

Fifth Bi-monthly Monetary Policy, 2016-17 Analysis

Contrary to expectations, the Reserve Bank of India (RBI) has kept the repo rate – the rate at which the banks borrow from the central bank – unchanged at 6.25% while reviewing the Monetary Policy on Wednesday, the first policy since the government's demonetization drive in November. The reverse repo rate under the LAF remains unchanged at 5.75%, and the marginal standing facility (MSF) rate and the Bank Rate at 6.75%. The decision of the Monetary Policy Committee (MPC) is consistent with an accommodative stance of monetary policy in consonance with the objective of achieving consumer price index (CPI) inflation at 5 percent by Q4 of 2016-17 and the medium term target of 4 percent within a band of +/- 2 percent, while supporting growth.

We believe RBI has maintained status quo as there are concerns of rising oil prices due to OPEC oil production cut, dollar has appreciated against the rupee from late October after the US election results and future stance of US monetary and fiscal policy could impart volatility to the exchange rate thereby feeding into inflation and a possible rate hike by US Federal reserve. Therefore, it was prudent for RBI to wait and watch how these factors play out and impinge upon the outlook. Accordingly, the policy repo rate has been kept on hold in this review, while retaining an accommodative policy stance.

Demonetization impact: The RBI, while reviewing the policy, acknowledged that the demonetization move has impacted economic momentum. As a result, incorporating the expected loss of growth momentum in Q3 and waning effects in Q4 alongside the boost to consumption demand from higher agricultural output and the implementation of the 7th Central Pay Commission (CPC) award, the RBI has revised down the gross value added (GVA) growth for 2016-17 from 7.6% to 7.1%.

"The outlook for GVA growth for 2016-17 has turned uncertain after the unexpected loss of momentum by 50 basis points (bps) in Q2 and the effects of the withdrawal of specified bank notes (SBNs) which are still playing out," the RBI said.

Incremental CRR withdrawn: The RBI has decided to withdraw the incremental CRR effective the fortnight beginning December 10, 2016. It had announced an incremental CRR of 100% of the increase in net demand and time liabilities (NDTL) of scheduled banks between September 16, 2016 and November 11, 2016 effective the fortnight beginning November 26, 2016. The move was aimed at absorbing a part of the large increase in liquidity in the system following the demonetization of Rs 500 and Rs 1000 notes in November.

Food inflation: While reviewing the policy, the RBI also took note of the upturn in the prices of several items that is masked by the easing of inflation on base effects during October. Given the demonetisation, the RBI feels that the prices of perishable items could soften in November, though the final reading will be available only in December.

RBI feels the withdrawal of specified bank notes (SBNs), or demonetization as it is popularly called, could result in a possible temporary reduction in inflation of the order of 10-15 basis points (bps) in Q3. Taking these factors into account, headline inflation is projected at 5% in Q4FY17, with risks tilted to the upside but lower than in the October policy review.

"Prices of housing, fuel and light, health, transport and communication, pan, tobacco and intoxicants, and education – together accounting for 38% of the CPI basket – may remain largely unaffected. Going forward, base effects are expected to reverse and turn unfavourable in December and February. If the usual winter moderation in food prices does not materialise due to the disruptions, food inflation pressures could re-emerge," the RBI statement said.



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For research related queries contact:

Mr. Akash Jain – Vice President (Research) at, 022-67160431 (D)

CIN: L74140MH1986PLC041941

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Website: www.ajcononline.com

Corporate and Broking Division

408 - (4th Floor), Express Zone, "A" Wing, Cello – Sonal Realty, Near Oberoi Mall and Patel's, Western Express Highway, Goregaon (East), Mumbai – 400063. Tel: 91-22-67160400, Fax: 022-28722062

Registered Office:

101, Samarth, Off. Hinduja Hospital, 151 Lt. P.N. Kotnis Road, Mahim (West), Mumbai – 400016. Tel: 022-24460335/36/40