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ICRA COMMENTS ON RBI'S SIXTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2018-19

MPC delivers a surprise repo rate cut of 25 bps, reduces inflation forecast, changes policy stance to "Neutral"

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HIGHLIGHTS

Highlights of the RBI's Sixth Bi-monthly Monetary Policy Statement for 2018-19 – Feb 2019

- In line with wider expectations, the Monetary Policy Committee (MPC) voted unanimously for a change in policy stance to neutral from calibrated tightening. However, in a surprise move, it voted for a cut in the Repo rate under the liquidity adjustment facility (LAF) by 25 basis points (bps) to 6.25% by a vote of 4:2 with two members voting for status quo.
- With a cut in the Repo rate, the Reverse Repo rate, Marginal standing facility (MSF) rate and bank rate were also revised lower by 25bps to 6.00%, 6.50% and 6.50%, respectively.
- Earlier during its fifth monetary policy in December 2018, the MPC had proposed to reduce the Statutory Liquidity Ratio (SLR) by 25 bps every quarter, starting January 2019, until the same reaches 18% of NDTL. Accordingly, the SLR stands at 19.25% and Cash Reserve Ratio (CRR) remained unchanged 4.0%.
- The MPC revised its CPI inflation forecast downwards to 2.8% in Q4 FY2018-19, 3.2-3.4% in H1 FY2019-20 and 3.9 per cent in Q3 FY2019-20 as against its earlier forecast of 2.7-3.2% for H2 FY2018-19 and 3.8-4.2% for H1 FY2020. It described the risks are broadly balanced around the central trajectory.
- The MPC revised its GDP growth outlook downwards for FY2019 to 7.2% from earlier estimate of 7.4% given in December 2018. The MPC also revised the GDP growth outlook for H1FY2020 to 7.2-7.4% as against its earlier estimate of 7.5%. The MPC highlighted that inspite of soft crude oil prices and the lagged impact of rupee deprecation on net exports and slowing global demand could pose headwinds.
- The RBI has guided to maintain comfortable liquidity conditions. Supported by sizeable open market operations (OMO) purchases of Rs 2.36 trillion during April-January 2019 (of which Rs 500 billion each was in November, December and January), the daily average liquidity deficit under LAF was reduced to Rs 368 billion in January 2019 as against Rs 1032 billion in December 2018. Earlier, RBI has also announced OMO purchases of Rs 375 billion for February 2019 to infuse further durable liquidity and ease out liquidity conditions.

Outlook

While the change in policy stance was unanimous, the cut in policy rate was not unanimous with a vote of 4:2 in favour of rate cut. The MPC noted that output has inched up lower than potential and there is a need for encouraging private investment and consumption which supported their decision for rate cut. Further, though a downward revision in inflation may make a case for further rate cuts, however we expect, given a divided vote and impending general elections, MPC may adopt a wait and watch approach in its upcoming monetary policy. Depending on the data related to agricultural output form Rabi harvest, monsoon forecast, and fiscal policies adopted by new central government, MPC may decide on future rate action.

Despite a rate cut, the bond yields closed marginally by 4 bps on the new 10-Year benchmark (7.26 10Yr 2029) traded at 7.32%. We expect the 10-year G-sec yield to trade in a band of 7.2-7.5% in the remainder of this quarter. An upward movement in crude oil prices or other geo-political factors will remain as the key risk that could push up G-sec yields from the current levels.

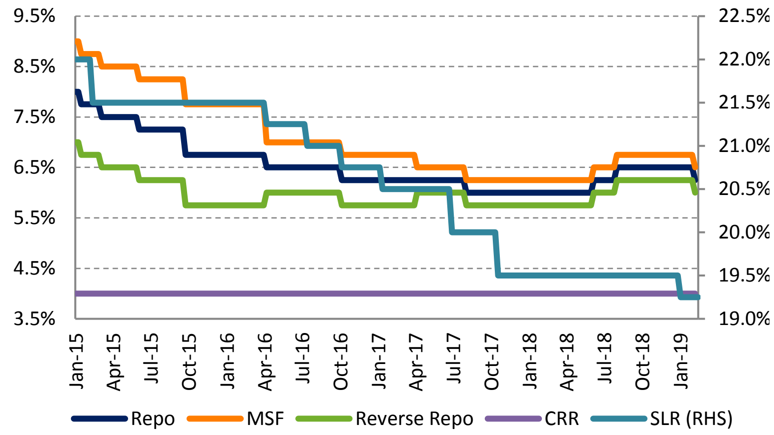
MPC delivers a surprise rate cut; and changes monetary policy stance to neutral on expected lines

Though the six-members of the MPC voted unanimously to change the policy stance from calibrated tightening to neutral, however the decision to cut the repo rate was not unanimous. In a split vote of 4:2, the MPC voted in favour of a 25-bps cut in the repo rate 6.25%. With change the stance of monetary policy to neutral, the future rate action would be data dependent. The MPC also reiterated its focus on achieving the medium-term inflation target of 4%. It revised its inflation forecast downwards to 2.8% for Q4FY2019 and 3.2-3.4% for H1FY2019-20 from its earlier projection of 2.7-3.2% for H2FY2018-19 and 3.8-4.2% for H1 FY2020. However, it also revised its baseline GDP growth forecast marginally downwards for FY2019 to 7.2% from 7.4% earlier and projected an improvement to 7.4% for FY2019-20.

The CPI inflation eased to a six-quarter low 2.6% in Q3 FY2019 from 3.9% in Q2 FY2019, mainly driven by unprecedented softening in inflation across various food sub-groups, larger than expected moderation in fuel subgroups. Moreover, core CPI inflation dipped mildly to 5.8% in Q3 FY2019 from 5.9% in Q2 FY2019. MPC noted that food inflation has continued to surprise on downside because of excess supply conditions domestically as well as internationally and short-term outlook for food inflation remains benign despite adverse base effects. The outlook on crude oil prices broadly remained unchanged and inflation excluding food and fuel continues to remain elevated. The RBI survey on inflation expectations shows considerable moderation in inflation expectations of households as well as input and output price expectations of producers. Taking these into account and assumptions of a normal monsoon, with risk balanced around the central trajectory, RBI revised its inflation downwards to 2.8% in Q4 FY2018-19, 3.2-3.4% in H1 FY2019-20 and 3.9 per cent in Q3 FY2019-20 as against its earlier forecast of 2.7-3.2% for H2 FY2018-19 and 3.8-4.2% for H1 FY2020.

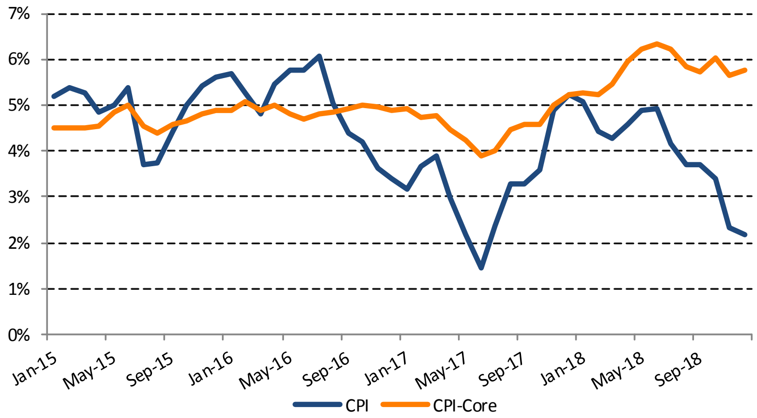
MPC noted that the bank credit and financial flows to the commercial sector continue to be strong but are yet to be broad-based. Despite Rupee depreciation, slowing global growth and trade uncertainties remain challenges for the growth. Several proposals of union budget are likely to boost demand by raising disposable incomes, but the full effect of these measures is likely to materialise over a period. The investment activity is recovering but is mainly supported by public spending on infrastructure. Further the output gap has opened modestly as actual output has inched up lower than potential. Hence there is a need to strengthen the private investment activity and support private consumption. Amid this, the MPC revised its GDP growth outlook downwards for FY2019 to 7.2% from earlier estimate of 7.4% given in December 2018. The MPC also revised the GDP growth outlook for H1FY2020 to 7.2-7.4% as against its earlier estimate of 7.5%.

Chart 1: Movement in Key Rates



Source: RBI; ICRA Research

Chart 2: CPI Inflation and core-CPI inflation (YoY)



Source: CSO; ICRA Research

RBI guides to maintain comfortable liquidity, undertakes record open market operations of Rs 2.75 trillion in FY2019 (April-Feb 2019)

The liquidity conditions remained largely in deficit during Q3FY2019 with very limited days of surplus liquidity. On a daily-average basis, the liquidity infusion under the liquidity adjustment facility (LAF) of RBI stood at Rs 831 billion during Q3FY2019 as compared to a deficit of Rs. 206 billion, and in contrast to the daily average surplus of Rs. 240 billion during Q1 FY2019, reflecting tightening liquidity conditions. Within Q3FY2019, the daily average liquidity recorded a deficit of Rs 622.7 billion during October, Rs. 847.3 billion during November and Rs. 1032.7 billion during December 2018. The deficit of systemic liquidity (on a daily average basis) during Q2 FY2019 was despite Open Market Operations (OMO) purchase of government securities by RBI of Rs. 360 billion during October, Rs 500 billion each in November and December aggregating to Rs 1.36 trillion during the quarter.

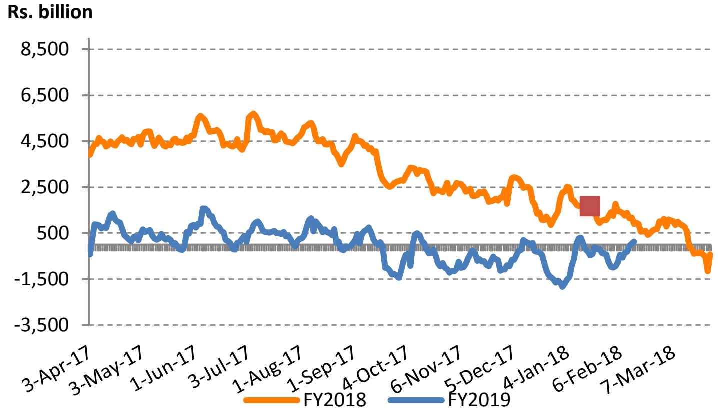
With further OMOs of Rs 500 billion for January 2019, the liquidity deficit reduced to Rs 368.8 billion during January 2019 and turned surplus during first few days of February 2019. RBI has guided to maintain comfortable liquidity conditions and as a step towards this, it has further announced OMOs of Rs 375 billion to be undertaken during February 2019. With this the overall OMOs announced stands at Rs 2.75 trillion for FY2019 (April-Feb 2019).

With FII outflows, likely intervention by the RBI in the spot forex market, rising currency with public and bank credit growth outpacing the deposit growth, the liquidity deficit may continue, and RBI may need to take continued actions to maintain comfortable liquidity conditions. During Q3FY2019, the CWP increased to Rs 19.5 trillion as on December 21, 2018 as compared to Rs 18.5 trillion as on September 29, 2018 (QoQ +6%) and Rs 16.2 trillion as on December 22, 2017 (YoY +21%). As can be seen that CWP is relatively high which has also lead to tighter liquidity conditions. With coming general elections, the CWP is expected to increase and may act as a drag on liquidity. The YoY growth in non-food bank credit growth stood at 14.5% as compared to 9.9% growth in deposits as on January 4, 2019.

Despite deficit liquidity conditions, the daily weighted average call money rates remained lower than the repo rate during Q3FY2019 at 6.41% but higher than 6.30% during Q2FY2019. The increase in call money rate during Q3FY2019 was also driven by a 25-bps hike in the repo and hence the reverse repo rate by the RBI on August 1, 2018, subsequent to which the call money rates increased above reverse repo rate of 6.25%. On daily average basis, the call money rates stood at 6.42% (peak of 6.56%) during October; 6.38% (6.50%) during November 2018 and 6.43% (6.59%) during December 2018. With cut in the policy rates and RBI's stance of maintaining comfortable liquidity, we expect the call money rates to decline and trade closer to 6.25% during rest of the quarter.

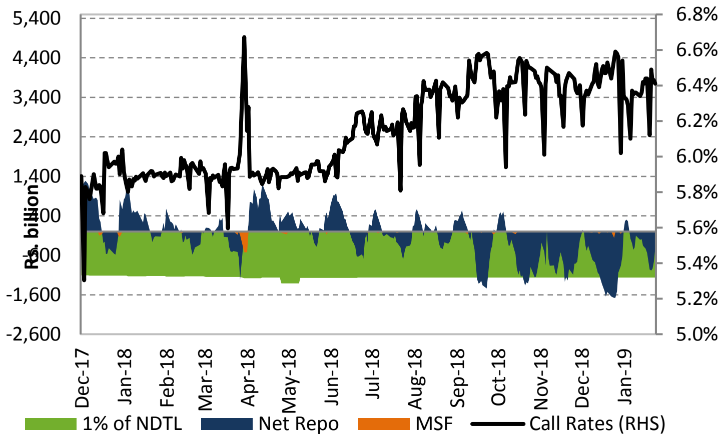
Chart 3: Liquidity Infusion (-)/ absorption (+)

(Net overnight & term repos/reverse repos; MSF; MSS)



Source: CEIC; ICRA Research

Chart 4: Call money rates



Source: RBI; ICRA Research

Other Key Developments

The RBI provided an update on the various other initiatives undertaken in the fields of banking, financial markets, payments & settlements and financial literacy as it continued to further strengthen the domestic financial system.

Risk weights for rated exposures to Non-Banking Financial Companies (NBFCs)

Currently the exposures of banks on rated and unrated NBFCs other than asset finance companies (AFCs), infrastructure finance companies (IFCs) and infrastructure debt funds (IDFs) are uniform at 100%. To facilitate the flow of credit to well rated NBFCs, the rated exposure of banks to all NBFCs excluding core investment companies (CICs) would be rated as per ratings assigned by rating agencies.

In our view, Banks' exposure to NBFCs is estimated at Rs 5.7 trillion of which exposure to AFCs, IFCs and IDFs is already risk weighted based on their ratings. Assuming a 50% exposure of banks' exposure to NBFCs in other category and a 50% reduction in their risk-weights, the capital requirements of banks against these exposures can reduce by ~Rs 125 billion, which in-turn can be used for incremental lending or improvement their capital ratios. This is equivalent to a 0.125% improvement in capital adequacy ratios for banks. The exposures to housing finance companies (HFCs) is also risk-weighted based on external ratings, and hence will have no impact on banks because of their exposure to HFCs.

Reduction in risk weights for NBFCs is expected to free up the equity capital for banks against their exposures to NBFCs, which the banks can use for incremental credit growth or improvement in their capital ratios. While this can also result in reduced borrowing rates and incremental credit supply for NBFCs, however this will depend on banks willingness to do so. The final guidelines in this regard will be issued in February 2019.

Harmonisation of NBFC categories

RBI has decided to harmonise the major categories of NBFCs engaged in credit intermediations such as AFCs, Loan companies (LCs) and investment companies into a single category that will reduce the complexities arising out of multiple NBFC categories and produce flexibility in their operations.

Relaxation of External commercial borrowing (ECB) framework for resolution under insolvency and bankruptcy code (IBC) 2016

Currently, ECBs (foreign currency or masala bonds) are not permitted to be utilised for repayments or for on-lending for repayment of domestic rupee loans. RBI has relaxed this norm and allowed the resolution applicant under corporate insolvency resolution process to borrow by ECB and repay the rupee loans of the target company. However, such ECBs cannot be raised from overseas branches/subsidiaries of Indian Banks. In our view, reduced borrowing cost from ECBs for some of the applicants can improve the attractiveness of domestic asset and higher recovery for Indian lenders if there is a improved participation from overseas investors.

Review of instructions on bulk deposits

Banks have discretion to offer differential rate of interest on bulk deposits as per their requirements and asset liability mismatches. The existing definition of bulk deposit, i.e. a single deposit of Rs 10 million or above was fixed in 2013, which has been increased now to Rs 20 million. Further, banks shall henceforth be required to maintain their bulk deposit rates in their core banking system for supervisory review.

In our view, the revision in the definition of bulk deposits as single rupee deposits will reduce ability to banks to offer differentiated rates on deposits higher than Rs 10 million but lower than Rs 20 million. This can affect their deposit mobilisation, however it will be positive as it will lower their cost of funds.

Investments by foreign portfolio investors (FPIs) in corporate debt

During April 2018, RBI stipulated that no FPI shall have an exposure of more than 20% of its corporate bond portfolio to a single corporate (including related entities) and were also given exemption till March 2019 to adjust their portfolios. Based on the market feedback, this provision has been withdrawn.

In our view, removal of restriction is positive for attracting FPI debt flows as well as the borrowers as many of smaller borrowers have limited investor base and this will enable these borrowers to raise funding from its available set of investors. However, RBI can also relax other FPI limits related to investments cap of 50% by single FPI in single issue or holding 20% of corporate debt with 1-year maturity to attract FPI debt flows.

Working group to review agricultural credit and enhancement in limit of collateral free agricultural loan

To address the issues related to regional disparity, coverage of agricultural credit and deepening long-term agricultural credit for capital formation, RBI has constituted internal working group to review agricultural credit to arrive at workable solutions. In the meanwhile, keeping in view of overall inflation and rise in cost of agricultural input costs, RBI revised the limit for collateral free loan for small and marginal farmers to Rs 0.16 million as against Rs. 0.1 million, that was fixed in year 2010.

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