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RESERVE BANK OF INDIA

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December 06, 2017

Fifth Bi-monthly Monetary Policy Statement, 2017-18
Resolution of the Monetary Policy Committee (MPC)
Reserve Bank of India

On the basis of an assessment of the current and evolving macroeconomic situation at its meeting today, the Monetary Policy Committee (MPC) decided to:

- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.0 per cent.

Consequently, the reverse repo rate under the LAF remains at 5.75 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 6.25 per cent.

The decision of the MPC is consistent with a neutral stance of monetary policy in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 per cent within a band of +/- 2 per cent, while supporting growth. The main considerations underlying the decision are set out in the statement below.

Assessment

2. Since the last meeting of the MPC in October 2017, global economic activity has been gaining momentum through the final quarter of the year, driven mainly by advanced economies (AEs). US growth remained largely resilient to hurricanes and grew at the highest pace in the past three years in Q3 of 2017, with positive contributions from private consumption, investment activity and net exports. The unemployment rate fell to 4.1 per cent in October, the lowest in the last 17 years. In the Euro area, economic activity expanded, underpinned by accommodative monetary policy and strong job gains. The Japanese economy also continued to grow in Q3, largely supported by external demand, which helped compensate for the slowing of domestic consumption.

3. Among major emerging market economies (EMEs), the services sector remained the main driver of growth in China in Q3. However, weakness in real estate and construction activity remained a drag on growth. In Brazil, incoming data suggest that the recovery gained further momentum in Q3, with unemployment touching an intra-year low in September. Business and consumer confidence rose in October. Economic activity in Russia moderated in Q3 due to weakness in industrial production. The South African economy continued to face headwinds from weak manufacturing activity, elevated levels of unemployment and political instability.

4. The latest assessment by the World Trade Organisation (WTO) for Q4 indicates a loss of momentum in global trade due to declining export orders. Crude oil prices touched a two-and-a-half-year high in early November on account of the Organisation of the Petroleum Exporting Countries' (OPEC) efforts to rebalance the market. Bullion prices have been under some selling pressure on account of the rising US dollar. Weak non-oil commodity prices and subdued wage dynamics have kept inflation contained in many AEs, while the inflation scenario remains diverse in major EMEs.

5. Global financial markets have remained buoyant, reflecting the improving economic outlook and the gradual normalisation of monetary policy by the US Fed. Equity markets have gained on improved corporate earnings and anticipation of large tax cuts in the US. Although equity markets have made gains in EMEs in general, they faced risk aversion in some economies. While bond yields in most AEs have moved sideways in the absence of inflation pressures, they have risen across most EMEs on country-specific factors. In currency markets, the US dollar has gained, while the surge in the euro on positive economic data lost some momentum in November due to political uncertainty. Several emerging market currencies weakened due to domestic factors. Capital inflows to EMEs have been differentiating among countries, based on investor perceptions of risk-return trade-offs.

6. On the domestic front, the growth of real gross value added (GVA) accelerated sequentially in Q2 of 2017-18, after five consecutive quarters of deceleration. It was powered by a sharp acceleration in industrial activity. All the three sub-sectors of industry registered higher growth. GVA growth in the manufacturing sector – the key component of industry – accelerated sharply on improved demand and re-stocking post goods and services tax (GST) implementation. The mining sector expanded in Q2 due to higher coal and natural gas production. GVA growth in the electricity, gas, water supply and other utility services sector also strengthened on higher demand. In contrast, growth in agriculture and allied activities slackened, reflecting the lower than expected *kharif* harvest. Activity in the services sector decelerated, mainly on account of slowdown in financial, insurance, real estate and professional services, and in public administration, defence and other services (PADO) following the large front-loading of government expenditure in Q1. Despite some improvement, construction sector growth remained tepid due to transitory effects of the RERA and GST implementation. Growth in the trade, hotels, transport and communication sub-group remained resilient, in spite of some slowdown in growth in Q2 as compared with the previous quarter. On the expenditure side, the growth of gross fixed capital formation improved for the second successive quarter. However, growth in private final consumption expenditure – the mainstay of aggregate demand – slowed to an eight-quarter low in Q2.

7. Looking beyond Q2, *rabi* sowing in Q3 has so far been marginally lagging behind the acreage sown during the comparable period of the previous year. Precipitation since October has remained at around 13 per cent below the long period average (LPA). Major reservoirs, the main source of irrigation during the *rabi* season, were at 64 per cent of the full reservoir level *vis-a-vis* 67 per cent in the previous year. On the positive side, pulses sowing increased significantly as compared with a year ago, partly reflecting the impact of lifting of the export ban for all varieties of pulses.

8. Available high-frequency indicators suggest a mixed picture of industrial activity for Q3. Core industries' growth was flat in October as all constituents barring steel and fertilisers slowed down sequentially. Coal mining, which revived strongly in Q2, slowed down too, while cement production contracted. In contrast, the Purchasing Managers' Index (PMI) for manufacturing, which fell in October, rebounded in November, driven by output and new orders. Also, according to the Reserve Bank's Industrial Outlook Survey (IOS), production is expected to pick up in Q3 as order books are rising.

9. Services sector activity has remained mixed in October. In the transportation sector, sales of commercial vehicles decelerated; those of passenger vehicles and two-wheeler turned into contraction mode. By contrast, domestic and international air passenger and freight traffic, and railway freight expanded robustly. The Reserve Bank's survey suggests that sentiments on service sector activity for Q3 are upbeat and auto sales have rebounded in November. On the other hand, PMI for services moved into contraction zone in November.

10. Retail inflation measured by year-on-year change in the consumer price index (CPI) recorded a seven-month high in October, driven by a sharp uptick in momentum, tempered partly by some favourable base effects. Food inflation was volatile in the last two months – declining sharply in September and bouncing back in October – due mainly to vegetables and fruits. Milk and eggs inflation has shown an uptick, while pulses inflation remained negative for the eleventh successive month in October. Cereal inflation remained stable. Fuel group inflation, which has been on an upward trajectory since July, accelerated further due to a sharp pick-up in inflation in liquefied petroleum gas (LPG), kerosene, coke and electricity.

11. CPI inflation excluding food and fuel, which increased from July to September, remained steady in October. This reflected the softening of petroleum product prices on account of the reversal of taxes on petroleum products by the central and state governments. However, there was a hardening of housing inflation following the implementation of higher house rent allowances for central government employees under the 7th central pay commission award.

12. The Reserve Bank's survey of households showed inflation expectations firming up in the latest round for both three months ahead and one year ahead horizons. Farm and industrial raw material costs rose in October. Firms responding to the Reserve Bank's Industrial Outlook Survey expect to pass on the increase in input prices to their output prices. Turning to other costs, wage growth in the organised sector edged up, while rural wage growth weakened, particularly in agriculture.

13. Surplus liquidity in the system has continued to decline during October and November. Currency in circulation increased by ₹ 736 billion in Q3 (up to December 1, 2017) over end-September on festival demand. The Reserve Bank managed surplus liquidity through the conduct of regular variable rate reverse repo auctions of various tenors, ranging from overnight to 28 days. Net average daily absorption of liquidity under the LAF declined from ₹ 2,229 billion in September to ₹ 1,400 billion in October 2017 and further to ₹ 718 billion in November. The Reserve Bank conducted open market sales of ₹ 300 billion in October-November, taking the total absorption of durable liquidity during the financial year so far to ₹ 1.9 trillion, comprising ₹ 900 billion in the form of open market sales and ₹ 1 trillion of long-term treasury bills under the market stabilisation scheme. The weighted average call rate (WACR) traded 12 bps and 15 bps below the repo rate during October and November, respectively, as against 13 bps in September.

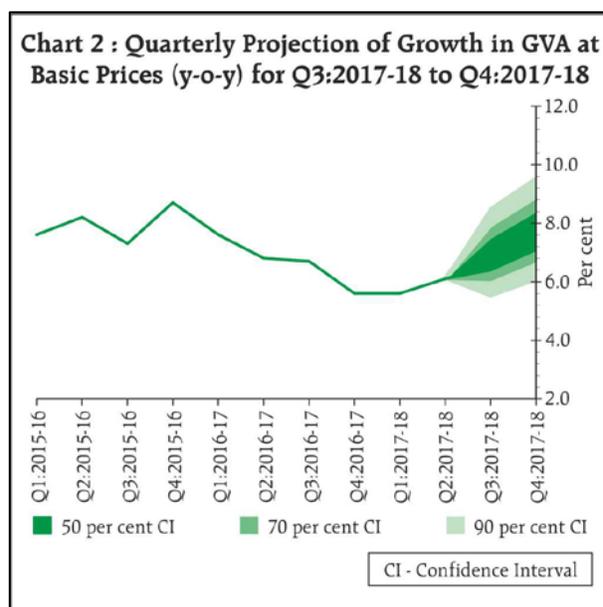
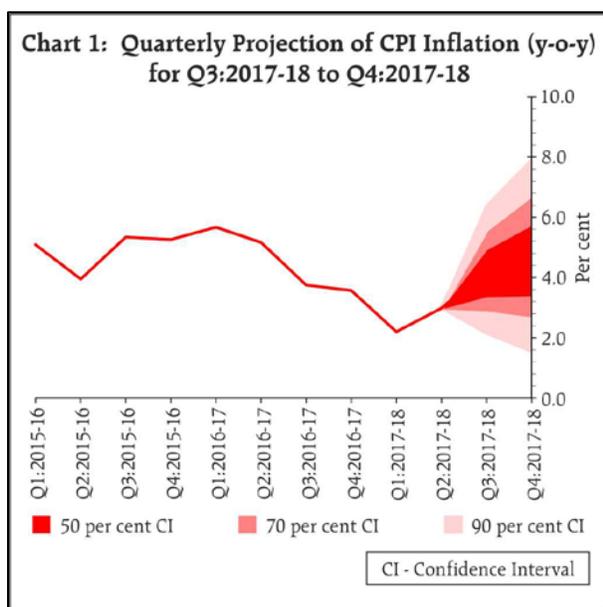
14. Merchandise exports declined by 1.1 per cent in October 2017 after showing positive growth for 14 consecutive months. A sustained increase in exports of engineering goods, petroleum products and chemicals during the month was outweighed by a sharp fall in shipments of gems and jewellery, ready-made garments, and drugs and pharmaceuticals. Imports continued to expand, though at a modest pace. Although gold imports rose sequentially in October, they moderated from their level a year ago. Consequently, the trade deficit widened again in October. Despite moderation in September, net foreign direct investment in H1 of 2017-18 was at the same level as a year ago. With the announcement of the recapitalisation plan for public sector banks, foreign portfolio inflows into equities resumed sharply in October, after recording outflows in the preceding month. India's foreign exchange reserves were at US\$ 401.94 billion on November 30, 2017.

Outlook

15. The October bi-monthly statement projected inflation to rise and range between 4.2-4.6 per cent in the second half of this year, including the impact of increase in house rent allowance (HRA) by the Centre. The headline inflation outcomes have evolved broadly in line with projections. Going forward, the inflation path will be influenced by several factors. First, moderation in inflation excluding food and fuel observed in Q1 of 2017-18 has, by and large, reversed. There is a risk that this upward trajectory may continue in the near-term. Second, the impact of HRA by the Central Government is expected to peak in December. The staggered impact of HRA increases by various state governments may push up housing inflation further in 2018, with attendant second order effects. Third, the recent rise in international crude oil prices may sustain, especially on account of the OPEC's decision to maintain production cuts through next year. In such a scenario, any adverse supply shock due to geo-political developments could push up prices even further. Despite recent increase in prices of vegetables, some seasonal moderation is expected in near months as winter arrivals kick in. Prices of pulses have continued to show a downward bias. The GST Council in its last meeting has brought several retail goods and services to lower tax brackets, which should translate into lower retail prices, going forward. On the whole, inflation is estimated in

the range 4.3-4.7 per cent in Q3 and Q4 of this year, including the HRA effect of up to 35 basis points, with risks evenly balanced (Chart 1).

16. Turning to GVA projections, Q2 growth was lower than that projected in the October resolution. The recent increase in oil prices may have a negative impact on margins of firms and GVA growth. Shortfalls in *kharif* production and *rabi* sowing pose downside risks to the outlook for agriculture. On the positive side, there has been some pick up in credit growth in recent months. Recapitalisation of public sector banks may help improve credit flows further. While there has been weakness in some components of the services sector such as real estate, the Reserve Bank’s survey indicates that the services and infrastructure sectors are expecting an improvement in demand, financial conditions and the overall business situation in Q4. Taking into account the above factors, the projection of real GVA growth for 2017-18 of the October resolution at 6.7 per cent has been retained, with risks evenly balanced (Chart 2).



17. The MPC notes that the evolving trajectory needs to be carefully monitored. First, two of the key factors determining the cost of living conditions and inflation expectations, *i.e.*, food and fuel inflation, edged up in November. Inflation expectations of households surveyed by the Reserve Bank have already firmed up and any increase in food and fuel prices may further harden these expectations. Second, rising input cost conditions as reflected in various surveys point towards higher risk of pass-through to retail prices in the near term. Third, implementation of farm loan waivers by select states, partial roll back of excise duty and VAT in the case of petroleum products, and decrease in revenue on account of reduction in GST rates for several goods and services may result in fiscal slippage with attendant implications for inflation. Fourth, global financial instability on account of the pace of/uncertainty over monetary policy normalisation in AEs and fiscal expansion in the US carry risks for inflation. The expected seasonal moderation in prices of vegetables, and fruits and the recent

lowering of tax rates by the GST Council could mitigate upside pressures. Accordingly, the MPC decided to keep the policy repo rate on hold. However, keeping in mind the output gap dynamics, the MPC decided to continue with the neutral stance and watch the incoming data carefully. The MPC remains committed to keeping headline inflation close to 4 per cent on a durable basis.

18. In the MPC's assessment, there have been several significant developments in the recent period which augur well for growth prospects, going forward. First, capital raised from the primary capital market has increased significantly after several years of sluggish activity. As the capital raised is deployed to set up new projects, it will add to demand in the short run and boost the growth potential of the economy over the medium-term. Second, the improvement in the ease of doing business ranking should help sustain foreign direct investment in the economy. Third, large distressed borrowers are being referenced to the insolvency and bankruptcy code (IBC) and public sector banks are being recapitalised, which should enhance allocative efficiency. However, the MPC notes that the impact of these factors can be buttressed by reducing the cost of domestic borrowings through improved transmission by banks of past monetary policy changes on outstanding loans.

19. Dr. Chetan Ghate, Dr. Pami Dua, Dr. Michael Debabrata Patra, Dr. Viral V. Acharya and Dr. Urjit R. Patel were in favour of the monetary policy decision, while Dr. Ravindra H. Dholakia voted for a policy rate reduction of 25 basis points. The minutes of the MPC's meeting will be published by December 20, 2017.

20. The next meeting of the MPC is scheduled on February 6 and 7, 2018.

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