Fifth Bi-monthly Monetary Policy Update, 2018-19

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Outcome of the fifth bi-monthly monetary policy was largely on expected lines. However, this was an expected move as the economy witnessed a sharp fall in inflation rate. Thus, based on an assessment of current and evolving macroeconomic situations, majority members of the Monetary Policy Committee (MPC) voted to keep the key policy rate unchanged.

Key Outcome

- The policy repo rate under the liquidity adjustment facility (LAF) remained unchanged at 6.5%.
- Consequently, the reverse repo rate under the liquidity adjustment facility (LAF) and the marginal standing facility (MSF) also stand unchanged at 6.25% and 6.75% respectively
- Cash Reserve Ratio (CRR) of scheduled banks remained unchanged at 4% of net demand and time liability (NDTL).
- In order to align the SLR with LCR, the RBI proposed to reduce the SLR rates by 25 bps every calendar quarter until the SLR reaches 18% of the NDTL. The first reduction will be effective in the quarter commencing January 2019.

However, the decision of the MPC is consistent with the calibrated tightening 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 November round of the RBI's survey of households reported a softening of inflation by 40 bps for the three-month ahead horizons compared with the last round, while they remained unchanged for the twelve-month ahead horizon. Further, the actual inflation outcome in Q2FY19 at 3.9% was marginally lower than the RBI projection of 4.0%. The October inflation print at 3.3% turned out to be unexpectedly low. With moderation in food inflation, falling crude oil prices, appreciating EM currency, waning HRA effect along with assuming normal monsoon in 2019, the RBI further lowered its inflation projection forecast for H2FY19 to 2.7-3.2% from the earlier projection of 3.9-4.5% and subsequently lowered the CPI inflation forecast to 3.8-4.2% from 4.8% projected earlier for H1FY20, with risk tilted to the upside. RBI projected inflation path remains unchanged after adjusting for the HRA impact of central government employees as this impact dissipates completely from December 2018 onwards.

The RBI believes that the broad-based weakening of food prices imparts downward bias to the headline inflation trajectory, going forward. Moreover, the MPC noted that the benign outlook for headline inflation is driven mainly by the unexpected softening of food inflation and collapse in oil prices in a relatively short period of time. Excluding food items, inflation has remained sticky and elevated.

Further, the MPC notes that inflation outlook is likely to be shaped by following factors:

- ❖ Movement in Crude oil prices
- ❖ Foreign exchange movement
- ❖ Impact of 2019 Monsoon

However, the 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 the Q2FY19 growth was lower than the projected growth in the October policy. However, GDP growth in H1FY19 has been broadly along the projected line. On the positive side, the RBI believes that there has been a significant acceleration in investment activity and high frequency indicators suggest that it is likely to be sustained. Moreover, increased capacity utilization in the manufacturing sector also portends well for new capacity additions. Furthermore, credit offtake from the banking sector has continued to strengthen even as global financial conditions have tightened. FDI flows could also increase with the improving prospects of the external sector.

On the negative side, the RBI believes that lower rabi sowing may adversely affect agriculture and hence rural demand. However, financial market volatility, slowing global demand, and rising trade tensions pose negative risk to exports. On the whole, the RBI maintains real GDP growth of 7.4% (7.2-7.3% in H2) in FY19, with risks broadly balanced. GDP growth forecast for Q1FY20 is maintained at 7.5%, with risks somewhat on the downside.

Conclusion

The MPC's decision to maintain status-quo comes against the backdrop of benign outlook for headline inflation. Moreover, the RBI's proposal to reduce SLR rates would ease the liquidity scenario into the financial systems staring January 2019. Further, the RBI's proposal to link retail loan with external benchmark rates would cheer borrowers from FY20. The minutes of MPC's meeting will be published by Dec 19, 2018. The next meeting of the MPC is scheduled from February 5 to 7, 2019.

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