

Second Bi-monthly Monetary Policy Update, 2018-19

June, 2018

Outcome of the second bi-monthly monetary policy was in line with expectation. However, this came after a sharp rise in CPI inflation excluding food and fuel inflation. Based on an assessment of current and evolving macroeconomic situations, the Monetary Policy Committee (MPC) unanimously voted to increase the benchmark repo rate by 25bps for the first time in more than four years.

Key Outcome

- The policy repo rate under the liquidity adjustment facility (LAF) was increased by 25bps to 6.25%
- Consequently, the reverse repo rate under the liquidity adjustment facility (LAF) and marginal standing facility (MSF) was increased by 25bps to 6% and 6.50% 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

RBI believes that CPI inflation excluding food and fuel inflation has inched up sharply. The May 2018 round of RBI's survey of households reported a significant rise in households' inflation expectations of 90 basis points (bps) and 130 bps, respectively for three-month and one-year ahead horizons. Thus, RBI believes that it is fair to hike the CPI inflation projection to 4.8-4.9% in H1FY19 from earlier projection of 4.4%-4.7% for H1FY19 and subsequently hike the CPI inflation projection to 4.7% from earlier projection of 4.4% in H2FY19. This includes the HRA impact for central government employees with risks tilted to the upside. However, with excluding the impact of HRA revisions, CPI inflation is projected at 4.6% in H1FY19 and 4.7% in H2FY19. Moreover, MPC notes that there are several uncertainties surrounding the baseline inflation, which include:

- a. Crude oil price volatility
- b. Staggered impact of HRA
- c. Impact of revision in MSP formula
- d. Uncertain monsoon scenario

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 exhibited sustained revival in recent quarters and the output gap has almost closed. This is well reflected in recovery in investment activity. RBI believes that all this is expected to accelerate the pace of economic activity. However, RBI believes that geo-political risks, global financial market volatility and the threat of trade protectionism may pose headwinds to the domestic recovery. On the whole, RBI maintains real GDP growth is expected to strengthen to 7.4% in FY19. Further, they expect GDP growth of 7.3-7.4% in H1FY19 and 7.3-7.6% in H2FY19, with risks evenly balanced. RBI also believes that with improving capacity utilization and credit offtake, investment activity is expected to remain robust even as there has been some tightening of financing conditions in recent months. Consumption, both rural and urban, remains healthy, and is expected to strengthen further. However, on negative side, the sharp rise in petroleum product prices is likely to impact disposable incomes.

Conclusion

The MPC's decision to hike policy rates comes against the backdrop of rising inflation, higher oil prices, and a weaker currency. This was the first rate hike by RBI since the BJP-led NDA government came into power in May 2014. However, on the positive side, MPC notes that investment activity is recovering well and could receive a further boost from resolution of stressed assets. Further, RBI's move clearly indicates that the policy is hawkish on inflation but dovish on economic recovery. Further, in order to bring greater convergence of priority sector lending guidelines for housing loans with respect to affordable housing scheme, RBI has decided to revise the housing loan limits for PSL eligibility from existing Rs. 28lacs to Rs. 35lacs in metropolitan centres and from existing Rs. 20lacs to Rs. 25lacs in other centres, provided the overall cost of the dwelling unit in the metropolitan centre and at other centres does not exceed Rs. 45lacs and Rs. 30lacs respectively. We believe this would benefit banks, housing finance companies and real estate companies, going ahead. The minutes of MPC's meeting will be published by June 20, 2018. The next meeting of the MPC is scheduled on July 31st and August 1st, 2018.

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Asit C. Mehta INVESTMENT INTERMEDIATES LTD.

Retail Research Desk:

Akhil Rathi	D: 91 22 2858 3210
Hrishikesh Yedve	D: 91 22 2858 3207
Vrinda Aditya	D: 91 22 2858 3209
Neeraj Sharma	D: 91 22 2858 3208
Rohan Gawale	D: 91 22 2858 3213
Dhiral Shah	D: 91 22 2858 3211

Email: retailresearch@acm.co.in

Research Analyst Registration Number:
INH000002483

CIN: U65990MH1993PLC075388



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