Second Bi-monthly Monetary Policy Statement, 2016-17

June 7, 2016

Policy Actions

- The key Repo rate is unchanged at 6.50%. Reverse Repo rate is unchanged at 6% and MSF and Bank Rate at 7%
- CRR is kept unchanged at 4% of NDTL
- Continue to provide liquidity as required but progressively lower the average forecasted liquidity deficit in the system from one percent of NDTL to neutrality

Assessment

Since April 2016, global growth is uneven and struggling to gain traction. World trade remains muted due to weak demand. In the United States, growth was slow once again in Q1 because of contracting industrial activity and exports. GDP growth slowed sequentially in China in Q1, with retail sales, industrial production and fixed investment showing signs of weakness in recent months amidst still rising levels of indebtedness among households and corporations. While macroeconomic stability is returning to some emerging market economies (EMEs), geo-political tensions and high volatility in financial markets impede the resumption of momentum, and the outlook remains challenging.

Global financial markets have recorded gains through Q2 of 2016, spurred by risk-on investor sentiment. Portfolio flows are returning, albeit hesitantly, to EME debt and equity markets. The firmness in crude prices that set in around mid-March has been supported in subsequent weeks by some temporary reductions in global supply. Gold prices remain elevated on safe haven demand. Other non-energy commodity prices remain stable with a hint of upside, while steel prices have firmed appreciably. Bond market yields across AEs have eased steadily, reflecting strong appetite in primary auctions in the face of the growing universe of negative yielding bonds. The US dollar continues to mirror changes in expectations of monetary policy action by the Fed.

On the domestic front, the recently released provisional estimate of gross value added (GVA) for 2015-16 marginally scaled down the annual growth rate to 7.2 per cent, on a deceleration of services sector activity in relation to the advance estimates. There was, however, a sequential pickup in activity in Q4 in line with expectations. The India Meteorological Department (IMD) has forecast an above-normal and well-distributed south west monsoon with a slightly delayed onset. Good monsoon critical for the outlook for agriculture since reservoir levels have been depleted to 17 per cent of capacity – 40 per cent lower than the level a year ago.

In May 2016, the manufacturing purchasing managers' index (PMI) remained subdued on account of slowing output and export orders. There are signs that corporate performance is improving. The Reserve Bank's latest rounds of forward looking surveys indicate an improvement in the overall business situation, driven by a pick-up in capacity utilisation and in order books – both domestic and external.

Inflation increased in the months of April and May 2016. Retail inflation rose more sharply than expected due to a more-than seasonal jump in food prices. Within the food group, inflation in respect of vegetables, fruits, sugar, meat and fish rose sizably. Inflation in respect of pulses remained elevated; the recent decline in prices of pulses reversed, yielding a sharp increase in April. Cereal inflation, however, remained subdued, reflecting supply management efforts that expanded offtake from food stocks. Inflation in respect of the fuel group eased mainly due to firewood and stronger deflation in respect of LPG prices.

CPI inflation excluding food and fuel edged up in April, driven by prices of petrol and diesel embedded in transport and communication. Services inflation remained elevated on account of house rents, water charges, tuition fees and taxi/auto fares. Excluding petrol and diesel from this category, inflation was sticky and above 5 per cent

Despite the waning of liquidity pressures in early April, stronger-than-usual currency demand during the first two months of the financial year and build-up of cash balances by the Government from the second week of May tightened liquidity conditions from mid-May. In order to mitigate these pressures, the Reserve Bank injected liquidity through purchases under open market operations (OMOs) of Rs 700 billion during April-May in pursuance of the revised liquidity management framework outlined in the April bi-monthly policy statement. Additionally, liquidity was injected through variable rate repos of various tenors, in addition to the regular 14-day term repos and overnight fixed rate repo and MSF. The average daily net liquidity injection through the liquidity adjustment facility (including MSF) declined from Rs 1935 billion in March 2016 to Rs 1030 billion during April-May and further to Rs120 billion in June (up to June 5, 2016). Volatility also declined significantly. Interest rates on money market instruments such as certificates of deposit (CDs) and commercial paper (CPs) also eased through the quarter so far.

Policy Stance and Rationale

The inflation surprise in the April reading makes the future trajectory of inflation somewhat more uncertain. The expectations of a normal monsoon and a reasonable spatial and temporal distribution of rainfall, along with various supply management measures and the introduction of the electronic national agriculture market (e-NAM) trading portal, should moderate unanticipated flares of food inflation. In addition, capacity utilisation indicators suggest that the available headroom in industry could keep output prices subdued even as demand picks up. Nonetheless, there are upside risks – firming international commodity prices, particularly of crude oil; the implementation of the 7th Central Pay Commission awards which will have to be factored into projections as soon as clarity on implementation emerges; the upturn in inflation expectations of households and of corporates; and the stickiness in inflation excluding food and fuel. Taking these factors into account, the inflation projections given in the April policy statement are retained, though with an upside bias.

In its bi-monthly monetary policy statement of April 2016, the Reserve Bank stated that it would watch macroeconomic and financial developments in the months ahead with a view to responding as space opens up. A strong monsoon, continued astute food management, as well as steady expansion in supply capacity, especially in services, could help offset these upward pressures. Given the uncertainties, the Reserve Bank will stay on hold, but the stance of monetary policy remains accommodative.

More monetary transmission to support the revival of growth continues to be critical. The government's reform measures on small savings rates combined with the Reserve Bank's refinements in the liquidity management framework should help the transmission of past policy rate reductions into lending rates of banks. The Reserve Bank will shortly review the implementation of the Marginal Cost Lending Rate framework by banks. Timely capital infusions into constrained public sector banks will also aid credit flow.

Third bi-monthly monetary policy statement for fiscal year 2016-17 August 9, 2016.

Conclusion:

Although status quo continues, RBI remains in an accommodative stance with upside risk for inflation due to recent upticks in CPI data. But the space for a rate cut has reduced.

RBI said that is has made enough provisions through forward contracts for the USD outflow scheduled in the month of September. RBI will continue to provide the liquidity in the money market.

The benchmark 10 year G-sec was at 7.47%. The bonds are likely to remain range bound between 7.45-7.50%. There are a few uncertainties in the form of rainfall Brexit and FOMC. At present we are maintaining a modified duration of around 4-5 years in all our Funds which will benefit us as the liquidity increases and spreads between the repo rate and the 10 year g-sec compresses.