Why no one is worried about MPC’s rate hike

Not so long ago, bi-monthly policy meetings of the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) entailed nail-biting suspense for market participants, who watched it for cues to the future direction of interest rates. Rate hike decisions by the MPC, that too after a long pause, inevitably roiled the stock and bond markets.

But the latest meeting saw the tables being turned. When the MPC decided to peg up its repo rate by 25 basis points, signalling a reversal from its cheap money policies of the last three years, traders and investors were unperturbed. The S&P BSE Sensex ended the day with a 275-point gain. The 10-year government security saw its yield rise by a mild 9 basis points. Commentators even congratulated the MPC for putting through a ‘dovish’ hike.

If you are wondering about this non-reaction, blame Mr. Market for it. The MPC’s recent rate decision has turned out be a non-event because India’s financial markets had already pre-empted it, many moons ago.

Consider bond markets first. While the MPC has been in pause mode for the last 10 months, the yield on the 10-year government bond, the benchmark for market interest rates, has shot up by 120 basis points from 6.60% to 7.83%.

Several factors have propelled market interest rates in this period. The most important one is the demand-supply mismatch in government securities (g-secs). Normally, the g-sec supply unleashed by the Centre’s borrowings is promptly mopped up by banks to fulfil their 19.5% SLR (statutory liquidity ratio) requirement. But post-demonetisation, domestic banks were flush with funds and took to parking these surpluses in g-secs, resulting in them holding as much as 30% in SLR securities.

With credit offtake picking up in recent few months, banks have gone slow with their g-sec purchases, to ensure that they had funds to lend. With the largest buyers in the market stepping back, excess g-sec supply has swamped the market, quelling prices and raising yields.

Other market forces have aggravated the supply glut. With global interest rates firming up lately, foreign portfolio investors, key players in the bond market, have been in sell mode, withdrawing a massive $6.7 billion between April 1 and June 6, 2018, as per the MPC. Rising rates lead to capital losses for holders of bonds. Therefore, soaring yields have prompted other bond buyers — insurance firms, mutual funds and pension funds — to shy away from long-dated g-secs too.

Looming inflation risks have impacted rates too. Aware that the monthly Consumer Price Index (CPI) reading is the biggest driver of MPC actions, market participants have been keeping a hawk eye on the inflation numbers. In its April policy review, the MPC had projected an inflation range of 4.7-5.1% for the first half and 4.4% for the second half of the financial year 2018-19. CPI inflation for April, reversing from a three-month decline, had already spiked to 4.58%, with the flare-up in global oil prices looking to push it up further. This has also prompted market players to pre-empt the MPC.

With all the above factors propping up market interest rates by over 120 basis points in the past year, the mild 25-basis point hike by the MPC proved underwhelming.

Sovereign bond rates set the floor for all other borrowers in the market. Therefore, this upward spiral in g-sec yields in the last 10 months has been faithfully mirrored by corporate bonds and commercial paper.

As a result, India Inc has already seen a 100-120 basis point escalation in its borrowing costs from the market in the last 10 months. That is why the stock market wasn't fazed by the repo rate hike either.

Indian banks in the past were faithful followers of MPC actions on interest rates. If the MPC stayed on hold, they dutifully followed suit. If it raised them, they would peg up their deposit and lending rates.

But this time around, even banks have not waited for the MPC's say-so to hike their rates. With deposit flows slowing down and credit offtake picking up, banks have had to hike their retail and bulk deposit rates by 25-50 basis points over the last six months to woo new depositors.

Given that the RBI requires banks to peg their lending rates to their incremental cost of funds, higher deposit rates have automatically fed into higher lending rates. The SBI's MCLR (marginal cost of funds based lending rate) for one-year loans bottomed out at 7.95% in November 2017, but is now at 8.25%.

This trend of debt market participants not looking to the MPC to decide on interest rates is not a very welcome development for policymakers. If the markets regularly pre-empt MPC moves, its policy rates lose their benchmark status and become a less effective tool to rein in inflation, stimulate growth or stabilise an unruly exchange rate.

But what can the MPC do to wrest back the controls from Mr. Market? For one, it can improve its forecasting skills. Given that its rate moves are predicated on the CPI, if the MPC proves better than the market at reading the tea leaves on oil prices and emerging inflation, its rate actions can pre-empt the market, instead of following it.

More importantly, it is worth questioning if the MPC should go back to a multiple-indicator approach to decide on its rate actions. Earlier, the RBI used incoming data on a whole host of factors — inflation, GDP numbers, deficit indicators, foreign flows — as inputs to its rate-setting decisions, so as to balance inflation, growth and stability objectives. As the RBI would assign different weights to these factors at different times, the markets were often kept guessing about RBI actions.

But after the new inflation-targeting framework adopted by the RBI and the Centre in 2015, the MPC has the single-point agenda of containing CPI inflation at 4-6%. It has thus taken to focussing mainly on the CPI print for its rate decisions. This has reduced its flexibility to respond dynamically to the other market-driven factors, such as demand from banks or foreign flows. Restoring this flexibility may give the MPC a fighting chance at staying ahead of the market.

aarati.k@thehindu.co.in

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