Sixth Bi-monthly Monetary Policy Statement, 2019-20

February 06, 2020

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 December 2019, global economic activity has remained slow-paced, but is getting differentiated across geographies. Among the key advanced economies (Aes), the US economy grew by 2.1 percent in Q4:2019, the same pace as in Q3, with slack in consumer spending offset by government expenditure. In the euro area, economic activity slowed down in Q4 as France and Italy shrank unexpectedly amid waning consumer confidence. The Japanese economy was weighed down in Q4 by weak retail sales as reflected in subdued consumer spending in the wake of the sales tax hike in October.

Among emerging market economies (EMEs), the Chinese economy slowed down to a 29-year low of 6.1 per cent in 2019, caused by sluggish domestic demand and prolonged trade tensions. In Russia, available indicators point to a loss of momentum in activity in Q4:2019 with industrial production easing, although private consumption may have provided some cushion.

Crude oil and gold prices shot up in early January sparked by the US-Iran confrontation, but both softened from mid-January as geo-political tensions eased. By end January, crude oil prices dipped sharply due to sell-offs triggered by the outbreak of the coronavirus.

Global financial markets remained resilient in December 2019 and for the most part of January 2020 as thawing US-China trade relations and improved prospects of an orderly Brexit buoyed investors' sentiment. Equity markets rallied across AEs and EMEs, turning bearish towards end-January with the outbreak of the coronavirus as markets braced up for the likely adverse impact on growth prospects, particularly in China.

Bond yields, which had hardened in the US towards the end of 2019 as investors turned to riskier assets, softened in January 2020, especially after the US Fed left the policy rate unchanged and assured the extension of repo operations. Yields also softened across several EMEs.

On the domestic front, both production and imports of capital goods – two key pointers of investment activity – continued to contract in November/December, though at a moderate pace compared with the previous month. As per revised estimates given in the Union Budget, growth in revenue expenditure of the Centre (excluding interest payments and subsidies) is estimated to be lower in Q4 compared with Q3.

Rabi sowing has been higher by 9.5 percent up to January 31, 2020 compared with a year ago. The north east monsoon rainfall was above normal. Storage in major reservoirs – the main source of irrigation during the rabi season – was 70 percent of the full reservoir level (as on January 30, 2020) as compared with 45 percent a year ago.

Several high frequency indicators of services have turned upwards in the recent period, pointing to a modest revival in momentum, although the outlook is still muted. Amongst indicators of rural demand, while tractor sales grew by 2.4 percent in December after ten months of a decline, motorcycle sales continued to contract. Growth in three-wheeler sales and railway freight traffic has accelerated. The PMI services index improved to 55.5 in January 2020 from 52.7 in November 2019, boosted by a rise in new business and output.

Retail inflation, measured by year-on-year changes in the CPI, surged from 5.5 percent in November to 7.4 percent in December 2019, the highest reading since July 2014. While food group inflation rose to double digits, the fuel group moved out of deflation.

CPI food inflation increased from 6.9 percent in October to 12.2 percent in December, primarily caused by a spike in onion prices due to unseasonal rains in October-November. In addition, inflation in several other food sub-groups such as milk, pulses, cereals, edible oils, eggs, meat and fish also firmed up. CPI inflation excluding food and fuel rose from a low of 3.4 percent in October to 3.8 percent by December 2019, driven by an increase in inflation in mobile phone charges, petrol, diesel, transportation fares and clothing

Overall liquidity in the system remained in surplus in December 2019 and January 2020. The Reserve Bank conducted four auctions involving the simultaneous purchase of long-term and sale of short-term government securities under open market operations (OMOs) for a notified amount of ₹ 10,000 crore each during December 19 and January 20. Reflecting these operations, the 10-year G-sec yield softened cumulatively by 15 bps between December 19, 2019 and January 31, 2020. During the intervening period, however, the yields fell by as much as 25 bps.

Monetary transmission across various money market segments and the private corporate bond market has been sizable. As against the cumulative reduction in the policy repo rate by 135 bps since February 2019, transmission to various money and corporate debt market segments up to January 31, 2020 ranged from 146 bps (overnight call money market) to 190 bps (3-month CPs of non-banking finance companies). Transmission through the longer end of government securities market was at 73 bps (5-year government securities) and 76 bps (10-year government securities).

Net foreign direct investment rose to US$ 24.4 billion in April-November 2019 from US$ 21.2 billion a year ago. Net foreign portfolio investment was of the order of US$ 8.6 billion in 2019-20 (up to February 4) as against net outflows of US$ 14.2 billion in the same period last year. In addition, net investments by FPIs under the voluntary retention route have aggregated US$ 7.8 billion since March 11, 2019. India's foreign exchange reserves were at US$ 471.4 billion on February 4, 2020 – an increase of US$ 58.5 billion over end-March 2019.

Outlook

In the fifth bi-monthly resolution of December 2019, CPI inflation was projected at 5.1-4.7 per cent for H2:2019-20 and 4.0-3.8 percent for H1:2020-21, with risks broadly balanced.

The inflation path is shaped by the following factors:

- Food inflation is likely to soften from the high levels as onion prices fall rapidly in response to arrivals of late kharif and rabi harvests. The recent pick-up in prices of milk and Pulses are likely to sustain which could impart some upward bias
- Crude prices are likely to remain volatile due to unabating geo-political tensions in the Middle East on the one hand, and the uncertain global economic outlook on the other
- Domestic financial markets remain volatile reflecting both global and domestic factors, which may have an influence on the inflation outlook
- Base effects would turn favourable during Q3:2020-21.
- The increase in customs duties on items of retail consumption in the budget may result in only a marginal one-time uptick in inflation.

Taking into consideration these factors, the CPI inflation projection is revised upwards to 6.5 per cent for Q4:2019-20; 5.4-5.0 percent for H1:2020-21; and 3.2 per cent for Q3:2020-21, with risks broadly balanced

For 2020-21, the growth outlook will be influenced by the following factors:

- Private consumption, particularly in rural areas, is expected to recover on the back of improved rabi prospects
- The easing of global trade uncertainties should encourage exports and spur investment activity. The breakout of the coronavirus may, however, impact tourist arrivals and global trade
- Monetary transmission in terms of a reduction in lending rates and financial flows to the commercial sector has progressed and this could spur both consumption and investment demand

Taking into consideration the above factors, GDP growth for 2020-21 is projected at 6.0 percent – in the range of 5.5-6.0 percent in H1 and 6.2 percent in Q3.

The MPC notes that inflation has surged above the upper tolerance band around the target in December 2019, primarily on the back of the unusual spike in onion prices. Over the coming weeks and months, onion prices are likely to ebb as supply conditions improve. Going forward, the trajectory of inflation excluding food and fuel needs to be carefully monitored as the pass-through of remaining revisions in mobile phone charges, the increase in prices of drugs and pharmaceuticals and the impact of new emission norms play out and feed into inflation formation. The MPC anticipates that the combination of these factors may keep headline inflation elevated in the short-run, at least through H1:2020-21. Overall, the inflation outlook remains highly uncertain

The MPC observes that the economy continues to be weak and the output gap remains negative. While some high-frequency indicators have turned around and point to a lift in the momentum of economic activity, there is a need to await incoming data to gauge their sustainability.

The fiscal deficit of the Central Government for 2019-20 is placed at 3.8 percent of GDP in the revised estimates as against 3.3 percent of GDP in the budget estimates. The fiscal deficit is budgeted to decline to 3.5 percent of GDP for 2020-21. Fresh gross market borrowings are budgeted to increase by ₹ 70,000 crore to ₹ 7.8 lakh crore in 2020-21 from ₹ 7.1 lakh crore in 2019-20.

The MPC notes that while there is a need for adjustment in interest rates on small saving schemes, the external benchmark system introduced from October 1, 2019 has strengthened monetary transmission. These developments should amplify the effects of the cumulative policy rate reductions undertaken by the Reserve Bank since February 2019 and pull up domestic demand going forward

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 during 31st March, 1st & 3rd April, 2020.

Statement on Development and Regulatory Policies

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

1). Revised Liquidity Management Framework: The key elements of the revised framework are set out below:

- The daily fixed rate repo and four 14-day term repos every fortnight being conducted, at present, are being withdrawn. However, the Reserve Bank will ensure adequate provision/absorption of liquidity as warranted by underlying and evolving market conditions - unrestricted by quantitative ceilings - at or around the policy rate.
- A 14-day term repo/reverse repo operation at a variable rate and conducted to coincide with the cash reserve ratio (CRR) maintenance cycle would be the main liquidity management tool for managing frictional liquidity requirements.
- The current requirement of maintaining a minimum of 90 per cent of the prescribed CRR on a daily basis will continue.
- Standalone Primary Dealers (SPDs) would be allowed to participate directly in all overnight liquidity management operations.
- The margin requirements under the Liquidity Adjustment Facility (LAF) would be reviewed on a periodic basis; the margin requirement for reverse repo transactions, however, would continue to be 'Nil'.

2). The Reserve Bank ensured that comfortable liquidity is available in the system in order to facilitate the transmission of monetary policy actions and flow of credit to the economy. Accordingly, it has decided that from the fortnight beginning on February 15, 2020, the Reserve Bank shall conduct term repos of one-year and three-year tenors of appropriate sizes for up to a total amount of ₹ 1,00,000 crore at the policy repo rate.

3). The Reserve Bank has decided that scheduled commercial banks will be allowed to deduct the equivalent of incremental credit disbursed by them as retail loans for automobiles, residential housing and loans to micro, small and medium enterprises (MSMEs), over and above the outstanding level of credit to these segments as at the end of the fortnight ended January 31, 2020 from their net demand and time liabilities (NDTL) for maintenance of cash reserve ratio (CRR). This exemption will be available for incremental credit extended up to the fortnight ending July 31, 2020.

4). RBI has decided to permit extension of date of commencement of commercial operations (DCCO) of project loans for commercial real estate, delayed for reasons beyond the control of promoters, by another one year without downgrading the asset classification, in line with treatment accorded to other project loans for non-infrastructure sector.

5). The Reserve Bank shall construct and periodically publish a composite "Digital Payments Index" (DPI) to capture the extent of digitisation of payments effectively.

Our Views & Conclusion:

The 10 yr G-sec yield was at around 6.50% before the policy announcement which softened to 6.45% due to the announcements in the Monetary policy on Long Term repo borrowings and the 15 day LAF repos. The 1and 3 year repo borrowing for the banks have triggered a 20 bps rally in the short end of the yield curve. Since the inflation is expected to be around 6% in the Q4FY20 and H1FY21, it is expected that the 10 year will be range bound and there could be further softening of near term rates in view of no daily repos under LAF. We will be keeping a close watch on the inflation and crude oil data and have positioned the Funds in the medium segment of the yield curve