First Bi-monthly Monetary Policy Update, 2019-20

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Outcome of the first bi-monthly monetary policy was in line with market expectation. This move came after witnessing a slowdown in economic growth over a last few quarters along with a benign inflation scenario. Based on an assessment of current and evolving macroeconomic situations, the Monetary Policy Committee (MPC) voted to cut key rate by 25bps and maintained a neutral stance, allowing it to adjust rates in both the directions, if needed.

Key Outcome

- The policy repo rate under the liquidity adjustment facility (LAF) was reduced by 25bps to 6.0% from 6.25% with immediate effect.
- Consequently, the reverse repo rate under the liquidity adjustment facility (LAF) and marginal standing facility (MSF) was also reduced by 25bps to 5.75% and 6.25% respectively
- Cash Reserve Ratio (CRR) of schedules banks remained unchanged at 4% of net demand and time liability (NDTL).

The MPC decided to maintain its neutral monetary policy stance. These decisions are 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 February round of the RBI's survey of households reported a softening of inflation by 40 bps each for the three-month and twelve-month ahead horizon. Retail inflation, measured by y-o-y change in the CPI, rose to 2.6% in February after four months of continuous decline. Moreover, CPI inflation excluding food and fuel declined to 5.2% in January 2019, but rose to 5.4% in February 2019, driven by a broad-based pick-up in inflation. However, as actual CPI inflation outcomes averaged 2.3% in January-February, these propelled RBI to revise its Q4FY19 CPI inflation projection to 2.4% from earlier guidance of 2.8%. Further, RBI believes food inflation to remain benign in the short term too. Further, assuming a normal monsoon in 2019, RBI further cuts inflation projection forecast for H1FY20 to 2.9-3.0% from earlier guidance of 3.2-3.4%. It also lowered H2FY20 CPI inflation projection from 3.9% to now 3.5-3.8%, with risks broadly balanced.

However, beyond the near term, RBI believes that several uncertainties cloud the inflation outlook, which includes the following:

- Probability of El Nino's impact on 2019 monsoon.
- Rising crude oil prices as continuing OPEC production cuts to reduce supplies.
- Inflation excluding food and fuel has remained elevated over the past twelve months.
- Volatile financial markets and trade uncertainty.
- Uncertain fiscal situation at the domestic level.

Nevertheless, RBI believes that recent slowdown in the domestic economic activity may have a bearing on the inflation outlook. Moreover, 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 there is a need to strengthen domestic growth impulses by spurring private investment, which has remained sluggish. Further, moderation of global growth might impact India's exports. On the positive side, indicators of the construction sector –

Steel consumption and cement production continued to show healthy growth. Further, capacity utilization in the manufacturing sector as measured by the RBI's order books, inventory, and capacity utilization survey (OBICUS), improved to 75.9% in Q3 from 74.8% in Q2 exceeding its long-term average. Furthermore, higher financial flows to the commercial sector augur well for economic activity. Private consumption, which has remained resilient, is also expected to get a fillip from public spending in rural areas and an increase in disposable incomes of households due to tax benefit. However, recent slowdown in the domestic economy along with lack of private investment is compelling the RBI to lower its FY20 GDP forecast projection from 7.4% earlier to 7.2%. Moreover, the RBI expects GDP growth of 6.8-7.1% in H1FY20 from earlier projection of 7.2-7.4% and 7.3-7.4% in H2FY20 from earlier projection of 7.5% in Q3FY20.

Conclusion

The MPC's decision to cut key rates comes against the backdrop of benign headline inflation and subdued economic growth. Moreover, lowering interest rate would act as key growth driver to lift the economy with the help of higher consumption. With assumption of normal monsoon in 2019, RBI believes that these would keep inflation under expected range, providing more room for a future rate cut. RBI allows banks to use an additional 2% from their SLR bucket for the purpose of Liquidity Coverage ratio. This would further release more money for banks to lend. We believe domestic facing companies will benefit from the falling interest rate scenario. This would augur well for sectors such as financial services, real estate, auto, infrastructure, and consumer durables. The minutes of MPC's meeting will be published by around April 18, 2019. The next meeting of the MPC is scheduled for June 3, 4, and 6, 2019.

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