Monetary Policy – June 2015

Delivering to market expectations, the Reserve Bank of India lowered the repo rate by 25 bps from 7.5% to 7.25% with immediate effect. This is in accordance with CARE’s forecast of a 25 bps cut in the key policy rate for this policy announcement. This is the third such rate cut by the Central Bank in 2015. The major criterion driving the decision appears to be held in the timing of this policy. This is arguably the most opportune time for a cut in interest rate as the broad conditions (inflation being well within RBI’s target, impact of unseasonal rains being muted, Banks having passed through previous rate cuts onto their lending rates and interest rate normalisation in the USA expected to be pushed back) of the RBI specified in the previous policy announcement have been largely met.

Highlights

- Policy repo rate under the Liquidity Adjustment Facility (LAF) is lowered by 25 bps from 7.5% to 7.25%.
- Therefore, reverse repo stands unmoved 100 bps lower than the repo rate at 6.25% while the Marginal Standing Facility (MSF) rate remains 100 bps higher than the repo rate at 8.25%.
- Cash Reserve Ratio (CRR) of scheduled banks is also unchanged at 4% of 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

- Uneven Global Growth: There is a diverging trend as regards growth across major economies of the world. Growth continues to elude majority of the key economies with US recovering in Q2 2015 following a severe winter which kept growth muted in Q1 2015 while the Euro area witnessed slight improvement on the back of ECB’s ongoing quantitative easing. In Asia, Japan recorded positive growth in Q1 2015 while China continues to struggle to push growth notwithstanding the monetary easing by the Central Bank. Thus, a complete recovery in global growth as also global demand still appears to be in an evolving stage. Further, there was significant volatility in global bond markets as effects of a resurgence in oil prices, Greek crisis and uncertainty pertaining to the Federal Reserve Bank’s future monetary stance came to fore.

- Domestic Economy:
Concerning Agri Growth: While the overall GDP growth was recorded at 7.3% in FY15, performance of the agriculture sector was weak owing to the sub-normal monsoon earlier in fiscal ‘15. Further, extensive damage to the rabi crop was reported in the aftermath of the unseasonal rains in the country in March ‘15. The agri outlook is blemished as the situation is exacerbated with the forecast of a sluggish monsoon (IMD’s forecast- South west monsoon to be 7% below the long time average in 2015) which would have a bearing on the kharif produce. Effective food management would be critical in keeping related inflation under check.

Reiteration of Industrial Recovery Awaited: While the industrial sector has exhibited signs of a revival following its poor performance in FY14, RBI indicates that further reiteration on this would drive home the point of a healthy industrial outlook. There are flags of concern which emanate from the corporate performance in FY15 indicating a contraction in sales and deteriorating capacity utilization across industries.

Favorable Movement in Inflation: The razor sharp focus maintained on the Consumer Price Index (CPI) throughout fiscal ‘15 and favorable base effects contributed in adhering to the disinflationary glide path put forward by the Dr. Urjit Patel Committee report. CPI inflation as of April ‘15 came in well under RBI’s 6% target at 4.87%. Excluding fuel and food, inflation rose marginally in the month of April ‘15.

Proactive Liquidity Management: After the pressure on liquidity during March ‘15, it remained smooth in the month of April ‘15. However, conditions were strained in May ‘15 on account of a build-up in currency in circulation and build-up of government balances. RBI thereby conducted term repos of various tenures along with the regular overnight repo and 14-day term repo auctions.

Trade Contraction: Trade has been contracting in 2015 with both export and imports recording negative growth rates. Export has been contracting since January ‘15 while imports are on the decline since December ‘15 implying a weak domestic demand. FII inflows ended at $ 41 bn in FY16 however have drifted into the negative space from May ‘15. Lastly, strong foreign exchange reserves of around $350 bn provide cushion to any external shock.

Policy Rationale
Timing of this policy appears to be at the core of the rationale for a rate cut in RBI’s announcement earlier today. While a conservative stance would be to await further clarity on data to assert the decision, the RBI adopted a progressive step by front loading the rate cut today as opposed to a later date.

Transmission Mechanism: In its first bi-monthly monetary policy announcement for FY16, RBI had reiterated the importance on the transmission mechanism by asserting that banks would need to pass through the earlier exercised rate cuts to warrant any further movement on interest rates from the RBI. Banks responded to this condition as many were seen to lower their lending rates in due course between the previous policy to this date.
**Softening Inflation:** Headline inflation and consumer inflation have remained southward oriented for three and two consecutive months respectively. There has been a considerable fall in vegetable and food prices as of April ‘15 while fuel inflation also remains under control. Further, the impact of the unseasonal rain and hail in March ‘15 is yet to be reflected in prices. However, that said, there remain upside risks to inflation with forecast of lower than normal monsoon this year which will feed into food inflation.

**Fed’s reversal on hold:** The Federal Reserve Bank has kept interest rates at a record low in the USA for seven years in order to aid recovery in the country. Following the end of its quantitative easing programme, there were speculations of an impending reversal in the policy stance of the Fed. However, given the uneven recovery signs in the USA, there appears to be a delay in the anticipated rate hike by the Fed. Thus, pressure on foreign inflows and exchange rate are pushed back than previously expected thereby giving a cushion to lower domestic interest rate now.

**Low credit off-take:** The case for rate cut is made stronger given the low credit off-take in the country in FY15 and continuous mixed signs of recovery.

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**RBI’s Macro Outlook**

**Growth:**
Given the risk of a sub-normal monsoon for a second year in a row as also muted global growth, RBI has lowered its growth forecast for GVA from FY16 marginally from 7.8% to 7.6% with a downward bias. (GVA is different from GDP and in FY15 grew by 7.2% against 7.3% in GDP.

**Inflation**
According to the RBI, a favorable base effect would augur well for consumer inflation and thereby maintain it at the existing level up to August ‘15. However, inflation would see an upward movement then on but would settle at 6% by January ‘16.

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**CARE’s View**

RBI’s policy rationale and announcement are in line with CARE’s views.

- Inflationary threats have resurged. The forecast of a sub-normal monsoon, oil price rise and impending interest rate hike by the Federal Reserve Bank pose an upside risk to inflation.
- We thereby expect RBI to hold the repo rate at 7.25% in the August ‘15 policy announcement.
- A further rate cut by the Central Bank could be likely in H2-FY16 provided inflation treads along the predicted path.
- We hold on to our GDP expectation of 7.8-8% for FY16 based on assumptions of a recovery in investment and manufacturing growth. A review would be taken in September based on trends in the same.
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