with these projections.

The inflation path is shaped by the following factors:

- The uptick in food inflation may be sustained by price pressures in vegetables and pulses as more recent data suggest.
- Crude oil prices may likely remain volatile due to geo-political tensions in the Middle-East.
- The outlook for CPI inflation excluding food and fuel remains soft.
- One year ahead inflation expectations of households polled by the Reserve Bank have moderated.

Taking into consideration these factors and the impact of recent policy rate cuts, the path of CPI inflation is projected at 3.1 percent for Q2:2019-20 and 3.5-3.7 percent for H2:2019-20, with risks evenly balanced. CPI inflation for Q1:2020-21 is projected at 3.6 percent.

Real GDP growth for 2019-20 is revised downwards from 7.0 percent in the June policy to 6.9 percent – in the range of 5.8-6.6 percent for H1:2019-20 and 7.3- 5 7.5 percent for H2 – with risks somewhat tilted to the downside; GDP growth for Q1:2020-21 is projected at 7.4 percent.

The MPC notes that inflation is currently projected to remain within the target over a 12-month ahead horizon. Since the last policy, domestic economic activity continues to be weak, with the global slowdown and escalating trade tensions posing downside risks. Private consumption, the mainstay of aggregate demand, and investment activity remain sluggish. Even as past rate cuts are being gradually transmitted to the real economy, the benign inflation outlook provides headroom for policy action to close the negative output gap. Addressing growth concerns by boosting aggregate demand, especially private investment, assumes the highest priority at this juncture while remaining consistent with the inflation mandate.

The MPC decided to reduce the policy repo rate by 35 basis points and to maintain the accommodative stance of monetary policy.

Four members voted to reduce the policy repo rate by 35 basis points, while two members voted to reduce the policy repo rate by 25 basis points.

The next meeting of the MPC is scheduled on October 1, 3 and 4, 2019.

Statement on Development and Regulatory Policies

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

- Introduction of stripping/reconstitution facility for State Development Loans (SDLs)
- Round-the-Clock Availability of National Electronic Funds Transfer System (NEFT)
- Reduction in risk weight for consumer credit except credit card receivables
- The Reserve Bank has taken following further measures to enhance credit flow to the NBFC sector:
  - a). Harmonisation of single counterparty exposure limit for banks' exposure to single NBFCs with general single counterparty exposure limit:
  - b). Credit to the Priority Sector – Permitting banks to on-lend through NBFCs:

Our Views & Conclusion:

The 10 yr G-sec yield was at around the levels 6.30 percent before the Policy and softened to 6.27 percent after announcement of 35 bps cut in the repo rates and reversed its gains subsequently on profit taking to hover around 6.38 percent mark in the afternoon. RBI continued with its monetary policy stance of being accommodative providing room for further rate cuts. We believe RBI future action will largely depend on how the growth outlook evolves with transmission of rate cuts by banks to the end consumer, timely and normal monsoon, system liquidity and global factors like oil prices, impact of global trade war along with Rupee volatility. RBI's targeted inflation trajectory is expected to remain comfortable. We expect 10year g-sec yield to be in the range of 6.15 percent – 6.40 percent in the near future.