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EcoScope
The Economy Observer

RBI should maintain neutral stance for now

Neither domestic nor global fundamentals support monetary tightening

- **In stark contrast to April 2018, a hike in repo rate as soon as August 2018 has become almost a unanimous call, with the Reserve Bank of India (RBI) expected to change its stance from neutral to hawkish this week. We, however, believe that the Bank should maintain its neutral policy this week for at least five reasons:**
  1. **Notwithstanding a spurt in crude oil prices, the average inflation forecast (private and RBI's) is sub-5% for FY19 and FY20, with 4-4.5% in 4QFY19. If the upside risks have not yet altered inflation forecasts significantly, how can they alter the monetary policy stance?**
  2. **Central banks across the developed world have turned more cautious in the past couple of months, with growth weakening in the Eurozone, the United Kingdom (UK), Japan and China. The US Federal Reserve has also toned down its stance. What is more relevant – cautious developed central banks or hawkish EM central banks?**
  3. **With fiscal policy reaching limits in its ability to support economic activity, the monetary policy should avoid any tightening for now. Although India's GDP growth in 2HFY18 improved, it was influenced by favorable base, which will start fading from FY19.**
  4. **The recent weakness in the Indian Rupee (INR), like other emerging market currencies, is a by-product of stronger US Dollar (USD). Although INR has weakened ~5% in nominal terms in 2018, the current level is similar to the average in 2016 and INR against USD is still stronger in real terms.**
  5. **Higher (or double-digit) growth in minimum support prices (MSPs) is still a valid fear, but not a certainty. It would be rational to wait and watch for the final MSP policy before acting on the risks.**
- **Further, the market rates – short-end and long-end – have already tightened significantly in anticipation of rate hikes by the RBI, which has contributed to wider spread between 10-year sovereign yield and policy repo rate. The RBI must try to narrow the spread by influencing the former rather than the latter. This is because the overnight call money market has behaved very well (within the reverse repo and repo rate), implying that system liquidity is not out-of-line. The bond yield has shot up because of the fear of anticipated hikes and lack of demand. The RBI must maintain neutral stance to address the former and must conduct further open market operations (OMOs) to address the latter.**
- **We understand that given the MSPs concern, the monetary policy is unlikely to be more dovish. However, the maintenance of neutral stance with the mention of potential risks – a repeat of the tone in April's post-policy conference – and (very importantly) matching it with the minutes will help bring down the bond yield by half a percentage point and narrow the spread.**

In stark contrast to the prevailing mood a couple of months ago in April 2018, a rate hike has become almost a consensus now. Four key developments have altered the consensus: (1) Widely unanticipated hawkish comments by RBI's Deputy Governor in the policy minutes, which were in stark contrast to the dovish tone in the post-policy conference; (2) Fear of the government hiking minimum support prices (MSPs) for kharif crops by 20-25% to meet its Budget commitment; (3) Crude oil price touching USD80/barrel; and (4) Weakness in Indian Rupee (INR) vis-à-vis US Dollar (USD). Barring the first development, which implies that two out of six MPC members are likely to vote for rate hike now, none of the other three factors warrant a change in the monetary policy stance, let alone a rate hike. In fact, we argue five reasons for the RBI to maintain neutral stance for now, unless the risks materialize.

Not only may the government have limited ability to stimulate the economy but the stimulus may not necessarily be effective to enhance GDP

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❶ Inflation forecasts remain sub-5% for FY19 and FY20, with 4-4.5% in 4QFY19

As per the survey of professional forecasters (SPF) released by the RBI, headline CPI inflation – the target variable – is expected to average 4.6% in FY19, as against 3.6% in FY18. Notably, base effect is expected to drive inflation higher in 1QFY19, which is pushing the full-year average higher. Inflation is expected at 4.3% in 4QFY19 by professional forecasters. RBI's own forecasts – released in April – were 4.7% for FY19 and 4.4% in 4QFY19.

Even though higher crude oil prices have pushed up the annual average slightly, subdued inflation in other components has almost entirely offset it

Similarly, the median inflation expected is 4.8% for FY19, as per the economists surveyed by Bloomberg. Notably, the recent inflation forecasts on Bloomberg are lower than the forecasts at the beginning of 2018. After an average forecast of 4.8% in the February and March surveys, the annual inflation forecast fell to 4.7% in the April survey before rising marginally to 4.8% in the latest survey in May 2018. It suggests that even though higher crude oil prices have pushed up the annual average slightly, subdued inflation in other components has almost entirely offset it *(Exhibit 1)*.

If the upside risks have not yet altered inflation forecasts significantly, how can they alter the monetary policy stance?

The point we are trying to drive home is that notwithstanding all the upside risks – related to MSPs fear or crude oil prices, almost all forecasters (including RBI) expect inflation to average less than 5% for the full-year FY19 and the inflation is expected to fall back to 4-4.5% by 4QFY19. If the upside risks have not yet altered inflation forecasts significantly, how can they alter the monetary policy stance?

Exhibit 1: Notwithstanding the risks, headline CPI-inflation forecasts remain sub-5% for FY19 (%)

	December forecast	February forecast	April forecast	May forecast
Survey of Professional forecasters	4.4	4.7	4.6	NA
Bloomberg	4.8	4.8	4.7	4.8
RBI	NA	5.0	4.7	NA

NA – Not Available   Source: RBI, Bloomberg, MOSL

❷ Major central banks turning cautious as global economic growth showing signs of slowdown

One of the most important reasons that does not justify any monetary tightening is the deterioration in the global economic recovery

One of the most important reasons that does not justify any monetary tightening is the deterioration in the global economic recovery. During the past quarter or so, major central banks in the world – US Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BoE) and Bank of Japan (BoJ) have all turned cautious in their bid to hike policy rates or end the quantitative easing (QE). The weakness in economic recovery in almost all these major developed economies has forced their respective central banks to go slow on their plan to withdraw monetary accommodation.

Economic growth slowdown was pervasive in 1QCY18 – the Japanese economy, in QoQ annualized terms, contracted for the first time in two years; UK grew at the slowest pace since 2012, Eurozone (EZ) growth weakened to the slowest in seven quarters and US economic growth was the weakest in a year *(Exhibit 2)*. In fact, composite PMI, especially in European economies, weakened considerably and has not shown any reversal in 2QCY18 *(Exhibit 3)*. Caution, thus, is required by the RBI.

Exhibit 2: 1QCY18 real GDP growth has weakened in developed economies…

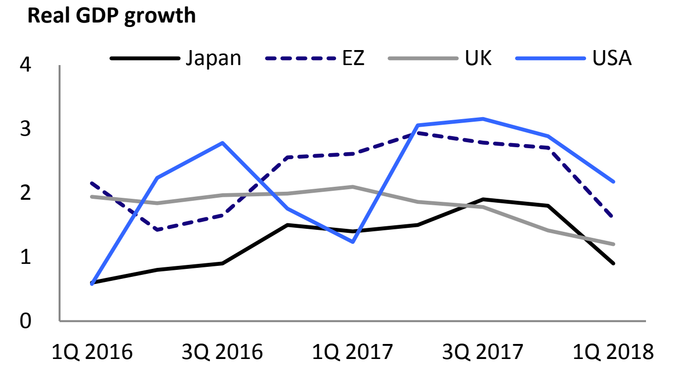
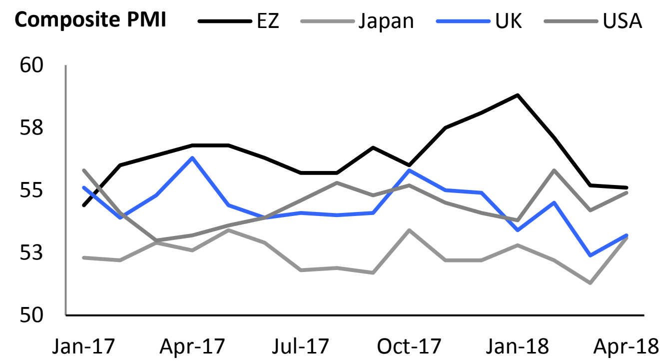


Exhibit 3: …and composite PMI also does not show strength in 2QCY18



Source: CEIC, Markit, MOSL

❸ Recent pick-up in GDP growth supported by favorable base, which will fade out in FY19

Real GDP growth picked up to 7.7% YoY in 4QFY18, marking its highest growth in seven quarters. Such high growth has brought some comfort to market participants that economic activity is strong enough to handle monetary tightening. Such confidence, however, is misplaced.

Two unusual factors, which supported higher GDP growth in 4QFY18 were abnormally high government consumption expenditure (GCE) and favorable base effect

Two unusual factors, which supported higher GDP growth in 4QFY18 were: (a) abnormally high government consumption expenditure (GCE), driven by states, and (b) demonetization-hit favorable base effect – real GDP growth was 6.1% in 4QFY17. Both the factors will disappear in FY19. Our **analysis** confirms that real fiscal spending (revenue spending *less* interest payments) is budgeted to grow 6.6% in FY19, the slowest pace in four years. Further, **historical analysis** also suggests that fiscal spending does not necessarily grow faster (or out-of-line with budget estimates) during election years such as FY19.

Further, household investments, which are – to our mind – the key driver of higher investments in FY18, grew strongly in 2HFY18, benefitting from a slump in 4QFY17 due to demonetization. This high growth will create adverse base effect in 2HFY19. Overall, the consensus forecast for real GDP growth is ~7.4% in FY19 (our forecast is much lower at 6.9%), which neither includes the potential adverse impact of monetary tightening nor from higher crude oil prices. The economic activity, thus, is not strong enough to warrant monetary tightening, especially when the fiscal policy has reached its limits.

Exhibit 4: Real fiscal spending is budgeted to grow 6.6% in FY19, slowest in four years

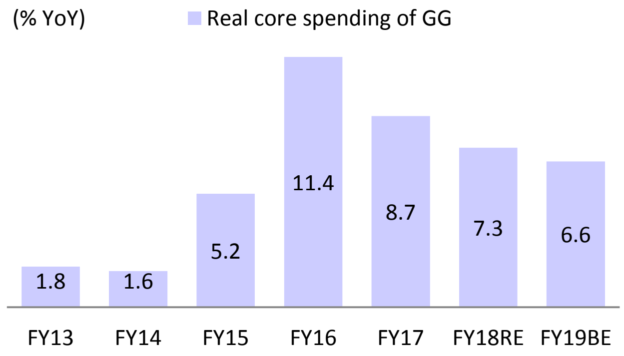
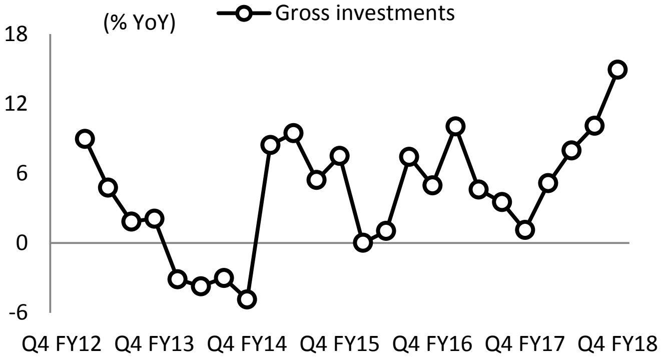


Exhibit 5: Investments have grown 10.5% YoY in FY18, the highest growth in six years



Source: Central Statistics Office (CSO), CEIC, MOSL

❹ INR has weakened in nominal terms, but remains stronger in real terms – against USD as well as the basket of major currencies

One of the factors that have led market participants to argue that the RBI should hike rates is the weaker INR against USD. The situation in the emerging markets (EMs) has deteriorated in the past two months due to USD strength. Early last month, Argentina sought a loan from the International Monetary Fund (IMF) to rescue Peso from downward slide. Indonesia has hiked its policy rate twice and Philippines also hiked policy rates in May 2018.

Although INR has weakened ~5% in nominal terms in 2018, the current level is similar to the average in 2016 and INR against USD, in real terms, is still stronger

As argued above, however, the movements in INR, like other EM currencies, are more influenced by the USD movements, than anything else *(Exhibit 6)*. One of the key reasons for the USD strength has been the weak economic data readings in other developed economies – EZ, UK and Japan. This has raised the possibility of monetary policy divergence between the US and non-US developed world. If so, then the rate hikes by the EMs are unlikely to help.

Further, although INR has weakened ~5% in nominal terms in 2018, there are two things to note: (a) INR strengthened 3.2% in 2017, implying that the current level is similar to the average in 2016, (b) INR against USD, in real terms, is still stronger *(Exhibit 7).* Why then do currency movements warrant a rate hike?

Exhibit 6: INR movements closely follow the movements in USD index

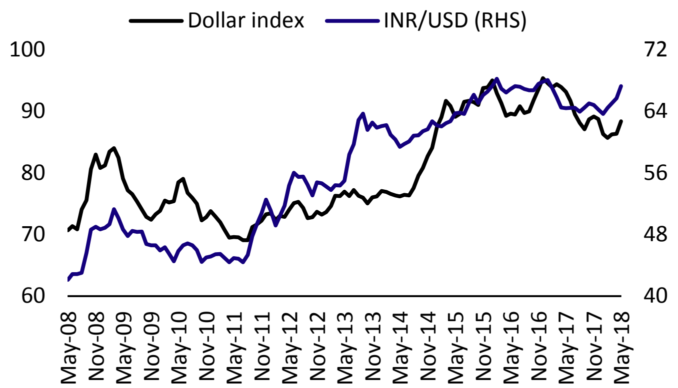
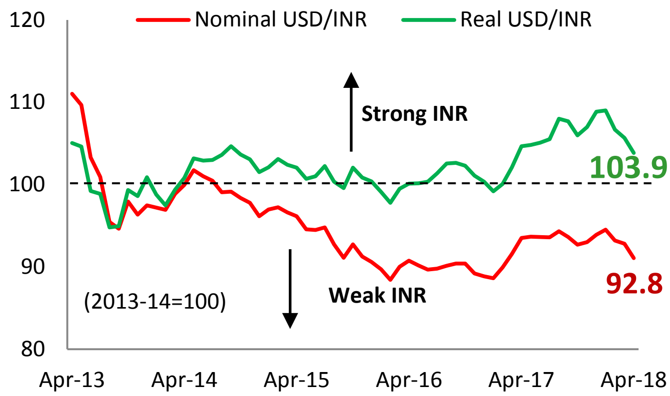


Exhibit 7: INR has weakened in nominal terms but still remains stronger in real terms



Source: St Louis Federal Reserve, Bloomberg, MOSL

❺ MSP policy a valid fear but yet unrealized

Finally, there is no denial that serious inflationary risks continue to linger. The announcement of hiking MSP to 1.5x the cost of production implies that the government will have to hike MSP by ~25% (considering A2+FL as the measure of cost of production) to make good on its announcement. If so, it implies an additional impact of 68 basis points on the headline CPI (one basis point in one-hundredth of a percentage point).

Unless risks materialize, there is no need for the monetary authority to front-run

Nevertheless, unless these risks materialize, there is no need for the monetary authority to front-run. This is simply because a delay by few months is not going to cost anything to the economy. The RBI, on the other hand, should consider the facts – timely arrival of South-West (SW) monsoon, still subdued headline inflation with forecasts broadly acceptable – in its monetary policy, which warrant no change in the neutral stance.

RBI must maintain neutral stance this week

Overall, neither domestic nor global developments warrant monetary tightening at this stage. In case the government announces a double-digit hike in MSPs (likely to be announced in the next two weeks), the RBI can hike policy rates in August 2018. Nevertheless, if the RBI changes monetary policy stance this week and the MSP hike remains in single-digit, the RBI's credibility will take a serious hit.

If the RBI wants to narrow spread between 10-year yield and the policy repo rate, the Bank must influence the former with more OMOs rather than hiking the repo rate

Finally, one could argue that the market interest rates have already tightened so much in the anticipation of a rate hike that the change in monetary policy stance will be nothing more than a formality. Such tightening in the market rates has contributed to the historically high spread between 10-year yield and the repo rate. If the RBI wants to narrow this spread, it must influence the former rather than the latter. This is because the system-wide liquidity (gauged from the daily money market operations) is behaving normally and the overnight call money market rate has remained in the range of the reverse repo and the repo rate *(Exhibit 8)*. If so, it suggests that higher bond yield must be targeted rather than the policy repo rate. Two factors that have led to sharp surge in bond yield are: (a) fear of anticipated hike by the RBI, and (b) lack of demand for G-Secs, as banks remain net sellers. We believe that the RBI must maintain the neutral stance to address the former and must conduct further open market operations (OMOs) to address the latter.

A repeat of the tone in April's post-policy conference and matching it with the minutes will help narrow the spread

We understand that given the MSPs concern, the monetary policy is unlikely to be more dovish. However, the maintenance of neutral stance with the mention of potential risks – a repeat of the tone in April's post-policy conference – and (very importantly) matching it with the minutes will help bring down the bond yield by half a percentage point and narrow the spread.

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