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EXPERT TAKE

Neutral stance suggests future rate action will be data-dependent


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WITH AN increase in the projection of the CPI inflation in H2 FY19 to 4.7% from 4.4% amid a narrowing of the output gap, the members of the Monetary Policy Committee (MPC) voted unanimously to pre-emptively hike the repo rate by 25 bps in the June 2018 policy review, while maintaining the neutral stance. The rate hike followed the uptick in inflationary expectations, the core CPI inflation and crude oil prices, even as additional clarity on factors such as the progress of the monsoon and revision in minimum support prices is awaited.

Some of the risks such as the substantial rise in global crude oil prices, accompanied by a depreciation of the rupee highlighted by the MPC in the April 2018 policy review have come to the fore. The MPC highlighted that the recent volatility in global oil prices imparts substantial uncertainty to the inflation outlook — upside as well as downside. It also highlighted other risks such as the uncertainty related to global financial market developments, the staggered impact of HRA revisions by various state governments and the sharp rise in domestic households' inflation expectations in the May 2018 round of the RBI survey. The latter may transmit into higher wages and input costs in the coming months, particularly given the narrowing of the output gap.

The MPC retained its FY19 GDP growth forecast at 7.4%, an appreciable uptick from 6.7% in FY18. However, it projected a mild dip in the GDP growth from 7.5-7.6% in H1 FY19 to 7.3-7.4% in H2 FY19, with risks evenly balanced.

It highlighted that domestic economic activity has displayed a sustained revival in recent quarters, and that investment activity is recovering. The latter is expected to be boosted further by the resolution of distressed sectors of the economy under the Insolvency and Bankruptcy Code. Nevertheless, the committee highlighted various risks to domestic growth arising from geo-political concerns, global financial volatility and possible trade wars. It pointed out the importance that public finances should not crowd out private sector investment activity at this stage. However, it also remarked that adherence to budgetary targets by the central and the state governments, would dampen the upside risks to inflation.

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The retention of the neutral stance, instead of a shift to withdrawal of accommodation, suggests that future rate hikes would be data-dependent. Regardless, the monetary tightening may push up bank lending rates. If the availability of capital constrains the credit growth of PSBs, particularly those under the PCA regime, it may hamper the ability of lower rated firms as well as SMEs to access adequate financing.

Moreover, domestic bond yields have recorded a considerable hardening in the recent months, in line with global trends as well as a decline in the systemic liquidity surplus, and emergence of fiscal and inflationary risks. Nevertheless, higher rated corporates are likely to tap the domestic bond market, despite elevated domestic bond yields, and external commercial borrowings, despite higher global rates, for their financing needs. Accordingly, interest costs are likely to rise in the current fiscal, which would weigh upon margins as well as the strength of the investment recovery in FY19.

The proposal for state development loans to get public ratings would bring in much-needed differentiation in the market's assessment of the credit profile of states. This would also aid in widening the spreads in the state development loan market, that tend to be quite narrowly clustered at present.

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