First Bi-monthly Monetary Policy Statement, 2018-19

October 5, 2018

Policy Actions

Keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.50 percent.

Consequently, the reverse repo rate under the LAF remains at 6.25 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 6.75 per cent.

The decision of the MPC is consistent with the stance of calibrated tightening of monetary policy in consonance with the objective of achieving the medium term target for consumer price index (CPI) inflation at 4 per cent with in a band of +/- 2 per cent, while supporting growth.

Policy Assessment

Since the MPC's last meeting in August 2018, global economic activity has remained resilient in spite of ongoing trade tensions, but the outlook is clouded by several uncertainties. Among advanced economies (Aes), the United States (US) economy appeared to have sustained pace in Q3:2018. In the Euro area, economic activity remained subdued due to overall weak economic sentiment, weighed down mainly by political uncertainty.

Economic activity in major emerging market economies (EMEs) has been facing headwinds from both global and country-specific factors. In China, industrial production growth has moderated with slowing exports and the ongoing deleveraging of the financial system weighing on growth prospects. The Russian economy has been gathering steam with the manufacturing sector turning around, and the employment scenario remaining upbeat on rising oil prices. The South African economy slipped into recession in Q2:2018.

Global financial markets continued to be affected by monetary policy stances in major AEs, the spreading of contagion risks from specific EMEs, and geopolitical developments. The 10-year sovereign yield in the US increased by end-September on robust economic data. EME currencies continued to depreciate against the US dollar.

On the domestic front, real gross domestic product (GDP) growth surged to a nine-quarter high of 8.2 per cent in Q1:2018-19, extending the sequential acceleration to four successive quarters. The growth of exports of goods and services jumped to 12.7 per cent, powered by non-oil exports on the back of strong global demand. In spite of import growth continuing to surge, high exports growth helped reduce the drag from net exports on aggregate demand.

Agricultural growth also picked up, supported by robust growth in production of rice, pulses and coarse cereals alongside a sustained expansion in livestock products, forestry and fisheries. In contrast, services sector growth moderated on account of a high base. Construction activity, maintained strong pace for the second consecutive quarter.

The progress of the south-west monsoon has been marked by uneven spatial and temporal distribution, with an overall deficit of 9 per cent in precipitation. However, the first advance estimates of production of major kharif crops for 2018-19 have placed foodgrains production at 141.6 million tonnes, 0.6 per cent higher than last year's level. The live storage in major reservoirs (as on September 27) rose to 76 per cent of the full capacity, which was 17 per cent higher than last year and 5 per cent higher than the average of the last 10 years. This bodes well for the rabi sowing season.

High-frequency indicators of services in July and August present a mixed picture. Indicators of rural demand, viz., growth in tractor and two-wheeler sales, slowed down. Passenger vehicle sales, an indicator of urban demand, declined possibly due to rising fuel prices. However, growth in air passenger traffic – remained robust. Transportation sector indicators, viz., commercial vehicle sales and port cargo, expanded at an accelerated pace.

Retail inflation, measured by the y-o-y change in the CPI, fell from 4.9 per cent in June to 3.7 per cent in August, due to a decline in food inflation. Some softening of inflation in items other than food and fuel also contributed to the decline. Adjusting for the estimated impact of an increase in house rent allowance (HRA) for central government employees, headline inflation was at 3.4 per cent.

Inflation in the food and beverages group declined sharply. Inflation in the fuel and light group continued to rise on the back of a significant increase in liquefied petroleum gas prices, tracking international product prices.

From a daily net average surplus of ₹201 billion during August 1-19, 2018, liquidity moved into deficit during August 20-30. After turning into surplus during August 31-September 10 due to increased government spending, the system again moved into deficit during September 11-29 on the back of an increase in government cash balances and Reserve Bank's forex interventions. Based on an assessment of the evolving liquidity conditions, the Reserve Bank conducted two open market purchase operations to inject ₹ 200 billion of durable liquidity. LAF operations absorbed, on a daily net average basis, ₹30 billion in August, but injected ₹ 406 billion in September.

On the financing side, net foreign direct investment (FDI) flows improved in April-July 2018. By contrast, foreign portfolio investors have been net sellers in both the equity and debt segments so far on a cumulative basis in 2018-19 due to higher US interest rates, risk-off sentiment in EMEs and escalation of trade wars. India's foreign exchange reserves were at US$ 400.5 billion on September 28, 2018.

Outlook

In the third bi-monthly resolution of August 2018, CPI inflation was projected at 4.6 per cent in Q2:2018-19, 4.8 per cent in H2 and 5.0 per cent in Q1:2019-20, with risks evenly balanced. Actual inflation outcomes, especially in August, were below projections as the expected seasonal increase in food prices did not materialise and inflation excluding food and fuel moderated.

The headline inflation outlook is driven by the following effects:

- Food inflation has remained unusually benign, which imparts a downward bias to its trajectory in the second half of the year.
- The risk to food inflation from spatially and temporally uneven rainfall is also mitigated, as confirmed by the first advance estimates that have placed production of major kharif crops for 2018-19 higher than last year's record.
- The price of the Indian basket of crude oil has increased sharply, by US$ 13 a barrel, since the last resolution.
- International financial markets remained volatile with EME currencies depreciating
- The HRA effect came off its peak in June and is dissipating gradually on expected lines. Taking all these factors into consideration, inflation is projected at 4.0 per cent in Q2:2018-19, 3.9-4.5 per cent in H2 and 4.8 per cent in Q1:2019-20, with risks somewhat to the upside.

Both global and domestic financial conditions have tightened, which may dampen investment activity. Rising crude oil prices and other input costs may also drag down investment activity by denting profit margins of corporates. Tailwinds from the recent depreciation of the rupee could be muted by the slowing down of global trade and the escalating tariff war.

GDP growth projection for 2018-19 is retained at 7.4 per cent as in the August resolution (7.4 per cent in Q2 and 7.1-7.3 per cent in H2)

While the projections of inflation for 2018-19 and Q1:2019-20 have been revised downwards from the August resolution, its trajectory is projected to rise above the August 2018 print.

The outlook is clouded with several uncertainties:

- Government announced in September measures aimed at ensuring remunerative prices to farmers for their produce, although uncertainty continues about their exact impact on food prices.
- Oil prices remain vulnerable to further upside pressures, especially if the response of oil-producing nations to supply disruptions from geopolitical tensions is not adequate.
- Volatility in global financial markets continues to impart uncertainty to the inflation outlook.
- A sharp rise in input costs, combined with rising pricing power, poses the risk of higher passthrough to retail prices for both goods and services.
- Should there be fiscal slippage at the centre and/or state levels, it will have a bearing on the inflation outlook.
- The staggered impact of HRA revision by the state governments may push up headline inflation.

The MPC decided to keep the policy repo rate unchanged. The MPC reiterates its commitment to achieving the medium-term target for headline inflation of 4 per cent on a durable basis.

The MPC notes that global headwinds in the form of escalating trade tensions, volatile and rising oil prices, and tightening of global financial conditions pose substantial risks to the growth and inflation outlook. It is, therefore, imperative to further strengthen domestic macroeconomic fundamentals.

Except for Dr. Chetan Ghate all the other five members of MPC voted in favour of the monetary policy decision.

Regarding the stance except for Dr. Ravindra H. Dholakia (who voted to keep the neutral stance unchanged) all the other five members voted in favour of changing the stance to calibrated tightening.

The next meeting of the MPC is scheduled on December 3 to 5, 2018.

Statement on Development and Regulatory Policies

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

- To encourage FPIs willing to undertake long-term investments, a special Route called 'Voluntary Retention Route' (VRR) is being proposed. Under the proposed Route, FPIs will have more operational flexibility in terms of instrument choices as well as exemptions from regulatory provisions such as the cap on short-term investments (less than one year) at 20% of portfolio size, concentration limits, and caps on exposure to a corporate group (20% of portfolio size and 50% of a single issue). To be eligible to invest under this route, FPIs would need to voluntarily commit to retain in India a minimum required percentage of their investments for a period of their choice. FPIs would apply for investment limits under the Route through an auction process.
- To improve the governance of the benchmark processes, RBI proposed to introduce a regulatory framework for financial benchmarks which shall apply, initially, to benchmarks issued by the Financial Benchmarks of India Ltd. (FBIL).

Our Views & Conclusion:

The 10 yr G-sec yield was at 8.13%before the Policy and softened to 8.03%. However, there is still uncertainty regarding rate hikes especially with a change of stance to "tightening with calibration". The crude oil prices are still high and rupee has depreciated to ₹74 to a dollar by 7.74% in this quarter. This has also led a strain on the Current Account Deficit as well. The 10 year G-sec yields are expected to stabilize around 8.00-8.25% levels and therefore we are in the process of increasing duration in our Funds to around 4.5 years from the current 2.75 years. These are attractive levels for us to buy and increase the portfolio yield and we will also see capital gains over 1-2 years time.

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