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RBI Policy Update

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An assessment of RBI's 3rd Bi-monthly Monetary Policy Statement, FY 2019-20

RBI's Policy Stance:

For the fourth time in a row, the MPC **cuts rates, though higher than expected and an unconventional 35-bps,** supported by a unanimous decision taken by the MPC member. The MPC further retained its policy stance to **'accommodative' to support growth within a benign inflation scenario**. **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 **35 basis points** from **5.75% to 5.40%** with immediate effect;
- continue the monetary policy stance as **'accommodative'**

Variable	Stands at
Repo	5.40%
Reverse Repo	5.15%
CRR	4.00%
MSF	5.65%
SLR	18.75%

Source: www.rbi.org.in

Policy Stance & Rationale:

- The 3rd bi-monthly policy meeting of FY20, chaired by the Reserve Bank of India governor Shaktikanta Das and members 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.

- The MPC reduced the policy repo rate under the liquidity adjustment facility (LAF) by an unconventional 35-bps to 5.40% Consequently, the reverse repo rate under the LAF stands adjusted to 5.15%, and the marginal standing facility (MSF) rate and the Bank Rate to 5.65%.

- The MPC noted that global economic activity is continuing to lose the pace of growth with slowdown evident both in advanced as well emerging economies. Crude oil prices fell sharply due to an excess supply and weakening demand, though the prices remained volatile on geo-political concerns. Gold prices have risen sharply since the last week of May'19, propelled by increased safe haven demand amidst rising downside risks to growth and a worsening geo-political situation.

- Macro-economic indicators have painted a mixed picture. Retail inflation edged up to 3.2% in Jun'19 from 3.0% in April-May 2019 quarter, driven by food inflation, even as fuel inflation and CPI inflation excluding food and fuel moderated. Rural demand measured by sales of tractors / 2 Wheelers continued to dry up, but air passenger traffic increased. Within urban indicators, passenger car sales continue to contract while commercial vehicle sales slowed down. Construction activity indicators slackened, while PMI showed some early shoots of improvement.

- The Business Expectations Index of the Reserve Bank's industrial outlook survey shows muted expansion in demand conditions in Q2FY20. As a result, RBI revised the real GDP growth for 2019-20 downwards from 7.00% in the Jun'19 policy to 6.90%; in the range of 5.8 - 6.6% for H1FY20, and 7.3 - 7.5% for H2 – with risks somewhat tilted to the downside. The GDP growth for Q1FY21 is projected at 7.40%.

- Considering that growth remains subdued, with sharp slowdown in investment activity and moderation in consumption activity, and inflation within RBI's mandate and expected to remain within 4% in next one year, the MPC concluded that there was scope for further policy accommodation to boost demand and kickstart the investment cycle.

Outlook:

- The RBI continued with the rate cut cycle but the change to the quantum of the reduction of rate took the participants by surprise. While this brings about some uncertainty in expectations of the quantum of rate changes, it provides MPC with an enhanced degree of flexibility in signalling their intent. The current unconventional 35-bps rate cut clearly signals that RBI is also concerned with the low growth and its outlook going ahead, and the urgency to take corrective actions to get growth back on track.

- The transmission of policy repo rate cuts to the Weighted Average Lending Rates (WALRs) on fresh rupee loans of banks has improved marginally since the last meeting of the MPC. Overall, banks reduced their WALR on fresh rupee loans by 29 bps during the current easing phase.

- A larger pass through by banks, through cuts in their lending rates, is expected to revive private investment and boost sentiment. RBI also signalled that Inflation for FY20 is expected to be stable around 3.4%, in line with its earlier forecasts but GDP growth will slow in FY20 from its earlier estimate of 7.0% to its revised estimate of 6.9% with a downside bias. The overall tone of the monetary policy was one of concern on slowing growth, both on the global front and in the domestic economy. Given benign and under-control inflation, RBI's complete focus is now on reviving private sector investment and growth.

- Bond markets had largely priced in a 25-bps rate cut by the MPC today given the slowing economic outlook and benign inflation readings. However, the extra 10 bps cut gave way to an initial buying impetus. The 10Y benchmark dropped to a near two-and-half year low of 6.27% immediately post the rate cut decision. However, the 10Y yields sold off later on profit taking and is trading around 6.35%.

- While government bonds have rallied a lot, corporate bond have been slow to catch on, especially in the last leg. Liquidity has improved drastically with interbank liquidity in excess of INR 2,00,000 crore. This is likely to support bond markets especially high-quality corporate bonds. We continue to favour short term corporate bond space, as a combination of further anticipated rate cuts and improving liquidity would likely lead to continued downward movement in the 2-5-year high quality corporate bonds. Further, FII flows would likely support bonds in the short end of the curve. Investors can look at looking at a mix of short end products for addressing liquidity requirements and medium-term funds for reaching their long-term goals.