MPC decides to be patient

The monetary policy committee (MPC) kept policy rates and stance unchanged in its sixth bimonthly policy review, in line with consensus expectations. The policy statement was more balanced than anticipated by bond markets, leading to a relief rally in bonds. In terms of macro projections, MPC revised down both FY18 and FY19 GVA (gross value added) estimates by 10 basis points (bps) and 20bps respectively. Conversely, it revised up Q4FY18 and H1FY19 inflation estimates while keeping Q4FY19 estimates constant.

MPC's inflation forecasts are somewhat inexplicable in my view. For one it has decided to look through the HRA (house rent allowance) effect in pushing up headline inflation in the 12-month period from August 2017 to July 2018.

However, the favourable base effects of the higher inflation that will be felt in H2FY19 is internalized in the inflation projections. Second, even including the HRA effect, MPC may be lowballing the Q1FY19 inflation at 5.6%. I see peak inflation in Q1FY19 at 6%, implying a higher average as well. It is likely that MPC's inflation forecast is under-emphasizing the impact of higher crude prices and fiscal slippage.

For instance, global crude prices are up nearly 40% from July 2017; however, domestic pump prices are up only 10% in this period. Even on a conservative basis if one assumes another 10% rise in prices from here, headline inflation would be higher by about 20bps. Similarly, going by RBI's research on inflation impact of fiscal slippage, the slippages in FY18 and FY19 should add another 15bps. Lastly, the new formula for fixing MSPs could cause inflation to go up by around 35bps. Put all this together and CPI inflation will likely touch 5% by Q4FY19. In fact, if one takes cleaner gauges of CPI excluding housing, the average inflation could be higher than 5% in that period.

In the past, MPC has shown flexibility in changing its inflation forecasts as data comes in. I expect the pattern to repeat this time once the government announces MSP fixing sometime in Q1FY19. Accordingly, I expect MPC to begin hiking policy rates with a 25bps hike in August this year. By then, there will be enough evidence of growth picking up on the back of recovery in consumption and exports. The only pushback against a hike by then would come if MPC has informally decided to dilute its insistence on hitting the 4% target in a durable manner. The committee may decide to allow inflation to be in the 4-6% target in order to support growth, given the fragile nature of the economy.

Indeed, looking at the pragmatic nature of the February policy statement, that could be a reasonable conclusion. However, I believe that MPC cannot afford to lower its guard on inflation especially when the government has pushed back the timeline for fiscal consolidation. Further global inflation pressures may be poised to rise given the tightening labour market in the US and the synchronized global recovery underway. As such, abandoning both fiscal and inflation targets at the same time could cause India to lose its cachet among foreign investors. While policy should be driven largely by domestic considerations, the global context cannot be lost sight of particularly when developed country central banks have started normalizing monetary policies.

Apart from policy stance and macro estimates, the interest of the market centred on RBI's commentary about recent hardening of yields. In the event, both the governor and deputy governor negated the need for any extraordinary measures by pointing to global and domestic factors that triggered the rise in yields. This ensures that the bond market will have to find its own level in an environment of better growth, creeping inflation and higher deficits. As such, I expect the benchmark 10-year bond yield to trade in the 7.25-8% range in FY19. One source of relief

could come if RBI decides to allow higher foreign portfolio investor participation in government bonds. However, I expect such a move to be paired with a road map for further reduction in banks' SLR and HTM limits. All said, higher interest rates are a reality, even if MPC decides to take its time in changing policy rates.

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