October 05, 2018 ECONOMIC UPDATE

Monetary Policy—October 2018

MPC maintains a surprise status quo, but shifts the Stance to "Calibrated Tightening"

RBI's monetary policy has emerged as a critical policy tool for achieving overall macroeconomic management, price stability and growth. The Monetary Policy Committee (MPC) met from 3rd October to 5th October 2018 to review the monetary policy framework of the country, decide on the repo rate, reverse repo rate, inflation projection and forecast of GDP growth rate.

All eyes were glued on MPC's decision to hike the repo rate (the key rate at which the RBI lends short-term funds to commercial banks) with a more aggressive policy stance. In its previous bi-monthly review (August Policy-the repo rate or the benchmark lending rate was raised by 25bps to 6.5%), the MPC had hiked the repo rate for the second time in this year and retained its stance at 'Neutral', due to uncertainty in terms of inflationary risks. Since then, the rising consumer inflation and depreciating rupee has created a notion amongst economists with a view of 25 bps rate hike from the central bank.

Highlights of October Monetary Policy:

- Repo Rate: 6.5% (was increased to 6.5% in August 2018)
- Reverse Repo Rate: 6.25% (was increased to 6.25% and the bank rate at 6.75% in August 2018)
- RBI lowers the inflation projection at 3.9-4.5% in H2
- The RBI has maintained the forecasted GDP growth of 7.4% including home rent allowance impact in FY19 from 6.6% in FY18. Further, the GDP growth has been projected at 7.1-7.3% in H2FY19.

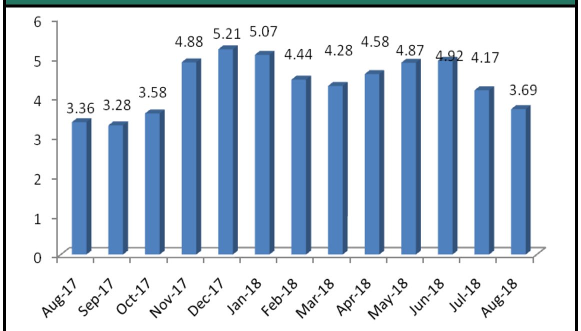
The RBI has surprisingly kept the the Repo Rate unchanged in the fourth bi-monthly monetary policy meeting, however maintaining a "Calibrated Tightening" stance, with the objective of achieving medium-term target for CPI inflation of 4%(+/-2%), while supporting growth.

Why a hike was expected:

Many analysts expected the RBI to bring in a hike of 25bps in repo rate, the third consecutive rate hike move towards a tightening stance in the current cycle. The other factors include

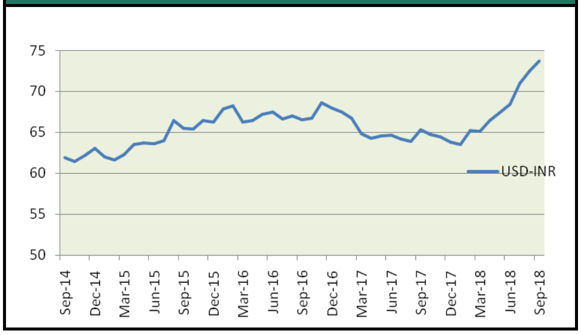
- Inflation, a key concern for India's central bank, slipped below the 4 percent target in August. With petrol and diesel prices moving up, there is a strong expectation that inflation will also move up (A 10% rise in global crude oil prices could have 20-30bps impact on inflation)
- The rupee is yet to show signs of significant strength against the US dollar. Since the last policy review, it is hovering around 73 against the dollar. (rupee depreciation around 5% could have 20bps impact on inflation)
- The central bank will merely match the three U.S. Federal Reserve rate hikes this year without giving the rupee any leeway to gain against the dollar to keep in pace with emerging market central banks including Indonesia, Argentina, Philippines and Turkey, recently increasing their respective interest rate.

India Inflation Rate



Source: investing.com

India Inflation Rate



Source: tradingeconomics.com

Our View– 25bps Rate Hike:

Factors like high core inflation along with risk of input prices being passed on over the next few quarters, rising US interest rates, capital outflows from emerging markets and India's weakening balance of payments and current account deficit price, rupee concerns, stronger growth implying inflationary pressure in medium term, all of these tilt towards a rate hike of 25 bps.

However, our expectation of 25bps along with majority of the market expecting the same was taken aback with a surprising status quo by the RBI.

The Final Verdict:

POLICY AT A GLANCE		
REPO	REVERSE	MPC's
UNCHANGED	UNCHANGED	STANCE CALIBRATED TIGHTENING
To 6.5%	To 6.25%	

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