Sixth Bi-monthly Monetary Policy Update, 2018-19

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Outcome of the sixth bi-monthly monetary policy and first monetary policy under new RBI Governor Mr. Shaktikanta Das largely surprised the market. However, we believe this move came after the economy registering subdued economy growth in Q2FY19 and a sharp fall in inflation rate. Thus, based on an assessment of current and evolving macroeconomic situations, members of the Monetary Policy Committee (MPC) voted to cut the key rate by 25bps and simultaneously decided to change the monetary policy stance from calibrated tightening to neutral.

Key Outcome

- The policy repo rate under the liquidity adjustment facility (LAF) cut by 25bps from 6.5% to 6.25% with immediate effect.
- Consequently, the reverse repo rate under the liquidity adjustment facility (LAF) and the marginal standing facility (MSF) also stand changed to 6% from 6.25% and 6.5% from 6.75% respectively.
- Cash Reserve Ratio (CRR) of scheduled banks remained unchanged at 4% of net demand and time liability (NDTL).

MPC decided to change the stance from calibrated tightening to neutral stance. These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 per cent within a band of +/- 2 per cent while supporting growth.

Inflation Outlook

The December round of the RBI's survey of households reported a softening of inflation by 80 bps for the three-month ahead horizons & by 130bps for the twelve-month ahead horizon. Further, Retail inflation, measured by y-o-y change in the CPI, declined from 3.4% in October 2018 to 2.2% in December, the lowest rate in the last eighteen months Moreover, Core CPI inflation excluding food and fuel also decelerated to 5.6% in December from 6.2% in October. RBI believes that continuing deflation in food items, a sharp fall in fuel inflation and some edging down of inflation excluding food and fuel contributed to the decline in headline inflation. With moderation in food inflation, falling crude oil prices, along with completely dissipated HRA effect & assuming normal monsoon in 2019, the RBI further lowered its inflation projection forecast for Q4FY19 to 2.8% from earlier projection of 2.7-3.2%. For FY20, RBI further lowered its inflation forecast for H1FY20 to 3.2-3.4% from the earlier projection of 3.8-4.2% and expects CPI inflation of 3.9% for Q3FY20, with risk tilted to the upside.

The RBI believes that headline inflation is projected to remain soft in the near term reflecting the current low level of inflation and the benign food inflation outlook. However, Rabi sowing so far (up to February 1, 2019) has been lower than in the previous year, but the overall shortfall of 4.0% across various crops is expected to catch up as the season comes to a close. Further, the MPC notes that inflation outlook is likely to be shaped by following factors:

- ❖ Any reversal in vegetable prices
- ❖ Movement in Crude oil prices
- ❖ 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

RBI believes that several proposals in the union budget for 2019-20 are likely to boost aggregate demand by raising disposable incomes, but the full effect of some of the measures is likely to materialize over a period of time. Further, investment activity is recovering but it is supported mainly by public spending on infrastructure development & thus there is need to strengthen private investment activity and buttress private consumption. Also, Reserve Bank's business assessment index of the industrial outlook survey (IOS) for Q3FY19 suggests a weakening of demand conditions in the manufacturing sector, however, the business expectations index (BEI) points to an improvement in Q4. On GDP outlook side, RBI has maintained its full year GDP growth guidance at 7.4% for FY19 and expects Q3FY19 GDP growth at 7.5%, with risks evenly balanced. RBI believes that growth outlook is likely to be influenced by following sectors.

1. Aggregate bank credit facilities & overall financial flows to the commercial sector
2. Trade tension & associated uncertainties in global market.
3. Recent depreciation of Indian rupee on net exports

Conclusion

The MPC's decision to cut key rates comes against the backdrop of benign headline inflation & subdued economic growth. Moreover, RBI unanimous decision to change policy stance also indicates chances of further rate cut in upcoming monetary policy. We believe, Government & RBI is on same path to lift consumption & spur growth in the economy. Hence, economy to cheers dual benefit of fiscal as well as monetary stimulus in coming months. We believe, domestic facing sector likely to witness good growth on back of higher consumption demand. The minutes of MPC's meeting will be published by February 21, 2019. The next meeting of the MPC is scheduled from April 2 to 4, 2019.

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