The fourth bi-monthly monetary policy review for this fiscal year is to be announced by the RBI on 4th October 2017. It will be seventh monetary policy review by Dr. Urjit Patel, RBI’s Governor and the Monetary Policy Committee.

*CARE Ratings expects status quo in the policy stance.*

This policy review is in the backdrop of inflation with upward bias, moderation in economic growth, decline in bank credit and bank deposits growth, increasing GSecs yields and sudden depreciation of rupee vis-à-vis dollar.

**Economic Backdrop**

1. **GDP growth**

The Indian economy in the first quarter of FY18 grew at the slowest pace in 5 years. The Q1FY18 GDP came in at 5.7%, a marked decline from the 7.9% growth in the corresponding period last year. The subdued and weakened economic performance of the economy was mainly on account of disruptions caused by demonetization and GST implementation, which could be temporary in nature. However, the SME segment has been under more pressure and would take some more time to normalize operations.

2. **IIP growth**

The cumulative growth in industrial output in the first four months of the current financial year was a mere 1.7%, compared with 6.5% growth for the comparable period a year ago. Subdued manufacturing and mining activity resulted in lower growth numbers for the period that was mainly attributed to the continued business disruptions caused by implementation of GST. In addition to this, the sharp contraction in capital goods is reflective of limited private investments in the economy.

3. **Agricultural growth**

The total area under cultivation declined by 0.7% to 1049.42 lakh hectares as of 15th September 2017 compared with corresponding period last year, with particularly sharp reductions in oilseeds (-8.8%) and pulses (-3.5%) on account of uneven geographic spread of monsoons as well as deviations in the month-wise distribution of rainfall compared with the long period average. The first advance estimates presented expect lower output in rice, maize, soybean, groundnut, tur and moong. This would be of concern from the point of view of supplies as well as food inflation which will have a bearing on policy decisions on interest rates.
Monetary Backdrop

1. Credit and Deposit growth for the financial year so far
   The growth in deposits has contracted by (-) 0.1% during the period Apr-1 Sep’17 compared with the growth of 5.1% in the corresponding period last year. The lower growth in bank deposits is mainly on account of the moderation in the inflow of deposits into banks following demonetization. It can also be attributed to the shift in investor preference to other assets viz. stock markets/ mutual funds that have been giving higher returns. Assets under Management (AUMs) of mutual funds have seen a 7% increase in August’17 (Rs. 20.6 lakh crs) from that in April’17 (Rs. 19.2 lakh crs).

   Credit growth in the economy has contracted by (-) 0.9% during the period Apr-1 Sep’17 compared with the growth of 0.7% of the comparable period a year ago. The growth in credit has remained lacklustre on account of the continued slowdown in private investments and the stressed balance sheets of banks that have been inhibiting fresh lending.

   The profile of sectoral growth in credit for the period April-July 2017 reveals decline in growth for agriculture, manufacturing and services. It was positive only in case of retail loans.

2. Excess money with the banking system
   The banking system still continues to face excess liquidity that can be illustrated through amount outstanding in reverse repo amounting to Rs 196,113 crs as on September 27, 2017. However, there has been a moderation in the excess liquidity in the recent months. The outstanding reverse repo borrowings by banks was 34% higher as on August 31,2017, 40% higher as on May 31, 2017 and 50% higher as on April 28,2017 compared with the amount as on September 27,2017.

3. Specific Measures taken to absorb excess liquidity
   RBI had conducted five open market sales totaling to Rs 50,000 crs since July’17 to absorb the excess liquidity in the market. The RBI undertook two OMO sales worth Rs 20,000 crs in July, two OMO sales of Rs 20,000 crs in August and Rs 10,000 crs on September 15, 2017.

4. Corporate bonds and Commercial paper
   The corporate bond issuances witnessed an increase during the period Apr- Aug’17, growing by 7% to Rs 2.8 lk crores compared with Rs 2.6 lk crores in the corresponding period last year. This increase can be attributed to constraints in bank lending and faster transmission of the policy rate cuts in these markets.

   However, outstanding amount of commercial papers declined by 5% to Rs 3.7 lk as on Aug 31’2017 compared with Rs 3.9 lk crores as on Aug 31’2016.

5. Inflation and international oil prices
   CPI inflation rose to 3.4% in the month of Aug’17, highest in the last 5 months compared with 2.4% recorded in the previous month. The rate however, is still below the RBI’s target of 4%.The higher number came in as a result of increasing food inflation ( viz increase in prices of vegetables and fruits) and waning base effect. Core inflation, too, still remains in the range of 5% and all the non-food components witnessed an increase in Aug’17 over the previous month.
Wholesale price inflation increased to 3.2% in the month of Aug ’17 and was the highest since April ’17. The higher inflation was mainly on account of growing inflation in Fuel and Power and food articles. International oil prices witnessed an increase with WTI and Brent prices increasing by 3.8% and 8.9% respectively during the period 3rd April’17 - 27th Sep’17. Going forward, oil prices are likely to remain under pressure on an expected reduction in global production given OPEC members has reached a compliance level of 116%, the highest level since the start of the Declaration of Cooperation.

6. Movement in 10-years-GSecs
The 10- year GSec yields has remained in the region of 6.6% to 6.7% during the period 3rd June’17- 27th September’17. The GSec yields particularly started increasing following the RBI policy rate cut of 25 bps on August 2 ‘2017 as markets expected a higher cut in the policy rates. During the month, the yields rose by as much as 14bps. However, sustained demand for the securities helped curtailed the rise in yields.

7. Movement in Exchange rates
The rupee has depreciated by 1% from Rs 65.03/$ to Rs 65.71/$ during 3rd Apr’17 -27th Sep’17. As per monthly trends, the rupee strengthened in the month of April and May on account of continued foreign inflows into the Indian equity markets and weakening of dollar as a result of growing concerns over US President’s Donald Trump ability to deliver his policies. However, the trend was reversed in the month of June where rupee depreciated against dollar following the interest rate hike by Federal Reserve on 14th June 2017.

Improved sentiments on the back of rollout of GST helped strengthening the rupee in the month of July and reduction in the policy rates by Reserve Bank of India on August 2, 2017 further supported the rupee during the month.

However, the rupee has been depreciating since September 20, 2017 on Federal Reserve’s plan to unwind its balance sheet and a likely interest rate hike in the month of December.

Policy perspectives: Factors favoring a status quo
Upside risks to inflation may emanate from the following major factors that could lead RBI to maintain status quo on policy rates in the October monetary policy meet.

- Fall in crop sowing area by 7.7 lakh hectares this year compared with year ago levels resulting in lower farm production.
- Changes in tax rates on account of GST could also be a cause for concern on inflation.
- Inflation in housing Index with implementation of 7th pay commission.
- Increase in prices of imports on account of recent rupee depreciation and increasing crude oil prices.
- Expectations of the Fed increasing rates. Unchanged rates will continue to attract FPI now that the investment limits in government debt have been increased.