Fourth Bi-monthly Monetary Policy Update, 2018-19

October, 2018

Outcome of the fourth bi-monthly monetary policy surprised majority of the market participants. The policy-setting committee headed by Governor Mr. Urjit Patel opted to take a pause after hiking the rates in its last two successive policy meetings. Thus, based on the assessment of current and evolving macroeconomic situations, majority members of Monetary Policy Committee (MPC) voted to keep the key policy rate unchanged.

Key Outcome

- The policy repo rate under the liquidity adjustment facility (LAF) remains unchanged at 6.5%
- Consequently, the reverse repo rate under the liquidity adjustment facility (LAF) and marginal standing facility (MSF) also stands unchanged at 6.25% and 6.75% respectively
- Cash Reserve Ratio (CRR) of schedules banks remained unchanged at 4% of net demand and time liability (NDTL)

However, the decision of the MPC is consistent with the change in stance from neutral to 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 September round of the Reserve Bank's survey of households reported a sharp uptick of 50 basis points in three-month ahead horizons compared with the last round. round. However, the actual inflation outcomes, especially in August 2018, were below RBI projections as the expected seasonal increase in food prices did not materialize and inflation excluding food and fuel moderated. RBI believes inflation will remain range bound during the second half of the year due to benign food inflation as the first advance estimates of production of major kharif crops for 2018-19 have placed food-grains production at 141.6 million tonnes, 0.6% higher than last year's level. The recent excise duty cuts on petrol and diesel will moderate retail inflation. We believe this gives RBI the confidence to lower its Q2FY19 inflation projection to 4% from 4.6% projected earlier. At the same time, it can lower its CPI inflation forecast for H2FY19 to 3.9-4.5% from earlier projection of 4.8% and subsequently also lower the CPI inflation forecast to 4.8% from 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, excluding the HRA impact, CPI inflation is projected at 3.7% in Q2FY19, 3.8-4.5% in H2FY19 and 4.8% in Q1FY20. Moreover, MPC notes that inflation outlook is likely to be shaped by following factors:

- Elevated crude oil prices
- Depreciating rupee
- Staggered impact of HRA revision

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 growth of gross value added (GVA) at basic prices accelerated in Q1FY19, underpinned by double-digit expansion in manufacturing activity which was robust and generalized across firm sizes. RBI believes that private consumption has remained robust and is likely to be sustained even as the recent rise in oil prices may have a bearing on disposable incomes. Further, improving capacity utilization, larger FDI inflows and increased financial resources to the corporate sector augur well for investment activity. In addition, RBI believes that rising crude oil prices and other input costs may also drag down investment activity by denting profit margins of corporate. Also, tailwinds from the recent depreciation of the Rupee could be muted by the slowing down of global trade and the escalating tariff war. However, RBI believes 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. On the whole, RBI maintains real GDP growth of 7.4% in FY19, with risks broadly balanced. Also, GDP growth for Q2FY19 was retained at 7.5% and 7.3-7.4% in H2FY19. However, GDP growth forecast for Q1FY20 is projected lowered at 7.4% as against 7.5% projected earlier, mainly due to the strong base effect of Q1FY19.

Conclusion

The MPC's decision to maintain a status quo comes against the backdrop of benign food inflation. However, RBI's change in stance from neutral to calibrated tightening of monetary policy clearly signals that economy to witness either rate hike or status quo outcome in upcoming monetary policy with no possibility of loose monetary policy. We believe rate sensitive sector will face demand challenges as rate cycle has gradually turned northwards, which might further dampen the hope of full economic recovery on the back of rising crude oil prices and falling Rupee. The minutes of MPC's meeting will be published by October 19, 2018. The next meeting of the MPC is scheduled from December 3 to 5, 2018.

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