Monetary Policy Review-December 2018

Contact:

Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-22-6754 3489

Dr. Rucha Ranadive
Economist
rucha.ranadive@careratings.com
91-22-67543531

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-22-6754 3515

In the fifth bi-monthly monetary policy review for fiscal year 2018-19, announced today, the RBI maintained status quo and kept the interest rate unchanged at 6.5%, which is in line with CARE Ratings' expectations. However there was no change in CRR, where we had assigned a 50% probability of a cut of 50 bps. The monetary policy stance has been also been retained at 'calibrated tightening'.

Highlights

- Repo rate unchanged at 6.5%.
- Reverse repo rate unchanged at 6.25%
- Marginal standing Facility and Bank rate maintained at 6.75%
- CRR retained at 4%.
- SLR to be lowered by 25 bps over 6 quarters to 18% starting January 2019

RBI's assessment

The RBI has taken into consideration following aspects.

- Signs of weakness in the global economic activities following trade tensions.
- Sharp decline in crude oil prices amidst high supplies and easing geo-political tensions.
- While the inflation in major developed economies has remained unchanged, inflation has risen in many key emerging markets. However, retreat in energy prices, tight monetary policy stance by central banks and stabilising currencies might reduce the inflationary pressures in the emerging markets.
- Financial markets were guided by rising policy rates in the US, volatile crude oil prices, and expectations of slowdown. Economies witnessed some sell-off in equity markets due to weak global growth outlook, subdued outlook for corporate earnings due to rising borrowing costs, political uncertainty in Euro area, shrinking global liquidity along with lingering trade tensions.
- In advanced economies, the bond yields softening on weak economic sentiments whereas in emerging markets it was on account of falling crude oil prices and strengthening currencies.

- India's GDP growth slowed down to 7.1% in Q2FY19 due to moderation in private consumption (following subdued rural demand, subdued growth in kharif output, sluggish growth in rural wages and low prices for agricultural commodities).
- Investment rate improved with increased public sector spending on national highways and rural infrastructure.
- Rabi sowing for Q2 has been 8.3% lower than the comparable quarter a year ago.
- Industrial output growth slowed down in Q2 however the capacity utilisation has improved indicative of pickup in industrial activities in Q3 FY19.
- Retail inflation moderated to 3.3% in Oct'18 owing to subdued food inflation.
- RBI undertook OMO purchases to the tune of Rs. 1.36 lakh crore to inject liquidity in the system.
- Exports growth rebounded however imports continued to grow at a higher pace than exports leading to widening of trade deficit.
- FDI flows moderated. FPI flows turned positive in November'18 due to decline in crude oil prices, less hawkish stance by Federal Reserve and softer US dollar.

Outlook

Inflation

The RBI has lowered the inflation projections for the second half of FY19 to 2.7-3.2%, which is lower than the RBI inflation target at 4%. The inflation is expected to be lower on account of

- Deflation in the food inflation especially in pulses, vegetables, cereals and sugar that exerts further downward bias in food inflation
- Sharp decline in international crude oil prices
- Appreciation in the rupee
- Waning effect of HRA increase by 7th Pay Commission which is likely to dissipate completely from December onwards
- Expectations of normal monsoon in 2019

However, the risks to inflation continue from uncertainty over crude oil prices with impending OPEC decision on production cut, food prices, increasing non-food inflation, impact of MSP, volatile global financial markets, fiscal slippages, household's inflation expectations, staggered impact of HRA revision.

	Aug'18	Oct'18	Dec'18
H2FY19	4.8%	3.9-4.5%	2.7-3.2%
Q1FY20	5%	4.8%	NA
H1FY20	NA	NA	3.8-4.2%

For the remainder of the year we are expecting the retail inflation to be around 4%.

Economic growth

The RBI has retained its economic growth outlook for FY19 at 7.4% while for the second half of FY19 it has been notched up to 7.2%-7.3%. On the positive side, the GDP growth will be aided by

- Decline in crude oil prices
- Improvement in corporate earnings
- Rise in private consumption through higher disposable income

- Increase capacity utilisation in the manufacturing sector
- Acceleration in investment activities
- Increase in credit off take
- Increase in FDI flows with improving prospects for external sector

However, the risk could arise from lower agriculture output due to lower rabi sowing that could affect he rural demand. On the trade front, exports could be affected on account of financial market volatility, slowing global demand and rising trade tensions.

	Aug'18	Oct'18	Dec'18
H2FY19	7.3-7.4%	7.1-7.3%	7.2-7.3%
FY19	7.4%	7.4%	7.4%
Q1FY20	7.5%	7.4%	NA
H1FY20	NA	NA	7.5%

We are expecting the GDP growth to be around 7.4% for FY19.

Developmental and regulatory policies

- **External Benchmarking of New Floating Rate Loans by Banks:** It has been proposed that all new floating rate (personal, retail, floating rate loans to MSMEs extended by banks will be benchmarked either to RBI repo rate or 91-day / 182-days treasury bill rate or any other benchmark market interest rate published by FBIL. The spread over benchmark rate will be at the bank's discretion.
- **Aligning Statutory Liquidity Ratio with Liquidity Coverage Ratio:** It is proposed to reduce the SLR by 25 bps every calendar quarter until the SLR reaches 18% of NDTL. The first reduction of 25 bps will take effect starting January 2019.
- **Access for Non-Residents to the Interest Rate Derivatives Market:** Following the proposal to give NRIs access to Rupee interest rate Derivatives markets and to participate in Overnight indexed swap (OIS), draft guidelines for the same will be issued.
- **Measures to Improve Liquidity Management by Banks:** From December 6, 2018, the RBI will provide information on daily CRR balance of the banking system to market participants on the very next day with an aim to enable banks to forecast their liquidity requirements with a greater degree of precision.
- **Expert Committee on Micro, Small and Medium Enterprises:** Expert Committee will be constituted by the Reserve Bank of India to identify causes and propose long-term solutions for the economic and financial sustainability of the MSME sector by the end of December'18.

CARE Ratings' View

We expect that if the inflation moderates further there is a case for rate cut and the stance of the monetary policy can be changed to neutral. We are also expecting that the GSec yields will be in the region of 7.5%..

CORPORATE OFFICE:
CARE RATINGS LIMITED (Formerly known as CREDIT ANALYSIS & RESEARCH LIMITED)
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022. CIN: L67190MH1993PLC071691
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com

Follow us on /company/CARE Ratings
/company/CARE Ratings