Economics

December 1, 2015

Monetary Policy – December 2015

The Reserve Bank of India announced its fifth bi-monthly monetary policy today. ***The RBI maintained a status quo on key rates in line with CARE's expectations***.

Highlights

- Policy repo rate under the Liquidity Adjustment Facility (LAF) is unchanged at 6.75%.
- Therefore, reverse repo stands unmoved 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 7.75%.
- Cash Reserve Ratio (CRR) of scheduled banks is 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

- **Slowdown across economies:** Global economies continue to moderate with falling demand and excess supply in several primary commodities and raw materials. The U.S is witnessing significant inventory accumulation as strengthening dollar continues to lower exports. In the Euro zone, some recovery is seen as indicated by upbeat retails sales, although it is moderate. World's second largest economy *China continues to be in slump* raising concerns of overcapacity and shrinking aggregate demand.
- **Financial markets:** The markets remained relatively calm in September as positive U.S data provided for strong case of rate hike by the FOMC later this month. *U.S dollar was seen to appreciate significantly causing pressure of emerging markets' currencies.* Markets remained positive on account of easing by China and signs of fiscal stimulus from Euro zone and Japan.
- **Domestic Economy:**
  - ***Pick-up in Economic growth:*** The domestic economy has fared better than expectations as indicated by provisional estimates for Q2FY16. There is seen modest increase in gross value added on the back of acceleration in industrial activity. Other factors contributing to economic recovery include increases in agricultural and allied activities. The government's timely intervention and measures taken to minimize the effect of second consecutive season of deficient monsoon has helped boost agricultural output.

- ***Mixed sectoral data:*** While some pick up is seen in industrial activity as indicated by IIP index for Q2FY16, however, insufficient demand is preventing industries to utilize their capacity efficiently. In a scenario of *weak rural demand, positive consumption from urban households has* provided some respite to industries with declining finished goods' inventories. Increased government expenditure and sustained public investments might help to boost, still low capacity utilization of manufacturing units.

  Services sector showed positive signs with increase in domestic passenger air traffic while decrease in railway freight traffic, international air cargo traffic, and slump in steel consumption show otherwise. RBI's countercyclical reduction of capital charges on low income housing loans and government initiatives in rail, port and road projects might help to boost this sector.

- ***Unfavorable Movement in Inflation***: Retail inflation moved upwards for third month in a row in October'15 led by surging food inflation despite declining international commodity prices. *Increase in prices of housing, recreation, education and health services were major contributors to rising inflation.* Lower prices of petrol and diesel have helped curb household's inflation expectations which are seen to rise otherwise.

- ***Tight Liquidity Condition*****:** Liquidity conditions during October-November tightened on the back of high festive currency demand and slowdown in government expenditure. The RBI conducted daily net injection of Rs. 372 billion in comparison to daily net absorption of Rs. 119 billion to meet money demand in the economy. As a result, second-week of November saw rates rise above the policy repo rate. Both bank credit in personal loans and non-banking financial flows increased in this period.

- ***Trade Contraction:*** Exports contracted due to weak global demand scenario for eleventh month in a row in October'15. Falling commodity prices had an adverse effect on exports of petroleum products even as signs of turnaround were seen in drugs and pharmaceuticals, electronics and readymade garments. However, the trade bill remained low on account of low gold demand.

- ***Positive FDI:*** Net foreign direct investment, external commercial borrowings and accretion to non-resident deposits saw significant increase compared to last year. On the other hand, FIIs have been withdrawing from the economy in both debt and equity. Despite capital outflows, India's foreign reserve remains comfortable with accretion of USD 10.8 billion in the period until 20 November'15

Policy Rationale

- ***Sustainable growth:*** The RBI has maintained an accommodative stance with 75bps cut in FY16. Its front-loaded rate cut came in a situation of subdued domestic and global demand. As such, keeping in purview of its inflation target of 5.8% (as announced in last policy review), the central banks has kept rates unchanged.
- ***Inflation Target:*** inflation has been increasing as expected. Vegetable and fruits' prices will moderate after seasonal demand subsides, although the government needs to take adequate supply management steps to minimize shortfall in rabi crop.

- ***Subdued Aggregate demand:*** Weak rural demand on account of subdued Rabi and Kharif crop output has overweighed on pick-up in urban consumption. Increased capital expenditure by the government and easy monetary policy will help boost private investment demand. The growth outlook remains at 7.4% as policy initiatives make the business environment more conducive

RBI's Outlook

Fiscal Developments:
The RBI will monitor the overall effect of Pay Commission proposals as this will help boost aggregate demand while government spending is likely to fall as it tries to remain on the path of fiscal consolidation.

Inflation
RBI continues to maintain accommodative stance, as it focuses on bringing inflation to 5% by March 2017, having nearly met its January 2016 target of 6% inflation.

Transmission
Only 60bps of the 125bps cut since Janaury'15 has been transmitted by the banks. RBI will focus on creating room for fresh lending, creating methodology for determining base rate on basis of marginal cost of funds and help further transmission mechanism.

CARE's View

- Inflationary apprehension remains as deficient monsoon provides risk to kharif and rabi output. As such we project CPI to be in the range of 5%-5.5% until March 2016.
- We expect the RBI to maintain its accommodative stance in its sixth bi-monthly monetary policy review with expectations of a possible 25bps cut in key repo rate in March 2016.

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