

theirview

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Retreating on the monetary policy front

Following its hasty policy shift, the RBI is in a tight spot. It is looking for a respectable way out

Last Wednesday, the Reserve Bank of India (RBI) held its ground when it came to interest rates. But it was less certain in defending its abrupt policy shift from accommodative to neutral. This has led to the RBI looking much less reassuring in keeping the rates unchanged and much more vulnerable in sticking to the shaky stance it took in its last policy. It is in a tight spot and if it gets a respectable way out, it will possibly grab it with both hands.

Let us take a step back to understand the RBI's delicate position. Back in January, when banks were awash with liquidity, thanks to demonetization, the rate cut was a given—the question was how aggressive it would be. Bond markets were magnanimously marking up the gilts to new highs, as they started factoring in a sizeable slice in the rates by RBI (rates and bond prices are inversely related). Some analysts made outrageous forecasts on the 10-year yield (on the downside) to feed the media frenzy and hit the headlines. Consensus trade was conspicuously long on bonds. Traders were sitting on sizeable MTM (mark-to-market) gains in their bond portfolios. So far so good, or so it appeared.

All hell broke loose on 8 February when the RBI, in an unusual move, decided to change its monetary stance from accommodative to neutral, citing the following fears: (i) the hardening profile of international crude prices, (ii) volatility in exchange rates on global cues which could add upside pressures to domestic inflation, (iii) aggressive rate hikes by the Federal Reserve on the positive US outlook as reflected in rising US yields and (iv) the impact of seventh pay commission recommendations on inflation.

For the bond markets, the shift was surreal and bizarre, as they were counting on surging liquidity in the banking system for rate cuts. The shift in stance was significant as it ruled out rate cuts for the foreseeable period. That was a blow to the markets that were marking in large cuts in bond prices. There was mayhem in the bond markets, triggering a huge sell-off. Prices slumped and yield surged by over 50 bps in a few quick sessions.

Four months have passed since the RBI made that significant shift in stance. We now have real data to assess whether the RBI and the monetary policy committee (MPC) went overboard with their fears. The RBI's concerns primarily came from four factors, i.e., the rising dollar index, the rupee's vulnerability to the Fed's tightening stance, the firming of commodity prices, especially crude, and lastly, the rising US 10-year yield.

Strangely, none of them played out the way the RBI had feared. In fact, all of them have moved in the opposite direction, favouring a dovish stance instead of a hawkish one. Surprisingly, the dollar index is back to the pre-Trump-era level and the US 10-year yield is hovering at a six-month low.

The biggest surprise has been the rupee, where the RBI was the most concerned. Instead of a downward risk, which the RBI had factored, the rupee has firmed up, putting the central bank in a tight spot. Even the April inflation data did not help the RBI, as it was below its forecast.

Though it is too early to draw any major conclusions, data from the past four months certainly suggests that the RBI could have waited for more evidence before deciding to shift its stance. With softening crude and a soaring rupee, fears of a spike in inflationary pressures have proved to be totally unfounded.

Recent developments in commodity markets have caused renewed optimism on the inflation front for India. Commodity heavyweights like iron ore and crude have slumped significantly from their recent highs. The *Bloomberg* commodity index is down over 9% from its high in February. Moreover, with rising rig levels in the shale gas industry in the US, the outlook for crude has worsened. One industry estimate puts the surge in rig levels to over 40% in the last few months. An increase in rig levels indicates increased shale gas output down the line; hence, the industry is

looking at a spike in shale gas production in the US in coming months. This is likely to keep crude prices under pressure for a long time to come, in spite of increased production cuts by the Organization of the Petroleum Exporting Countries (Opec).

Moving beyond commodities, with additional support coming from a slumping US 10-year yield on rising risks for Trump's reflationary trade (with increasing fears about Trump's ability to garner bipartisan support for fiscal stimu-

lus or tax cuts), the RBI and the MPC will find it difficult to defend their shaky stance—unless these trends reverse. However, the chances for this are increasingly bleak.

The markets also seem to have understood the RBI's delicate dilemma and its need for an honourable exit. The first hints of dissent in the MPC in its latest policy meeting have only reinforced the chances of a reversal in the next policy meeting in August. The sharp drops in both the consumer and wholesale price indices for May couldn't have come at a better time. Retail inflation for May cooled to a record low of 2.18% from 2.99% in April, driven primarily by a slump in food prices. The same is the case for wholesale price inflation too, with a sharp fall to 2.17% in May from 3.85% in April. Most analysts expect the soft trend in inflation to continue, raising hopes of a favourable policy shift by the RBI. Taking these cues, bond markets have already started rallying in anticipation of a repo rate cut that may come sooner than later.

Comments are welcome at
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