

Thematic Research - Fourth Bi-monthly Monetary Policy analysis

Oct. 3, 2016

RBI Governor Urjit Patel's first credit policy announcement as the head of the central bank has met market consensus as he announced a 25 basis points cut in repo rates. This was also the first time that the decision was based on the recommendation made by the Monetary Policy Committee (MPC).

Here are five key takeaways from the RBI policy:

1. Inflation: The rate cut is in line with our expectations but considered as a surprise move by some economists as retail inflation had started moving up. Retail inflation measured by the headline CPI has risen on account of a sharp pick-up in the momentum of food inflation as per RBI document. In August, however, the momentum of food inflation turned negative and surprised expectations which pulled down headline inflation to an intra-year low. This probably gave the central bank some comfort in cutting down rates. MPC expects that the strong improvement in sowing, along with supply management measures, will improve the food inflation outlook.

2. Liquidity: Liquidity conditions have remained comfortable in Q3, which was helped by liquidity infusion of Rs 20,000 crore. The weighted average call money rate (WACR) remained tightly aligned with the policy repo rate and, in fact, traded with a soft bias. Interest rates on commercial paper (CPs) and certificates of deposit (CD) also eased. This should enable the smooth transmission of the policy action through various market segments.

3. Rural push: On the domestic front, the outlook for agricultural activity has brightened considerably. The south west monsoon ended the season with a cumulative deficit of only 3 per cent below the long period average, with 85 per cent of the country's geographical area having received normal to excess precipitation. *Kharif* sowing has surpassed last year's acreage, barring cotton, sugarcane and jute and mesta. Accordingly, the first advance estimates of *kharif* foodgrains production for 2016-17 by the Ministry of Agriculture have been placed at a record level, and higher than the target set for the year. *Kharif* sowing has surpassed last year's acreage, barring cotton, sugarcane and jute and mesta with the first advance estimates of *kharif* foodgrains production for 2016-17 have been placed at a record level, and higher than the target set for the year.

4. Manufacturing: Not much activity is visible in the industrial sector which suffered a contraction in early fiscal year Q2, after a sequential deceleration in gross value added in Q1. Some pockets of growth was visible in the steel sector as production rose to a 37-month high and cement production maintained momentum. Output of core industries as a whole was weighed down by a decline in the production of coal, crude oil and natural gas and deceleration in refinery products and electricity generation. In the services sector, the acceleration in the pace of activity in Q1 appears to have been sustained.

5. Positive outlook: Business expectations polled in the Reserve Bank's industrial outlook survey and by other agencies remain expansionary in Q2 and Q3. The strong public investment in roads, railways and inland waterways, the recent efforts to unclog cash flows in large projects under arbitration, and the boost to spending from the 7th Pay Commission's award, should improve the industrial outlook. The momentum of growth is expected to quicken with a normal monsoon raising agricultural growth and rural demand, as well as by the stimulus to the urban consumption spending from the pay commission's award.

RBI expects that the accommodative stance of monetary policy and comfortable liquidity conditions should support a revival of credit to the productive sectors. The only negative is the poor scenario in the world market. We expect domestic bourses to take positive cue from this policy.

Next meeting of MPC is scheduled on December 6-7, 2016.



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