Thematic report **April 05, 2016**

Key Highlights of First Bi-Monthly Monetary Policy 2016-17 – Repo rate cut by 25 basis points..

In its first monetary policy review for the financial year 2016-17, the Reserve Bank of India announced a 25 basis point reduction in the repo, or repurchase rate, which is the rate at which banks borrow from the central bank. One basis point is one hundredth of a percentage point.

The repo rate now stands at 6.5%, the lowest it has been since March 2011. To boost liquidity, it has also reduced the minimum daily maintenance of the cash reserve ratio (CRR) from 95% of the requirement to 90% with effect from the fortnight beginning April 16, 2016.

However, the RBI cut the reverse repo or the rate at which banks park excess funds with the central bank, to 6%, narrowing the policy corridor between the repo and reverse repo by 50 bps, bringing the marginal standing facility (MSF) rate to 7.0%. The Bank Rate which is aligned to the MSF rate also stands adjusted to 7.0%. But the CRR has been kept unchanged at 4.0 per cent of net demand and time liabilities (NDTL).

The rate cut had been widely expected, although the quantum of the cut had had mixed backers. A Reuters poll had predicted an interest rate of 25 basis points.

With this slew of measures, the RBI has essentially opened the liquidity spigot in the expectation that banks will pass on the benefits to companies that can then restart the investment which may boost growth.

RBI's assessment of Global Markets

1) Perceptions of downside risks to recovery in some advanced economies (AEs) at the beginning of 2016 have eased, while major emerging market economies (EMEs) continue to contend with weak growth and still elevated inflation amidst tighter financial conditions.

2) World trade remains subdued due to falling import demand from EMEs and stress in mining and extractive industries.

3) In the US, consumer spending was underpinned by a strengthening labour market, but flagging exports proved to be a drag on growth in Q4 and cloud the nearterm outlook.

4) In the Euro area, tailwinds in the form of aggressive monetary policy accommodation and still low energy prices have supported activity in an environment beset with uncertainties from the migrant crisis, intensifying stress in the banking sector, and possible Brexit. While Japan escaped recession in Q4 of 2015, a combination of weak consumer spending, business investment and exports has slowed the economy in Q1 of 2016. In China, sluggish industrial production, contracting exports, capital outflows and substantial excess capacity in factories and the property market remain formidable headwinds, notwithstanding significant monetary and fiscal policy stimulus. EME commodity exporters have benefitedrecently from the firming up of commodity prices and risk-on investor sentiment has appreciated their currencies. Across EMEs, however, weak domestic fundamentals, lacklustre external demand and country-specific constraints continue to restrain growth.

5) Global financial markets have recouped the losses suffered in the turbulence at the beginning of the year. From mid-February, a firming up of crude prices buoyed market sentiment, allaying fears of global recessionary risks.

6) With China reducing reserve requirements, the ECB expanding accommodation and the Fed providing dovish guidance while staying on hold, equity markets rallied. In bond markets across AEs and EMEs, yields gradually eased, with country-specific variations. The US dollar has retreated from January peak and has eased further in the aftermath of the FOMC's March meeting.

7) On the other hand, the euro and the yen have appreciated, reacting perversely to exceptional accommodation. Currencies across EMEs have also appreciated as portfolio flows returned cautiously to local debt and equity markets.

8) Gold prices have jumped 16 per cent in Q1 of 2016 on safe haven demand.

9) Commodity prices, including oil, have picked up recently, though they still remain soft. However, the uneasy calm that prevails in financial markets could be dispelled easily by a sudden return of risk-off investor sentiment on incoming data, especially pertaining to China or to US inflation.

RBI’s assessment of Inflation

Retail inflation, for long a thorn in the side of monetary policy, seems to have finally been brought under control, even though much credit for that may lie at a creeping global slowdown led by China. Inflation has eased to 5.18% in February. While that is still higher than the RBI’s own target of 5% for March 2017, expectations are that it could fall to as low as 4% in coming months. A weakening El Nino could also help bring a good monsoon and further drive down food prices – which carry the most weight in the Consumer Price Index (CPI) – in the second half of the fiscal Wholesale inflation has been in negative territory for all of FY2016, a trend that is likely to continue.

The RBI said on Tuesday that it expects retail inflation to stay at around 5% for the rest of the current fiscal year. The domestic investment cycle has also been slow to pick up.

Companies have also complained that credit remains tight because of high interest rates, while Governor Raghuram Rajan has made his displeasure clear that banks have not passed on the 125 basis point reduction in repo rates since January 2015 to borrowers, while banks have complained of tight liquidity. The latest rate cut now takes the total quantum of rate cuts since the turning of the policy cycle to 150 basis points.

However, factory output in March jumped to an 8-month high of 52.4, as shown by the Nikkei/Markit Purchasing Managers’ Index. This was the third straight month of manufacturing expansion. Additionally, the new orders sub-index, which reflects domestic demand, rose to an 8-month high of 53.9, encouraging firms to increase output.

The RBI, though, projected GDP growth to at about 7.6% for FY2017. citing both upsides from a good monsoon, higher consumer demand from the 7th Pay Commission and OROP for ex-servicemen, and downsides from sluggish investment.
"The uneven recovery in growth in 2015-16 is likely to strengthen gradually into 2016-17, assuming a normal monsoon, the likely boost to consumption demand from the implementation of the 7th Pay Commission recommendations and OROP, and continuing monetary policy accommodation. After two consecutive years of deficient monsoon, a normal monsoon would work as a favourable supply shock, strengthening rural demand and augmenting the supply of farm products that also influence inflation," “the central bank noted. "On the other hand, the fading impact of lower input costs on value addition in manufacturing, persisting corporate sector stress and risk aversion in the banking system, and the weaker global growth and trade outlook could impart a downside to growth outcomes going forward."

Governor comments on Indian Bankers

The RBI governor again called out banks' on their reluctance to pass on the cuts, saying 'Banks have said there is not enough liquidity, now we have given them more liquidity, banks can transmit more." "Hope to see significant monetary transmission over the next few months." he added. He also took note of the ongoing cleanup of bad loans at various banks, mostly public sector banks, saying "Finally the process of cleaning up bank balance sheets is underway and i am happy with the progress."

Market reaction to rate cut by RBI

The markets' reaction, though, was not too enthusiastic. The benchmark S&P BSE Sensex fell about 516 points to 24,883.59 points, expressing its disappointment at the size of the rate cut and Nifty fell by 155.60 points to 7603.

The coupon on the 10-year bond fell from 7.59% to 7.395%, a decline of 0.0130%.

Policy stance in line with Central Government's commitment to fiscal discipline

The rate cut also suggests that the RBI has taken note of the central government's commitment to fiscal discipline, freeing it up to infuse more liquidity into the system. In the Budget for FY2017, Finance Minister Arun Jaitley had reaffirmed the government's intention to contain fiscal deficit at 3.9% of GDP.

RBI's new guidelines soon:

Concerned over rising bad loans, the Reserve Bank will soon come out with a draft framework on large exposure of bank loans to corporates. "Taking into account the views and suggestions from stakeholders on the discussion paper on 'Large Exposures Framework and Enhancing Credit Supply through Market Mechanism', a fresh discussion paper will be issued by April 30, 2016 on large borrowers meeting part of their funding requirements from markets," RBI Governor Raghuram Rajan said.

A draft circular on the Large Exposures Framework will be issued for public comments in June 2016, which is to be implemented by January 1, 2019, he said, after unveiling the first bi-monthly monetary policy review for 2016-17. In order to promote start-ups in the country, RBI will also release norms with respect to deferred payment.

Policy stance going ahead

Introduction of Marginal cost of funds based lending rates should improve transmission & likely to magnify the effects of current policy rate cut. The stance of RBI will remain accommodative & will continue to watch macroeconomic & financial development in the month ahead with a view to respond with further policy action as space opens up. We hope that the banks will now reduce their lending rates, especially for home loans more aggressively.

Upcoming bi-monthly policy dates

a) The second bi-monthly policy will be announced on 06th June, 2016
b) The third bi-monthly policy will be announced on 09th August, 2016
c) The fourth bi-monthly policy will be announced on 04th Oct, 2016
d) The fifth bi-monthly policy will be announced on 06th Dec, 2016
e) The sixth bi-monthly policy will be announced on 07th Feb, 2017

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