Economics

September 29, 2015

Monetary Policy – September 2015

The Reserve Bank of India has taken the window of opportunity given to it by low inflation levels in the past months as it cut key rate by a surprising 50 basis points*. **As such the repo rate stands at 6.75%, contrary to CARE's expectations of RBI maintaining a status quo.***

Highlights

- Policy repo rate under the Liquidity Adjustment Facility (LAF) is revised to 6.75%.
- Therefore, reverse repo stands 100 bps lower than the repo rate at 5.75% while the Marginal Standing Facility (MSF) rate remains 100 bps higher than the repo rate at 8.75%.
- Cash Reserve Ratio (CRR) of scheduled banks is however, unchanged at 4% of net demand and time liabilities (NDTL).

Liquidity front

- Continue providing liquidity under the overnight repos at 0.25% of bank wise NDTL at the LAF repo rate and through 14-day term repos and longer term repos of up to 0.75% of NDTL of the banking system through auctions.
- Continuation of daily variable rate repo and reverse repo auctions to ensure smooth management of liquidity.

Macroeconomic Backdrop

- **Moderation in Global Growth:** Most global economies, especially the emerging markets witnessed a slowdown in the last quarter. U.S saw a fall in industrial production as exports slackened. Euro area although showed some recovery on the back of domestic consumption and improved financial condition, however remains risk prone. China's intension to boost its economy after it devalued Yuan has kept the markets unstable. The world's second largest economy remains prone to low consumption, stock market meltdown and weak industrial pick up. Japan, Brazil and Russia also suffer with a weak growth with the latter two facing recessionary outlook. Federal Reserve's decision to keep rates on hold helped global markets stabilize briefly.
- **Domestic Economy:**
  - ***Economic recovery underway:*** The timely onset of monsoon led to increased sowing this year. Agricultural output of kharif crop is expected to be higher than last year even as monsoon is deficient on the back of contingency measures taken by the government keeping the short fall in check. However rural demand remains subdued as uncertainty over harvest prevails.
  - ***Subdued aggregate demand:*** While some pick up is seen in urban demand led by consumer durables the aggregate demand remains weak. Despite higher margins given by low input costs, investment remains weak. Manufacturing sector is weakening as export growth slackens amid

global overcapacity leaving little room for export expansion. Services sector's performance was volatile as stalled investment projects revived while no new investment especially in real estate is seen underway.

- ***Favorable Movement in Inflation***: The CPI reached its lowest level in August since November 2014 as low month-on-month price rise and favorable base effects kept CPI low. Food inflation remained subdued as falling vegetable and sugar prices outweighed the price rise in onions and pulses. Falling diesel and petrol prices helped cut down transportation costs. Except inflation expectations of houses, credibility built around RBI's inflation target as inflation for major groups of commodities remained low.

- ***Easy Liquidity Condition*****:** Liquidity conditions during August-mid September remained easy as deposit mobilization in excess of credit flow, lower currency demand and high government spending kept the money markets in surplus. RBI conducted OMO operations worth Rs. 261 bn in August and Rs. 544 bn until mid-September as quarterly tax collections went out leading to deficit like conditions. This kept the call money rate close to the repo rate by mid-September.

- ***Trade Contraction:*** Trade contracted for first two months of Q2 with world trade volume growth falling below the world GDP growth. Exports contracted on the back of weak global demand. Despite falling international crude prices, the high import volumes led to rising import bill. Moderating merchandise and services exports and increasing import volumes is likely to increase current account deficit. Although FII inflows remained negative, FDI and deposits from non-residents were steady. Lastly, strong foreign exchange reserves build-up will provide cushion to any external shock.

Policy Rationale

- ***Transmission Mechanism:*** In a hawkish stance taken the RBI, a 50 bps cut comes in purview of RBI meeting its inflationary target and decision taken by the FOMC. After its front-loaded rate cut of 75 bps since January, banks have reduced lending rates by a fraction of 30bps. However, the rate cuts have been transmitted to markets via commercial paper and bonds. Thus, suggesting that further transmission is possible.
- ***Tightening Inflation:*** Headline inflation and consumer inflation reached its ninth month in August. However, inflation is likely to reverse it's descend in September as favorable base effect wears off. Food inflation outlook could improve if higher sowing translates to higher output. Although, government would have to pro-actively manage supply side constraints to prevent any build-up of food prices. Weakening rupee can have an adverse effect as imports rise for pulses and onions. As such, inflation is expected to reach 5.8% in January 2016, lower than previous projection.
- ***Tepid economic activity:*** Despite easing of commodity prices, falling inflation and de-clogging of investment projects by higher capital expenditure by the government, economic activity remains subdued due to persistent falling exports, deficient monsoon and a weak pick-up in industrial production.

RBI's Outlook

Growth:
The RBI downgraded its growth projections to 7.4% for 2015-16, from earlier projection of 7.6%. This comes in the wake of slowing trade and continued slackening in private investments as business confidence remains subdued.

Inflation
RBI continues to maintain accommodative stance, as it focuses on bringing inflation to 5% by the end of fiscal year 2016-17 having nearly met its January 2016 target of 6% inflation.

Transmission
RBI will focus on short term actions to remove impediments for banks which are preventing them from transmitting cumulative rate cut of 125 bps to the markets.

RBI's Development and Regulatory Framework

- **Financial markets**
  - The limits for FPI investments in central government securities will be increase to 5% of outstanding stock by March'18, providing room for an additional investment worth Rs. 1200bn in G-sec.
  - Separate limits to be set up for FPI investment in State Development Loans, to be increased to 2% of outstanding stock by March'18.
- **Banking structure**
  - Large exposures report to be released by end- December 2015 by the central bank with the aim to encourage alternate sources of funding to bank credit for the corporate sector to finance growth.

CARE's View

- For interest rate cut to work, the transmission mechanism has to be efficient. Hence, it remains to see how the banks translate the front-loaded rate cut to the markets.
- Inflationary apprehension remains as favorable base effect wears off and deficient monsoon provides food inflation risk due to kharif harvest. We project CPI to be in the range of 5%-5.5% by March 2016.
- We revise our GDP expectation to 7.6% for FY16 from 7.8% based on RBI's view on how economy is progressing, given that pick-up in investment is much awaited.
- We expect the RBI to continue to maintain its accommodative stance. A rate cut of 25-50 bps maybe expected in the year.
- Large exposures report will provide a boost for the corporate bond markets.
- Higher limits for FPI in government securities will enhance FPI inflows and stabilize balance of payments.

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