

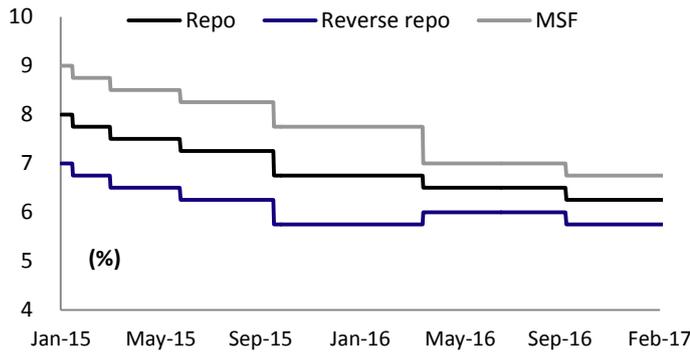
Don't expect more rate cuts

RBI shifts monetary policy stance from 'accommodative' to 'neutral'

- As against the market consensus of a 25bp cut (and our expectation of a 25bp cut after the Union Budget 2017-18), the Monetary Policy Committee (MPC) has chosen to keep policy interest rates unchanged. More surprisingly, the MPC has shifted its stance from 'accommodative' to 'neutral'.
- The MPC believes that the sharp deceleration in headline inflation in recent months was on account of vegetable prices and core inflation has been sticky. In line with higher crude oil prices, volatile exchange rates, and fuller effects of the 7th Central Pay Commission (CPC), the MPC expects CPI of 4-4.5% in 1HFY18 and 4.5-5% in 2HFY18.
- The Committee still believes that the adverse impact of demonetization on economic activity is transient. It has revised its FY17 GVA growth forecast from 7.1% to 6.9% and projects FY18 growth at 7.4%.
- Overall, with the RBI shifting its focus entirely to the 4% inflation target, we believe that rate cuts are behind us. In fact, if headline inflation moves towards 6% (we expect it to be 5.8% in 4QFY18), there could be a serious risk of a rate hike towards the beginning of 2018.

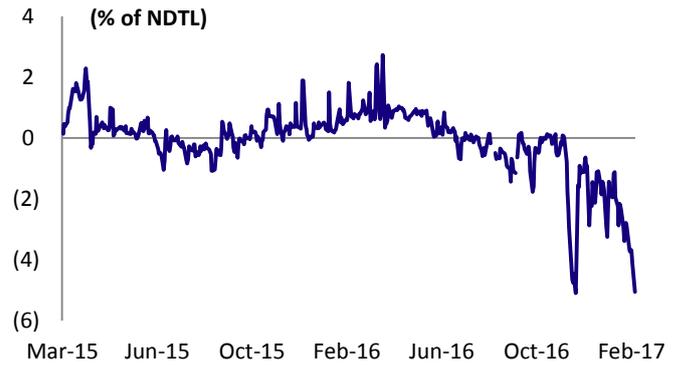
- **Policy rates kept unchanged...:** As against market consensus of a 25bp rate cut, the MPC has decided to keep key policy rates unchanged – repo rate at 6.25%, reverse repo rate at 5.75%, and MSF at 6.75%. (*Exhibit 1*). The cash reserve ratio (CRR) is kept unchanged at 4% of net demand and time liabilities (NDTL).
- **...driven by inflationary fears:** Interestingly, the Committee believes that the recent deceleration in headline inflation was primarily driven by lower vegetable prices, since core inflation (excluding food & fuel) has been broadly unchanged at 4.9%. Accordingly, though the Committee sees CPI inflation below 5% in 4QFY17, it expects it to pick up towards 4-4.5% in 1HFY18 and further to 4.5-5% in 2HFY18. The MPC notes three significant upside risks to inflation: (1) rising crude oil price, (2) exchange rate volatility, and (3) fuller effects of 7th CPC.
- **FY17 GVA growth also revised down:** Like inflation, GVA growth outlook for FY17 was revised down from 7.1% to 6.9%, with *risks evenly balanced*. Interestingly, the Committee maintains that the adverse impact of demonetization on economic activity will be transient. Accordingly, it projects FY18 GVA growth at 7.4% (*Exhibit 4*).
- **Monetary policy stance shifts from 'accommodative' to 'neutral'...:** The most surprising part of the monetary policy was the fact that the RBI shifted its stance from accommodative to neutral. This, it believes, is in line with the 4% medium-term target for inflation.
- **...implying rate cuts are behind us:** We believe that the RBI has hinted an end to the rate cuts. Though it expects inflation to move towards 5% by FY18-end due to adverse base effects, our fear is that an inflation rate of closer to 6% (we forecast 5.8% inflation in 4QFY18) could result in rate hikes in early 2018.

Exhibit 1: RBI keeps policy rates unchanged



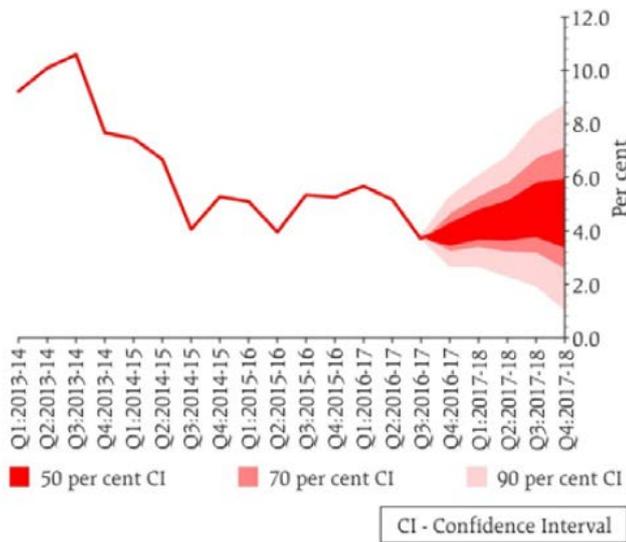
Source: RBI

Exhibit 2: Liquidity remains extremely comfortable



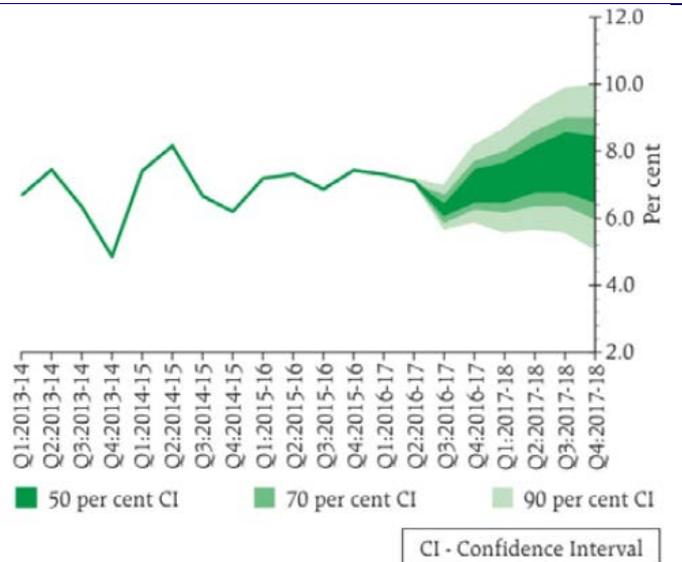
Source: RBI

Exhibit 3: RBI sees upward trajectory in inflation in FY18...



Source: RBI

Exhibit 4: ...and expects GVA growth to pick up from 6.9% in FY17 to 7.4% next year



NOTES

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