RBI cuts repo rate by 25 bps to 6.5%, lowest in 6 years

Business Standard, 5 April 2016

In its first monetary policy review for the financial year 2016-17, the Reserve Bank of India announced a 25 basis point reduction in the repo, or repurchase rate, which is the rate at which banks borrow from the central bank. One basis point is one hundredth of a percentage point.

The repo rate now stands at 6.5%, the lowest it has been since March 2011. However, it reduced the minimum daily maintenance of the cash reserve ratio (CRR) from 95% of the requirement to 90% with effect from the fortnight beginning April 16, 2016.

However, the RBI increased the reverse repo, or the rate at which banks park excess funds with the central bank, to 6%, narrowing the policy corridor between the repo and reverse repo by 50 bps, bringing the marginal standing facility (MSF) rate to 7.0%. The Bank Rate which is aligned to the MSF rate also stands adjusted to 7.0%. But the CRR has been kept unchanged at 4.0 per cent of net demand and time liabilities (NDTL).

The rate cut had been widely expected, although the quantum of the cut had had mixed backers. A Reuters poll had predicted an interest rate of 25 basis points.

With this slew of measures, the RBI has essentially opened the liquidity spigot in the expectation that banks will pass on the benefits to companies that can then restart the investment

On Tuesday, Rajan again called out banks' on their reluctance to pass on the cuts, saying 'Banks have said there is not enough liquidity, now we have given them more liquidity, banks can transmit more."

"Hope to see significant monetary transmission over the next few months." he added.

He also took note of the ongoing clean-up of bad loans at various banks, mostly public sector banks, saying "Finally the process of cleaning up bank balance sheets is underway and i am happy with the progress."

The markets' immediate reaction, though, was not too enthusiastic. At 11:30 a.m., the benchmark Sensex fell about 300 points to 25,108 points, expressing its disappointment at the size of the rate cut.

The coupon on the 10-year bond fell from 7.59% to 7.395%, a decline of 0.0130%.

The rate cut also suggests that the RBI has taken note of the central government’s commitment to fiscal discipline, freeing it up to infuse more liquidity into the system. In the Budget for FY2017, Finance Minister Arun Jaitley had reaffirmed the government’s intention to contain fiscal deficit at 3.9% of GDP.

Additionally, retail inflation, for long a thorn in the side of monetary policy, seems to have finally been brought under control, even though much credit for that may lie at a creeping global slowdown led by China. Inflation has eased to 5.18% in February. While that is still higher than the RBI's own target of 5% for March 2017, expectations are that it could fall to as low as 4% in coming months. A weakening El Nino could also help bring a good monsoon and further drive down food prices – which carry the most weight in the Consumer Price Index (CPI) – in the second half of the fiscal Wholesale inflation has been in negative territory for all of FY2016, a trend that is likely to continue.

The RBI said on Tuesday that it expects retail inflation to stay at around 5% for the rest of the current fiscal year.

The domestic investment cycle has also been slow to pick up. A Business Standard report points out that Indian private sector companies are not expected to press the pedal on fresh capital expenditure in the financial year 2016-17, or FY17, mainly because of low capacity utilization of existing units, highly leveraged balance sheets and static demand.

Companies have also complained that credit remains tight because of high interest rates, while Governor Raghuram Rajan has made his displeasure clear that banks have not passed on the 125 basis point reduction in repo rates since January 2015 to borrowers, while banks have complained of tight liquidity. The latest rate cut now takes the total quantum of rate cuts since the turning of the policy cycle to 150 basis points.

However, factory output in March jumped to an 8-month high of 52.4, as shown by the Nikkei/Markit Purchasing Managers' Index. This was the third straight month of manufacturing expansion. Additionally, the new orders sub-index, which reflects domestic demand, rose to an 8-month high of 53.9, encouraging firms to increase output.

The RBI, though, projected GDP growth to at about 7.6% for FY2017, citing both upsides from a good monsoon, higher consumer demand from the 7th Pay Commission and OROP for ex-servicemen, and downsides from sluggish investment.

"The uneven recovery in growth in 2015-16 is likely to strengthen gradually into 2016-17, assuming a normal monsoon, the likely boost to consumption demand from the implementation of the 7th Pay Commission recommendations and OROP, and continuing monetary policy accommodation. After two consecutive years of deficient monsoon, a normal monsoon would work as a favourable supply shock, strengthening rural demand and augmenting the supply of farm products that also influence inflation," "the central bank noted. "On the other hand, the fading impact of lower input costs on value addition in manufacturing, persisting corporate sector stress and risk aversion in the banking system, and the weaker global growth and trade outlook could impart a downside to growth outcomes going forward."