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RBI Policy Update

February 07, 2019

An assessment of RBI's 6th Bi-monthly Monetary Policy Statement, FY 2018-19

RBI's Policy Stance:

Against the market expectations, the MPC decided to cut the repo rate by 25 bps to 6.25% and changed its stance to "Neutral" from the earlier "Calibrated Tightening". This is the first rate cut announced by the MPC since August'17 and this could mark a reversal in the rate cycle. **The MPC reiterated its commitment to achieve the medium-term target for headline inflation of 4% within a band of +/- 2% while supporting growth and decided to**:

- **reduce** the policy repo rate under the liquidity adjustment facility (LAF) by **25 basis points** from **6.5% to 6.25%** with immediate effect;
- change of the monetary **policy stance** from calibrated tightening to **neutral**

Variable	Stands at
Repo	6.25%
Reverse Repo	6.00%
CRR	4.00%
MSF	6.50%
SLR	19.25%

Source: www.rbi.org.in

Policy Stance & Rationale:

- The 6th bi-monthly policy meeting of FY1819, the first chaired by the new Reserve Bank of India governor Shaktikanta Das shocked market participants by voting in for a rate cut of 25 bps with 2 MPC Members voting against a rate cut.
- During the 6th bi-monthly policy meeting, RBI decided to reduce the benchmark interest rate amidst reduction in retail inflation and weakening of global economic activity based on the current and evolving macroeconomic situation. The MPC reduced the policy repo rate under the liquidity adjustment facility (LAF) by 25bps from 6.5% to 6.25%. Consequently, the reverse repo rate under the LAF stands adjusted to 6.0%, and the marginal standing facility (MSF) rate and the Bank Rate to 6.5%. The committee also decided to change its stance to 'neutral' from 'calibrated tightening'. The recent economic developments as well as the interim budget proposal impact were factored in for the policy decision.
- Since the last monetary policy meet, globally, the economic situation and governance slowdown in major economies have impacted the domestic market sentiments. with US losing steam and industrial activity weakening in Euro area. During the last month, domestic markets were positively impacted by the tailwinds of weakening in the Eurozone, US markets losing steam after the announcement of the Fed Chairman to be watchful about the future rate hikes, reduction in the global trade tensions and an impending shutdown in US. The 10-year yield in the US, rose in Jan'19 on the back of increase in crude oil prices and some truce in sight of the ongoing trade wars, though softening of the Fed stance restricted the gains. Bond yields softened in Euro region, Japan as well as most Emerging economies on the back of diminishing optimism about global growth. In addition, Japan started recovering gradually and policy stance changed to accommodative. The deceleration also continued in emerging economies like china showing stalled growth in Q42018, softening oil price posing downside risk to Russian economy and South African having weak industrial activity. Macro-economic indicators showed some sign of improvement as compared to Dec'18 numbers with crude recovering and remaining range bound and inflation edging lower in Advanced as well as Emerging economies.
- On the domestic front, the release of the first advance estimates (FAE) for 2018-19, by the Central Statistics Office (CSO) have positioned India's real GDP growth at 7.2%. The FAE highlighted an

acceleration in gross fixed capital formation along with a slowdown in consumption expenditure on both private and government sides. The GVA growth got revised to 7.0% in 2018-19 compared to 6.9% in 2017-18, on back of an acceleration in industrial growth and growth in public administration and moderating defence services.

- Retail inflation declined to 2.2% in Dec'18 from 3.4% in Oct'18, primarily because of deflation in food items, a sharp fall in fuel inflation. Other Non-food and fuel items in the CPI Basket also helped inflation in its downward trajectory. Housing inflation continued to edge down as the impact of the house rent allowance (HRA) increase for central government employees dissipated

- Weak global demand and high base effect resulted in the export numbers not inching from their previous month print. Growth of imports slowed in Nov'18 and turned negative in Dec'18. The trade deficit for April-December 2018 was higher than its level a year ago. FDI net flows to India during April-November 2018 were higher than a year ago. Foreign portfolio flows turned negative in January 2019, after rebounding in November and December 2018. Foreign exchange reserves of India were at US$ 400.2 billion on February 1, 2019.

Outlook:

- However, the budget focus on boosting consumption on the back of announcing tax relief to a specific cadre of population which could lead to increase in spending capacity and in turn put pressure on inflation. During, the Interim budget, 2019-20, government has revised the fiscal deficit to 3.4% for FY19 and FY20 as well which could put upwards pressure on interest rates as the deficit could lead to more borrowing by the government to make up for the expenses in coming months. Additionally, the announcement of tax relief in the budget could lead to increase in spending capacity and in turn put pressure on inflation.

- Volatile crude oil prices and other input costs may also drag down investment activity and could impact the profit margins of corporates. In addition, volatile movement in rupee and trade related conflict could impact the export growth which could lead to a further widening of India's CAD in FY19.

- The shift in stance of monetary policy from calibrated tightening to neutral provides RBI the flexibility and room to address the challenges to sustain growth of the Indian economy, if inflation is curbed. Going ahead, we expect the RBI to be more data dependent and it is expected to closely monitor data, both domestically and internationally and decide the course of interest rates more prudently.

- RBI has kept the OMO support for the market and has announced Rs. 36,000 Cr worth of OMO for the month of Feb and the same shall continue till March. RBI is expected to closely monitor the liquidity condition in the last quarter of financial year. With CPI remaining contained and central bankers like US Fed giving dovish commentary and keeping in mind the expansionary fiscal policy, RBI has reduced rates hinting at the end of the calibrated tightening cycle. In near term, interest rates are expected to remain range bound.