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RBI Policy Update

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An assessment of RBI's 4th Bi-monthly Monetary Policy Statement, FY 2019-20

RBI's Policy Stance:

For the fifth time in a row, the Monetary Policy Committee (**MPC) cuts rates to the tune of 25-bps,** supported by a unanimous decision taken by the MPC members. The MPC further retained its policy stance to **'accommodative' as long as it is necessary to revive growth, while ensuring that inflation remains within the target**. **The MPC reiterated its commitment to achieve the medium-term target for headline inflation of 4% within a band of +/-2% while supporting growth and decided to**:

- **reduce** the policy repo rate under the liquidity adjustment facility (LAF) by **25 basis points** from **5.40% to 5.15%** with immediate effect;
- continue the monetary policy stance as **'accommodative'**

Variable	Stands at
Repo	5.15%
Reverse Repo	4.90%
CRR	4.00%
MSF	5.40%
SLR	18.75%

Source: www.rbi.org.in

Policy Stance & Rationale:

- The 4th bi-monthly monetary policy meeting of FY20, chaired by the Reserve Bank of India governor Shaktikanta Das concluded with the unanimous decision of reduction in interest rates. The Committee voted 6-0 in favour of rate cut and the continuation of the "accommodative" stance with 5 members voting for reduction by 25 bps and 1 member voted for reduction by 40 bps.

- The MPC reduced the policy repo rate under the liquidity adjustment facility (LAF) by 25-bps to 5.15% Consequently, the reverse repo rate under the LAF stands adjusted to 4.90%, and the marginal standing facility (MSF) rate and the Bank Rate to 5.40%.

- The MPC noted that global economic activity, since the last policy meeting, has lost further momentum, extending in the third quarter as well. Major economies like US, Euro and UK have seen softer industrial demands, declining PMI and contraction in production activities. In Japan too, the loss of momentum in Q2 spilled over into Q3, albeit cushioned by a fiscal stimulus and frontloaded consumer spending. Global financial markets have seen bouts of volatility due to protectionist policies and worsening global growth prospects. Against this backdrop, central banks across the globe across the world are becoming increasingly accommodative in their stances aided by benign inflation conditions.

- For the emerging market economies, the worsening global economic and trade environment weighed down upon their macro-economic factors as well. Crude oil prices were pulled down by softer demand and adequate supplies until mid sep'19 disruptions in refineries in Saudi Arabia but, normalisation has occurred faster than expected.

- Indian GDP slumping down to 5% in Q1FY20 has been followed by weaker indicators in the second quarter too. Industrial production was lower in Jul'19 pulled down primarily by manufacturing activities. The production of Capital goods and consumer durables contracted resulting in the output of industries contracting the previous months. Services sector activities also continued to slow down in the previous couple of months. RBI's consumer confidence survey also showed signs of weakening consumer sentiments; especially relating to non-essential goods.

- However, there has been a rapid catch up on the south west monsoons after the initial delay surpassing the cumulative long-term average by 10%, increasing the possibility of a good upcoming agriculture season. This augurs well for rural employment thereby paving way for the revival of consumer demand. Construction activities looked better than the previous quarters and merchandise imports contracting faster than exports led to the trade deficit becoming a little smaller, currently at 2% of GDP in Q1FY20.

- In the wake of GDP growth sliding to a six-year low of 5% in Q1FY20, owing to on a massive slowdown in consumption and private sector investments, RBI corrected its GDP growth forecast to 6.1% from 6.9% for 2019-20 - 5.3% in Q2, 6.6% in Q3, 7.2% in Q4FY20 with risks evenly balanced. Considering the recent developments and the impact of the monetary policy rate cuts, the RBI has also revised slightly upwards the retail inflation to 3.4% for Q2FY20 while retaining the projections for the second half of the fiscal and the first quarter of next year.

Outlook:

- The RBI continued with the rate cut cycle on the expected lines from the market participants. While RBI still looks positioned to try to revive the demand and thereby growth, the rate cut by RBI is expected to complement other fiscal measures taken by the government.

- Clearly, benign inflation has given greater scope for RBI to go for a revival of the economy. It is further expected that banks will now accelerate the transmission of the RBI rate cuts to the masses to improve the demand and consumption across all sectors

- Markets sold off post policy, as markets had already discounted a 25bps rate cut. Some market participants were expecting a steeper rate cut of 40 bps (post an unconventional 35bps cut in Aug'19 policy), but their hopes were belied. The market participants are aware of fiscal risks emanating from steep corporate tax rate cuts and drop in GST tax collections. Despite the bonanza of Rs.1.72 lac crores in form of RBI dividend, the consensus is of slippage of 0.5-0.7% in the fiscal deficit. While the government has not increased the borrowing amount for 2HFY2020, there is a sign that they would review the situation in Dec'19. For that reason, the current borrowing calendar finishes in Jan'20, leaving Feb/Mar'20 for the extra borrowing needed. This uncertainty is likely to keep markets on tender-hooks.

- Inflation in H2FY20 is also likely to creep towards 4% (on back of higher food prices as well as oil price volatility), which may pressure bond markets. With liquidity remaining in excess, hopes of open market purchases have further dwindled. We expect the new 10Year benchmark to remain range bound in near term with upward bias.