

Third Bi-monthly Monetary Policy Update, 2018-19

August, 2018

Outcome of the third bi-monthly monetary policy was in line with market expectation. However, this move came after witnessing further uptick in inflation. Based on an assessment of current and evolving macroeconomic situations, majority members of Monetary Policy Committee (MPC) voted to increase the benchmark repo rate by 25bps for the consecutive second straight time.

Key Outcome

- The policy repo rate under the liquidity adjustment facility (LAF) was increased by 25bps to 6.50%
- Consequently, the reverse repo rate under the liquidity adjustment facility (LAF) and marginal standing facility (MSF) was increased by 25bps to 6.25% and 6.75% respectively
- Cash Reserve Ratio (CRR) of scheduled banks remained unchanged at 4% of net demand and time liability (NDTL)

However, the decision of the MPC is consistent with the neutral stance of monetary policy in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2% while supporting growth.

Inflation Outlook

The June round of the RBI survey of households reported a further uptick of 20bps in inflation expectations for both three-month and one-year ahead horizons compared with the last round. Further, retail inflation, measured by YoY change in the CPI, rose from 4.9% in May 2018 to 5% in June, driven by an uptick in inflation in fuel and in items other than food and fuel, even as food inflation remained muted due to lower than usual seasonal uptick in prices of fruits and vegetables in summer months. Inflation also picked up modestly with regards to education and health. Further, RBI projected Q2FY19 inflation at 4.6%. At the same time, the RBI expects CPI inflation for H2FY19 at the lower end of projection of 4.8% from earlier projection of 4.8-4.9%. It subsequently forecast the CPI inflation of 5% for Q1FY20 with risk evenly balanced. This includes the HRA impact for central government employees with risks tilted to the upside. However, excluding the impact of HRA revisions, CPI inflation is projected at 4.4% in Q2FY19 and 4.7-4.8% in H2FY19 and 5.0% in Q1FY20. Moreover, MPC notes that inflation outlook is likely to be shaped by following factors:

- a. Hike in MSP will have direct impact on food inflation and second round effects on headline inflation
- b. Overall performance of monsoon
- c. Elevated crude oil prices
- d. Pass through impact of GST rates
- e. Inflation excluding food and fuel has risen significantly

However, MPC reiterates its commitment to achieve the medium-term target for headline inflation of 4% on a durable basis.

Growth Outlook

The MPC notes that domestic economic activity has continued to sustain momentum and the output gap has virtually closed. RBI believes that there are several indicators which suggest that economic activity has continued to remain strong. The progress of the monsoon and a sharper than the usual increase in MSPs of kharif crops is expected to boost rural demand by raising farmers' income. Moreover, robust corporate earnings, especially of fast moving consumer goods (FMCG) companies, also reflect buoyant rural demand. Further, investment activity remains firm even as there has been some tightening of financing conditions in the recent period. This is well reflected in recovery in investment activity. However, RBI believes that rising trade protectionism, geopolitical risks, global financial market volatility, and elevated oil prices may continue to pose headwinds to the domestic as well as global growth. Overall, the RBI maintains real GDP growth of 7.4% in FY19, ranging 7.5-7.6% in H1FY19 and 7.3-7.4% in H2 with risks evenly balanced. Further, GDP growth for Q1FY20 is projected at 7.5%.

Conclusion

The MPC's decision to hike policy rates comes against the backdrop of continuous rise in inflation. This the first time since October 2013 that the central bank has hiked borrowing costs at two consecutive policy meetings. However, RBI's move clearly indicates that the policy is hawkish on inflation but dovish on continuous recovery in economic activity. We believe, rate sensitive sector will face demand challenges as rate cycle has gradually turn northward. This might could delay a full-fledged economic recovery, going ahead. The minutes of MPC's meeting will be published by August 16, 2018. The next meeting of the MPC is scheduled from October 3 to 5, 2018.

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