Sanctum View

June 06, 2019

Monetary Policy Update

Dovish Policy Tilt

The Reserve Bank of India today unanimously decided to reduce the policy repo rate to 5.75% from 6.00% and changed the monetary policy stance to "accommodative" from "neutral" with an objective of achieving a medium-term target for CPI of 4% within a band of ± 2%, while supporting growth.

Key highlights of the RBI's Monetary Policy

The MPC's inflation expectations remain broadly unchanged:

- 3.0-3.1% for H1FY20 (vs. expectation of 2.9-3.0% earlier)
- 3.4-3.7% for H2FY20 (vs guidance of 3.5-3.8% earlier)

The GDP growth rates expectations trimmed down:

- 6.4-6.7 for H1FY20 (vs 6.8-7.1% earlier)
- 7.2-7.5% for H2FY20 (vs 7.3-7.4% earlier)
- 7.0% in FY20 (vs 7.2% earlier)

Rationale for a Rate Cut

In listing its rationale for a rate cut, the RBI flagged a slowdown in global economic activity, declining factory activity and retail sales in US, soft industrial activity and weak business confidence in the Euro Area as well expectations of growth slowdown in major emerging market economies (EMEs). In China, incoming data on industrial production and retail sales suggest that the growth momentum may weaken in coming quarters. Further, uncertainties surrounding US-China trade negotiations and Brexit continue to add worries around global growth.

Slowing Domestic Activity

Domestically, quarterly GDP data decelerated sharply to 5.8% in Q4FY19 from 6.6% in Q3FY19 and 8.1% in Q4FY18. The slowdown was on account of a decline in gross fixed capital formation, moderation in private consumption growth and a drag on aggregate demand from net exports though partly offset by a large increase in government final consumption expenditure.

Growth in eight core industries decelerated sharply in April, pulled down largely by coal, crude oil, fertilisers and cement. However, the manufacturing purchasing managers' index inched up to 52.7 in May with strengthening of output, new orders and employment. The India Meteorological Department (IMD) has predicted that south-west monsoon rainfall (June to September) is likely to be normal at 96 per cent of the long period average – some respite to slowing rural economy.

Net FDI inflows were strong in Q4FY19. Foreign portfolio investors remained net buyers in the domestic capital market in first two months of FY20 though the net inflows moderated in March. India's foreign exchange reserves were at USD421.9 bn as on May 31, 2019.

Market Reaction

- The yield on the 10 year government bond witnessed a steep fall of 9bps to 6.91% as the RBI changed its stance from "neutral" to "accommodative". Yields have come off meaningfully from 7.49% seen in April-19.
- The Indian rupee is stable at 69.2 per Us dollar.

Outlook

An Appropriate Strategy Stance on Solvency and Liquidity

While many – in particular those that were making high risk loans – have been clamouring for a liquidity window for NBFCs; in our opinion, the RBI's decision to step in on systemic liquidity risk rather than solvency risk is the appropriate choice. Moral hazard, heads I win, tails you lose, too big to fail is not the appropriate choice. In order to drive growth, re-organization via IBC has proven to be an effective mechanism.

A Dovish Central Bank and Additional Rate Cuts

The RBI has moved to a dovish positioning and the prospect of additional rate cuts, alongside surprisingly low crude oil prices, and a strong mandate are likely to provide support to the economy. Indian markets have consistently run ahead of fundamentals. The macro backdrop will provide the support necessary in coming months to justify the move higher.

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