Thematic Research **April 06, 2017**

Highlights of First Bi-monthly Monetary Policy 2017-18

1) The Reserve Bank of India (RBI) kept the repo rate unchanged at 6.25 percent, forecast robust a 7.4 growth in 2017-18 aided by waning effects of demonetisation, although inflation risks remain in the medium term. The RBI hinted at a looming inflation threat over the next 6-12 months, obliquely leaving the door ajar for an interest rate hike in 2017-18. For 2017-18, inflation is projected to average 4.5 per cent in the first half and 5 per cent in the second half**.** On inflation, the RBI said **"Underlying inflation pressures persist, especially in prices of services. Input cost pressures are gradually bringing back pricing power to enterprises as demand conditions improve,"** the central bank said flagging weak monsoon, expected rise in government employees' allowances and goods and services tax (GST) as the primary factors that could knock up prices in the short-term. With regards to food inflation, the uncertainty surrounding the outcome of the south west monsoon in view of the rising probability of an El Nino event around July-August could impact food inflation

2) The status quo on rates, however, was accompanied by a string of regulatory changes including **raising the reverse repo by 25 basis points to 6 percent**, ***allowing banks to investment in real estate investment trusts (REITs), raising the minimum fund requirements of asset reconstruction companies (ARCs), allowing collateral substitution under repo that will give banks more funds to lend, and proposing the introduction of standing deposit facility (SDF)—another window for banks to borrow.*** Please note Reverse repo is the rate at which RBI borrows from banks to absorb or release cash from and into the system.

3) At higher reverse repo, the central bank would suck cash from the system to stymie demand and cool prices. It will also encourage banks to park excess funds with the RBI that will fetch higher returns. Banks are awash with funds as millions have deposited outlawed old Rs 500 and Rs 1000 notes between November 8 and December 30, 2016.The overnight call-money rates—the rate at which banks lend to each other to address daily liquidity shortages—normally remains within the LAF.

4) Last year, RBI announced its intent to progressively reduce the LAF from 100 basis points to 25 basis points, based on an expert panel's recommendations. Likewise, the marginal standing facility (MSF) or the rate at which banks borrow from the RBI during periods of acute liquidity shortage, will stand reduced to 6.5 percent. When banks are extremely short of funds, they are willing to pay a higher interest rate to borrow extra money from the RBI even at a much higher rate. It will now stand at 25 basis points above the repo rate. "In either extremely tight liquidity conditions or in situations of persistent excess liquidity, when most market participants are on one side of the market for overnight liquidity, a narrower corridor can contribute to finer alignment of the operating target with the policy rate," the RBI said in a statement on `Developmental and Regulatory Policies'.

5) Allowing banks to participate in REITs will likely open up a new fund source for the cash-starved realty sector, battling fund shortage, low demand and a long unfinished project pipeline."The Securities and Exchange Board of India (SEBI) has put in place regulations for REITS and InvITs and requested the Reserve Bank to allow banks to participate in these schemes. Currently, banks are allowed to invest in equity-linked mutual funds, venture capital funds (VCFs) and equities to the extent of 20 percent of their NOF. It is proposed to allow banks to invest in REITS and InvITs within this umbrella limit," the

RBI said. Detailed guidelines will be issued by end-May 2017. A REIT, or Real Estate Investment Trust, is an investment vehicle modelled on the lines of a mutual fund (MF). It allows individuals and institutions to invest in real estate projects in a way similar to people invest in companies' shares and bonds through MFs.

6) In a bullish commentary on growth prospects, it projected gross valued added (GVA) to growth at 7.4 per cent in 2017-18 from 6.7 per cent in 2016-17. The government's central statistics office (CSO) data released in February showed that growth in GVA, which is GDP minus net taxes, will slow down to 6.7 percent in 2016-17 or 1.1 percentage points lower than 7.8 percent GVA growth in 2015-16. GVA serves as a more realistic proxy to measure changes in the aggregate value of goods and services produced in the economy. The demonetisation effect and the resultant slowdown in household spending and corporate investment may well be hiding in the steeper fall in GVA growth estimates compared to GDP.

7) The RBI, however, said several favourable domestic factors will help engineer a quick turnaround in the broader economy due to the following factors:

a) First, the pace of remonetisation will continue to trigger a rebound in discretionary consumer spending. "Activity in cash-intensive retail trade, hotels and restaurants, transportation and unorganised segments has largely been restored."
b) Second, significant improvement in transmission of past policy rate reductions into banks' lending rates post demonetisation should help encourage both consumption and investment demand of healthy corporations.
c) Third, various proposals in the Union Budget should stimulate capital expenditure, rural demand, and social and physical infrastructure all of which would invigorate economic activity.
d) Fourth, the imminent materialization of structural reforms in the form of the roll-out of the GST, the institution of the Insolvency and Bankruptcy Code, and the abolition of the Foreign Investment Promotion Board will boost investor confidence and bring in efficiency gains. Fifth, the upsurge in initial public offerings in the primary capital market augurs well for investment and growth.

The RBI expects growth to recover sharply to 7.4 percent in 2017-18 on account of factors:

a) discretionary consumer demand held back by demonetisation is expected to bounce back soon,
b) economic activity in cash-intensive sectors such as retail trade, hotels and restaurants, and transportation, as well as in the unorganised sector, is expected to be rapidly restored,
c) demonetisation-induced ease in bank funding conditions has led to a sharp improvement in transmission of past policy rate reductions into marginal cost-based lending rates (MCLRs), and in turn, to lending rates for healthy borrowers, which should spur consumption and investment,
d) the emphasis in the Union Budget for 2017-18 on stepping up capital expenditure, and boosting the rural economy and affordable housing should contribute to growth.

That said, the RBI has unambiguously stated that it is on the side of price control in the growth-versus-inflation contest.

"The MPC remains committed to bringing headline inflation closer to 4.0 per cent on a durable basis and in a calibrated manner. Accordingly, inflation developments have to be closely and continuously monitored, with food price pressures kept in check so that inflation expectations can be re-anchored," it said.

Please find the key highlights of the policy document:

1) Global growth indicators suggest signs of stronger activity in most advanced economies (AEs)
2) Outlook gradually improving for emerging market economies (EMEs), with indications that the slowdown characterising 2016 could be bottoming out.
3) Global trade volumes showing signs of improvement, with exports rising strongly in several EMEs as well as in some AEs with weak currencies.
4) Food prices firming up globally, driven by cereals.
5) Significant loss of momentum across domestic industry, barring electricity generation. The services sector also slowed, pulled down by trade, hotels, transport and communication as well as financial, real estate and professional services.
6) Government expenditure made up for weakness in private consumption and capital formation to some extent.
7) Foodgrains production at an all-time high, bumper production of pulses to keep the price of pulses under check – domestic price of pulses already below minimum support price (MSP).
8) Indicators such as exports and non-oil non-gold imports suggest a brighter outlook for industry. But over capacity in several industries could be a drag on investment.
9) Activity in the services sector improving. Rural demand depressed, but high-frequency indicators relating to railway traffic, telephone subscribers, foreign tourist arrivals, passenger car and commercial vehicles regaining pace.
10) Reserve Bank's industrial outlook survey indicates that pricing power is returning to corporates as profit margins get squeezed by input costs
11) Inflation excluding food and fuel persisting and significantly above headline inflation since September 2016.
12) With progressive remonetisation, the surplus liquidity in the banking system declined from a peak of Rs 7,956 billion on January 4 to an average of Rs 6,014 billion in February and further down to Rs 4,806 billion in March.
13) Surge in imports in January and February 2017 mainly due to hardening of commodity prices such as crude oil and coal. Non-oil non-gold imports continue to grow at a modest pace, though capital goods imports remain sluggish.
14) For the year as a whole, the current account deficit is likely to remain muted at less than 1 per cent of GDP.
15) Headline CPI inflation set to be below target of 5.0 per cent for Q4 of 2016-17. For 2017-18, inflation projected to average 4.5 per cent in the first half of the year and 5 per cent in the second half.
16) A strengthening global economy may lift commodity prices further and pass through into domestic inflation.
17) Government deficit-- high by international comparison--poses yet another risk for the path of inflation, which is likely to be exacerbated by farm loan waivers.
18) Banks have cut rates, but there is more room for rates to fall, including rates on small savings instruments.

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