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CANARA ROBECO
Mutual Fund

RBI Policy Update

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An assessment of RBI's Second Bi-monthly Monetary Policy Statement, FY 2018-19

RBI's Policy Stance:

Post the assessment of current and evolving macroeconomic dynamics, the MPC decided to increase the policy repo rate by 25 basis points while keeping the stance 'neutral'. The MPC reiterated its commitment to achieve the medium-term target for headline inflation of 4% on a durable basis and decided to:

- **increase** the policy repo rate under the liquidity adjustment facility to **6.25%;**
- consequently, increase the reverse repo rate under the LAF unchanged to **6.00%** and the Marginal Standing Facility (MSF) rate to **6.50%**

Variable	Stands at
Repo	6.25%
Reverse Repo	6.00%
CRR	4.00%
MSF	6.50%
SLR	19.50%

Source: www.rbi.org.in

Policy Stance & Rationale:

- On the back of increase in CPI inflation along with an increase in other global commodities especially crude oil price and recent firming up of interest rates in the advanced economies, the MPC decided to increase the policy repo rate by 25 bps.

- Economic activity in major emerging market economies (EMEs) remained largely resilient and their financial markets have been driven mainly by monetary policy expectations and geopolitical developments of various advanced economies. Global economic activities have firmed up and the advanced economies have continued to grow albeit with a moderated pace. Inflation pressures have emerged in some key advanced and emerging economies, driven in part by rising commodity prices. This, combined with the volatility in crude oil prices hardening have resulted in the markets remain in the volatile zone for most parts post the last monetary policy.

- Domestically, retail inflation rose sharply to 4.6% in Apr'18, driven mainly by a significant increase in inflation excluding food and fuel. Excluding the estimated impact of an increase in house rent allowances (HRAs) for central government employees, headline inflation was at 4.2% in Apr'18, up from 3.9% in Mar'18.

- All the six members of the MPC voted in favour of a rate hike citing concerns of higher oil prices, rising inflation and a depreciating rupee. The repo and reverse repo rates now stand at 6.25% and 6%, respectively. Market participants have expected rate hike in recent times on the back of increasing gap between repo rate and government bond yields. In the near future, the MPC expects inflation to remain below 5% and come around 4.8-4.9% in H1 FY19 and 2HFY19 could see inflation moderating to 4.7%. On the economic growth front, the MPC retained its GDP growth forecast at 7.4% in FY19. The apex bank also noted visible improvement in overall investment activity, which could get a further boost from resolution of NPAs in distressed sectors.

- Additionally, RBI allowed 2% more SLR carve out to meet liquidity cover ratio. Margin requirements for GILTs is expected to be 0.5-4% range for LAF. Margin requirement for state bonds at 2.5%-6% under LAF. Margin requirement for rated state bonds at 1.5%-5% under LAF. RBI in its additional statement also said that it looks to ease norms for participation of gilt short sale. All these have been kept in mind to encourage banks to lend more and increase retail market participation in the Indian fixed income markets.

Outlook:

- The rate hike comes against the backdrop of market uncertainties, liquidity and imbalances in the bond market. While domestic macro factors are the primary concern for RBI, the global backdrop has become more important in recent months.

- In addition, FPIs have been withdrawing funds from emerging markets causing unexpected depreciation in the emerging market economies. RBI has also resorted to increasing in interest rates as it has thus weighed higher rates as a buffer for the Indian currency markets.

- In the recent past, Crude oil prices have remained volatile which could significantly impact the outcome of inflation in near future. In addition, significant rise in households' inflation and the volatile global financial markets have emerged as another important source of uncertainty. Domestic recovery could be obstructed by ongoing geo-political risks, global financial market volatility and the threat of trade protectionism.

- On the back of increase infrastructural investment and related activity, the Indian economy grew at 7.70% for Q4FY18. With improving capacity utilisation and credit offtake, investment activity is expected to remain robust even as there has been some tightening of financing conditions in recent months. The increase in crude oil price could add pressure on the disposable income however, the global demand which has remained buoyant, could encourage exports and provide a further thrust to investment. The unchanged stance on GDP growth forecast of 7.40% indicates that RBI expects overall growth to be better in FY19 but would still be lower than that in FY16. However, this comes as a respite to the market participants who have witnessed more pessimism than optimism in the recent past.

- Market participants had been expecting a tough stance, though the general consensus was a pause. However, with RBI maintaining a neutral stance, the market seems to believe that the current rate hike cycle is likely to be short. This led to limited market sell off with the 10-years yield remaining sticky in the 7.85-7.95% range. The rupee has held firm above 67 to the dollar and such a rate hike can send a signal for foreign investors that the returns in India could be going up. Hence, FPI flows could look positively now considering that they have been negative so far this year.

- With the global macros turning against the Indian economy, the RBI had to choose between either raising the rates and keeping the stance neutral or keeping the rates where they were and adopting a hawkish stance. They have chosen the former. The real question is that keeping a neutral stance means that RBI has adopted a 'Wait and Watch' mode and is really uncertain about how the things will shape up in the Indian context.

- In short to medium term, the Indian fixed income market could remain cautious over factors such as the distribution of a normal monsoon, domestic currency movement and the trend in global crude oil prices which could result in the market being volatile.