Inflation is expected to pick up from its recent lows as favourable base effects reverse and enhanced house rent allowances are disbursed to central government employees. Economic activity is expected to recover, with an improvement in the services sector, even as investment activity remains anaemic.

Since the Monetary Policy Report (MPR) of April 2017, the macroeconomic setting for the conduct of monetary policy has undergone significant shifts. The gradual firming up of global growth, especially in advanced economies (AEs), has whetted a renewed search for returns that has buoyed global financial markets. Capital flows to emerging market economies (EMEs) have resumed strongly, albeit with some differentiation in favour of jurisdictions that have relatively resilient fundamentals. These flows are likely to abate to an extent due to the upcoming unwinding of quantitative easing (QE) by the US Federal Reserve.

In India, the slowdown of economic activity that set in from Q1 of 2016-17 and became pronounced in the second half of the year appears to have extended into the first half of 2017-18. Looking ahead, some improvement in services may counterbalance the persisting weakness in industrial production. Inflation underwent a dramatic decline, reaching a historic low in June, but as the prints for July and August portend, a gradually rising trajectory may take hold over the rest of 2017-18. Alongside these developments, there has been an improvement in external viability; the foreign exchange reserves were around 11.5 months of imports in September 2017 and over 4 times short-term external debt.

Monetary Policy Committee: April-August 2017

Against this backdrop, the monetary policy committee (MPC) met in June and August under its pre-announced bi-monthly schedule. Following up on its decision to keep the policy rate unchanged in April 2017, the MPC maintained status quo in its June 2017 meeting. While taking note of the significant easing of inflation, the MPC observed that there is considerable uncertainty around the evolving inflation trajectory. Accordingly, it persevered with a neutral stance, while remaining watchful of incoming data, and noted that premature action risked disruptive policy reversals later and loss of credibility. In its August 2017 meeting, the MPC decided to reduce the policy repo rate by 25 basis points (bps), noting that (i) the baseline path of headline inflation excluding the impact of house rent allowances (HRA) awarded under the recommendation of the seventh central pay commission (CPC) was likely to fall below the projection made in June to a little above 4 per cent by Q4; (ii) inflation excluding food and fuel had fallen significantly since May after remaining sticky through 2016-17; (iii) the roll-out of the GST during July 2017 had been relatively smooth; and (iv) the monsoon was expected to be normal. It judged, therefore, that several upside risks to the baseline inflation path had either reduced or not materialised. These factors opened up some space for monetary accommodation, especially after accounting for risks to the growth outlook.