

# Fourth Bi-monthly Monetary Policy Statement, 2019-20

October 04, 2019

## Policy Actions

Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 5.40 percent to 5.15 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 per cent within a band of +/- 2 per cent, while supporting growth.

## Policy Assessment

Since the MPC's last meeting in August 2019, global economic activity has weakened further. Among advanced economies (Aes), the slowdown in the US economy in Q2:2019 appears to have extended into Q3:2019, weighed down by softer industrial production. In the Euro area too, incoming data suggest that activity may have moderated further in Q3, with retail sales declining and manufacturing PMI remaining in contraction for the eighth consecutive month in September.

The macroeconomic performance of major emerging market economies (EMEs) was weighed down by a deteriorating global environment in Q3. The Chinese and Russia economy appears to have slowed down in Q3.

Crude oil prices were pulled down by softer demand, amidst adequate supplies in early August. Gold prices remained elevated on safe haven demand.

In the US, bond yields, continued easing till August on growth worries, before a slight uptick was triggered in early September by better than expected US retail sales data and hopes of conciliatory trade negotiations between the US and China. In the Euro area, bond yields sank further into negative territory, propelled by the cut in the deposit rate by the European Central Bank (ECB) to (-) 0.5 per cent and the reintroduction of quantitative easing.

In EMEs, bond yields exhibited mixed movement. In currency markets, the US dollar strengthened against currencies of other Aes. EME currencies, which were trading with a depreciating bias in August, appreciated in early September on country-specific factors and a revival of global risk-on sentiment.

On the domestic front, growth in gross domestic product (GDP) slumped to 5.0 per cent in Q1:2019-20, for the fifth quarter. Agriculture and allied activities were lifted by higher production of wheat and oilseeds during the 2018-19 rabi season. Growth in the services sector was stalled by construction activity.

As of September 30, 2019, the cumulative all-India rainfall surpassed the long period average (LPA) by 10 per cent. Looking ahead at the rabi season, the live storage of water in major reservoirs was 115 per cent of the live storage. Overall, the prospects of agriculture have brightened considerably, positioning it favourably for regenerating employment and income, and the revival of domestic demand.

High frequency indicators suggest that services sector activity weakened in July-August. Indicators of rural demand, viz., tractor and motorcycles sales, contracted. Of underlying indicators of urban demand, passenger vehicle sales contracted in July-August, while domestic air passenger traffic accelerated in August. The sales of commercial vehicles, a key indicator for the transportation sector, contracted by double digits in July-August.

Retail inflation, measured by y-o-y changes in the CPI, moved in a narrow range of 3.1- 3.2 per cent between June and August. While food inflation picked up, fuel prices moved into deflation. Inflation excluding food and fuel softened in August

CPI inflation excluding food and fuel increased in July, - mainly bullion prices, and transport and communication, reflecting rise in prices of petrol and diesel. Gold prices spiked further on global uncertainties.

Overall liquidity remained surplus in August and September 2019 despite expansion of currency in circulation and forex operations by the Reserve Bank draining liquidity from the system. Net daily average absorption under the LAF amounted to Rs. 1,40,497 crore in August, essentially on account of spending by the government.

Monetary transmission has remained staggered and incomplete. As against the cumulative policy repo rate reduction of 110 bps during February-August 2019, the weighted average lending rate (WALR) on fresh rupee loans of commercial banks declined by 29 bps.

Net foreign direct investment rose to US\$ 17.7 billion in April-July 2019 from US\$ 11.4 billion a year ago. Net foreign portfolio investment (excluding the voluntary retention route) was of the order of US\$ 3.3 billion during April-September 2019 as against net outflow of US\$ 11.5 billion in the same period of last year. India's foreign exchange reserves were at US\$ 434.6 billion on October 1, 2019 - an increase of US\$ 21.7 billion over end-March 2019.

## Outlook

In the third bi-monthly resolution of August 2019, CPI inflation was projected at 3.1 per cent for Q2:2019-20, 3.5-3.7 per cent for H2:2019-20 and 3.6 per cent for Q1: 2020-21 with risks evenly balanced. The actual inflation outcomes for Q2 so far (July-August) at 3.2 per cent have been broadly in line with these projections.

The inflation path is shaped by the following factors:

- The outlook for food inflation has improved considerably since the august bi-monthly policy.
- Price pressures in CPI excluding food and fuel are likely to be muted.
- Crude oil prices may remain volatile in the near-term; while global demand is slowing down, the persisting geo-political uncertainties pose some upside risks to the inflation outlook
- Financial markets remain volatile with currencies of several emerging market economies trading with a depreciating bias in the recent period.

Taking into consideration these factors and the impact of recent policy rate cuts, the CPI inflation projection is revised slightly upwards to 3.4 per cent for Q2:2019-20, while projections are retained at 3.5-3.7 per cent for H2:2019-20 and 3.6 per cent for Q1:2020-21, with risks evenly balanced.

Real GDP growth for 2019-20 in the August policy was projected at 6.9 per cent - in the range of 5.8-6.6 per cent for H1:2019-20 and 7.3-7.5 per cent for H2 - with risks somewhat tilted to the downside; GDP growth for Q1:2020-21 was projected at 7.4 per cent. GDP growth for Q1:2019-20 was significantly lower than projected.

The MPC notes that the negative output gap has widened further. While the recent measures announced by the government are likely to help strengthen private consumption and spur private investment activity, the continuing slowdown warrants intensified efforts to restore the growth momentum. With inflation expected to remain below target in the remaining period of 2019-20 and Q1:2020-21, there is policy space to address these growth concerns by reinvigorating domestic demand within the flexible inflation targeting mandate. It is in this context that the MPC decided to continue with an accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target.

**The MPC decided to reduce the policy repo rate by 25 basis points and to maintain the accommodative stance of monetary policy.**

Five members voted to reduce the policy repo rate by 25 basis points, while one member voted to reduce the policy repo rate by 40 basis points.

The next meeting of the MPC is scheduled on December 3-5, 2019.

## Statement on Development and Regulatory Policies

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

- Increase the household income limit for borrowers of NBFC-MFIs from the current level of Rs. 1 lakh for rural areas and Rs. 1.60 lakh for urban/semi urban areas to Rs.1.25 lakh and Rs. 2 lakh, respectively. Also raised the lending limit from Rs. 1 lakh to Rs.1.25 lakh per eligible borrower.
- RBI Allowing domestic banks to freely offer foreign exchange prices to non-residents at all times, out of their Indian books, either by a domestic sales team or through their overseas branches.
- RBI will extend the collateralised liquidity support, which is currently available till 7.45 pm on NEFT working days, round the clock.

## Our Views & Conclusion:

The 10 yr G-sec yield was at around the levels 6.60% before the policy and has not increased to 6.65% mainly on the concerns of extra government borrowing going forward in the last quarter of FY20. Another factor for the yields not softening is the fact that the OMO purchase by the RBI has stopped as there is ample liquidity in the system. The OMO purchase also helps in the reducing the floating stock in the system while giving exit to the traders. Since RBI is not conducting the OMO purchase, yields are not softening further. RBI has signaled accommodative stance going forward aimed at aiding the growth and the market can expect further rate cuts in the policy rates. By RBI going forward. Impact of Normal monsoon, direct tax & GST collections, final decision on the issue of overseas sovereign bonds, US & China trade war, oil prices and expected fiscal slippages as a result of cut in the corporate tax might impact bond yields in the near future.

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