

## RBI Keeps Rates Unchanged, Awaits More Data

Sahil Kapoor

Chief Market Strategist

sahil.kapoor@edelweissfin.com

+91 (22) 4088 6044

The Reserve bank of India sprung up a surprise by keeping its policy rate unchanged at 6.25% citing a) its commitment to the inflation target b) transitory and insignificant effects of demonetization on growth. The street had expected at least a 25 bps rate cut with very few analyst, including ourselves, keeping an expectation open for a deeper 50 bps rate cut. However, there are three key takeaways from the present policy.

1. **The firming up of inflationary indicators** - One of the drivers of the present monetary policy seems to be the following ..... “Prices of housing, fuel and light, health, transport and communication, pan, tobacco and intoxicants, and education – together accounting for 38 per cent of the CPI basket – may remain largely unaffected” due to the demonetization drive. It also noted the rise in crude oil prices and the impending effects of implementation of the 7th pay commission. The hawkish stance on achieving its 5% inflation target of March’17 seems to be one of the key drivers of the policy. At one hand this appears a little challenged given the impact of demonetization on economy which was already seeing an uneven recovery. However continued focus on inflation fighting would send out the right message to the bond markets at a time when global bond yields are diverging and EM currencies are weakening.
2. **Slower growth** – The RBI has reduced its estimate for GVA growth for FY17 by 50 bps to 7.1%. This reduction, in line with our own estimates, is shallower than street consensus of a more pronounced slowdown. We believe that RBI’s comment that monetary policy should not be dependent on transitory effect to the economy highlights the fact that it is assuming the effects of demonetization to be transitory. This stance would stand scrutiny not too far in the future. High frequency data due this month and in January 2017 shall throw abundant light on the magnitude and durational impact of demonetization on growth. This means RBI may have to review its stance on growth once new data comes in and act accordingly. Abstaining from an interest rate reduction at this juncture and waiting for economic effects to show up could have costs which needs to be balanced.
3. **11.55 Lk Cr of deposits** – In its post policy interaction the RBI confirmed that INR 11.55 lk cr worth of deposits after the demonetization has come back into the banking system. This means that lion’s share of SBNs (Specified Bank Notes of old 500/1000 denomination) worth INR 14.5 lk cr is already back in the system. This leads to two narratives. Firstly that the windfall gain for the government by the way of a RBI dividend seems to have shrunk. Secondly that the amount of black money which has found its way into the banking system will create gains for the government through taxation. In either case to assess the approximate gain would require more disclosure from the RBI and the government over the next few weeks.

The removal of incremental CRR by the RBI would release a large part of liquidity into the interbank market post 10th December. However, this liquidity is likely to be mopped up through the MSS bonds to keep liquidity at net neutrality.

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### **Market impact:**

The bonds markets are expected to see the greatest impact from this monetary policy. The 10 year govt securities have reversed a part of gain made over the last few weeks. This is a readjustment of the path interest rates were expected to follow in the next few months. We believe that any rise in bond yields would only be temporary due to the underlying disinflationary trend and the mountain of liquidity that is still hitting the banking system. Moreover the current reduction in bond yields was accompanied by FPI sales and the current rise could see a balancing act from foreign investors as flows reverse.

Equities are expected to readjust to the new reality. However we believe that the market is currency focused more on normalization of liquidity in the hands of consumers and its subsequent demand impact. This would remain the driver for markets for the next few weeks. Price correction could remain contained and markets would look forward to the upcoming US Fed's monetary policy and global markets.

One clear winner is expected to be the Rupee. Interest rate differential expectations would get readjusted for the time being and fixed income markets could provide some support to the Indian currency. We expect Rupee to stabilize after a round of appreciation.

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**Edelweiss Broking Limited**, 1<sup>st</sup> Floor, Tower 3, Wing B, Kohinoor City Mall, Kohinoor City, Kirol Road, Kurla(W)  
Board:(91-22)42722200

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**Vinay Khattar**

Head Research

[vinay.khattar@edelweissfin.com](mailto:vinay.khattar@edelweissfin.com)

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