RBI Policy Update

December 07, 2016

RBI's Fifth Bi-monthly Monetary Policy Statement, 2016-17

First policy after demonetisation – Market participants surprised by no rate cut!

In a major surprise, RBI decided to hold fire in this policy and accordingly decided to:

- keep the policy repo rate under the liquidity adjustment facility **unchanged** at 6.25%;
- keep the cash reserve ratio (CRR) of scheduled banks **unchanged** at 4.0% of net demand and time liabilities (NDTL)
- keep the reverse repo rate under the LAF stands **unchanged** at 5.75% and the marginal standing facility (MSF) rate at 6.75%

Variable	Stands at
Repo	6.25%
Reverse Repo	5.75%
CRR	4.00%
MSF	6.75%
SLR	20.75%

Source : www.rbi.org.in.

Policy Stance & Rationale:

- All the members of the Monetary Policy Committee (MPC) unanimously decided to keep the key policy rates unchanged in the fifth bi monthly monetary policy. Accordingly, the Repo was kept unchanged at 6.25% & CRR unaltered at 4%. Consequently, the reverse repo rate under the LAF also stood at 5.75% and the MSF rate at 6.75%. Effective October 01, 2016, the SLR was kept at 20.75% of NDTL. The decision of the MPC was consistent with an accommodative stance of monetary policy.

- On the global front, growth was seen reviving in the second half at a pace faster than that in the first half of the year; led by a rebound in the US. Inflation was seen picking up in some advanced economies, though remaining way below the target, and that in the emerging economies was seen easing moderately. All this led to the world trade improving from its bottom seen around July-Sept'16 period. The results of US presidential elections and the strong data points that hint at a US Fed rate hike in the coming policy impacted the international financial markets alarmingly. This was witnessed by pulling out of capital flows from emerging market economies, sizable depreciations in emerging market currencies, equity markets of such countries hitting near term lows etc. Crude prices have hardened after the OPEC's decision to cut output and has increased woes of such countries.

- Domestically, with weak demand conditions and rising input costs lowering the profitability of corporates, GDP is expected to be lower than earlier estimates. A weak IIP imprint strengthens this belief as the industrial activity has remained slugish for the recent period. The RBI is still watching the impact of demonetisation on the economy. The withdrawal of high value banknotes (INR500 and INR1000) is expected to transiently interrupt some part of industrial activity in Nov-Dec 2016 due to delays in payments of wages and purchases of inputs. The complete effect of the same is yet to be witnessed.

- Liquidity surplus conditions in October'16 and early November'16 were accentuated by the impact of the withdrawal of high value bank notes from November 9 2016. Currency in circulation plunged; consequently, deposits surged into the banking system, leading to a massive increase in reserves. From the fortnight beginning November 26th, 2016, an incremental CRR of 100% was applied on the increase in net demand and time liabilities (NDTL) between September 16, 2016 and November 11, 2016 as a temporary measure to drain excess liquidity from the system. Liquidity management was bolstered by an increase in the limit on securities under the market stabilisation scheme (MSS) from INR 0.2 trillion to INR 6 trillion on November 29, 2016. Consequently, RBI has also announced the withdrawal of incremental CRR from the fortnight starting 10th December 2016.

Demonetisation and the impact of withdrawal of Specified Bank Notes (SBN):

The status quo in rates in the RBI policy has come as an unpleasant surprise since most market participants were expecting at least a 25 bps rate cut, some even a 50 bps rate cut. RBI has held rates steady despite the fears that the economy is staring at a slowdown as a repercussion of the implementation of the demonetisation exercise. The RBI has revised the full year GVA growth for 2016-17 down from 7.6% to 7.1%. It chose to adopt a wait-n-watch approach and see the impact on macro-economic conditions beyond Dec'16.

Outlook:

- The fifth bi-monthly policy was held against a backdrop of hightened uncertainity. Policy tighteneing in the US could have bouts of intermittent volatility in the emerging markets space which could impact the Indian markets as well.

- Domestically, supply disruptions in the wake of currency replacement may drag down growth, full effects of the move would be analysed by the RBI in the time to come. This may have led the RBI to be a little over-cautious in this policy; albeit retaining an accommodative policy stance.

- Recent inflation print, though lower on a YoY basis, had an underlying momentum as prices rose month-on-month across the board. The RBI fears the base effect waning as food prices other than vegetables exhibited sustained firmness and a pick-up in momentum. Volatility in commodity prices including crude oil prices and the surge in financial market turbulence could put the inflation target for Q4 of 2016-17, which currently is under the comfort zone of RBI, at some risk.

- These factors may have put RBI in a cautious mode, awaiting more data both globally and locally.

- However, we continue to believe that deflationary impact of the slowdown is likely to be significant and inflation may undershoot RBI's target by a wide margin. Though the intermittent factors are hinting at a temporary disruption in the downward trajectory of the interest rates, the long term prospects of the Indian fixed income markets is good and the structurally positive factors will result in the flattening of the yield curve in the medium to long term. Further, there is likely to be positive spill-overs of demonetisation on tax collections and overall government finances. The current volatility gives another opportunity to long term investors to make fresh allocations with a 1 – 3 years timeframe.