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ICRA COMMENTS ON RBI'S FIRST BI-MONTHLY MONETARY POLICY STATEMENT FOR 2019-20

MPC delivers a repo rate cut of 25 bps in line with market expectations, reduces inflation forecast, maintains policy stance at "Neutral"

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HIGHLIGHTS

Highlights of the RBI's First Bi-Monthly Monetary Policy Statement for 2019-20 – April 2019

- As expected, the Monetary Policy Committee (MPC) voted 4:2 for a cut of 25 basis points (bps) in the Repo rate under the Liquidity Adjustment Facility (LAF) to 6.00% from 6.25% in the First bi-monthly monetary policy statement for FY2020. The Committee also retained the stance of monetary policy at neutral, by a vote of 5:1, indicating that future decisions will be data dependent.
- 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 5.75%, 6.25% and 6.25%, 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 19.00% and Cash Reserve Ratio (CRR) remained unchanged 4.0%.
- The MPC revised its CPI inflation forecast downwards to 2.4% for Q4 FY2019 and 2.9-3.0% for H1 FY2020, from the forecasts of 2.8% and 3.2-3.4%, respectively, in February 2019. The inflation projection for H2 FY2020 is placed at 3.5-3.5%. The MPC also described the risks as broadly balanced.
- The MPC revised its GDP growth outlook downwards for H1 FY2020 to 6.8-7.1% from the earlier forecast of 7.2-7.4% given in February 2019, while placing its forecast for H2 FY2020 at a higher 7.3%-7.4%. For FY2020, the MPC revised the GDP growth to 7.2% from 7.4% projected in February 2019, with risks evenly balanced.
- The RBI has guided to maintain comfortable liquidity conditions, however it eluded from explicitly mentioning the tools to be used for managing the liquidity conditions. Earlier during FY2019, RBI conducted sizeable open market operations (OMO) purchases of Rs 2.98 trillion, of which Rs 1.125 trillion was in Q4FY2019. Additionally, RBI infused liquidity in banking system through long-term foreign exchange swaps of US$5 billion during March 2019 and has additionally announced similar swaps of US$5 billion for April 2019. Despite large scale liquidity infusion during Q4FY2019, the liquidity deficit under LAF stood at Rs 513 billion, though it was lower than Rs 831 billion during Q3FY2019. Given the neutral stance of monetary policy as well as cut in policy rates, we expect RBI to infuse further durable liquidity and ease out liquidity conditions for better transmission of monetary policy action in lending rates.

Outlook: While the policy stance was kept unchanged at neutral, however the cut in policy rate was not unanimous with a vote of 4:2 in favour of rate cut. Further, despite a downward revision in inflation forecasts and estimate of 3.5-3.8% for H2FY2020, MPC has continued to maintain a neutral stance on the policy as the crude oil prices and weaker monsoons continue to remain the near-term concerns for the inflation outcomes. We believe, if the inflation outcomes are in line with projected estimates, there can be a scope of further cut in policy rates to support domestic growth given the weak global growth outlook. However, MPC may adopt a wait and watch approach in its upcoming monetary policy and future rate actions would depend on data related to agricultural output form Rabi harvest, monsoon forecast, and fiscal policies adopted by new central government.

Despite a cut in policy rates, the yield on new 10-Year government security (7.26 10Yr 2029) increased by 5 bps to 7.33%, as the demand-supply mismatch is expected to continue for bonds. Going ahead, 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, whereas any announcement on OMO purchases by RBI is expected to cool-off the yields.

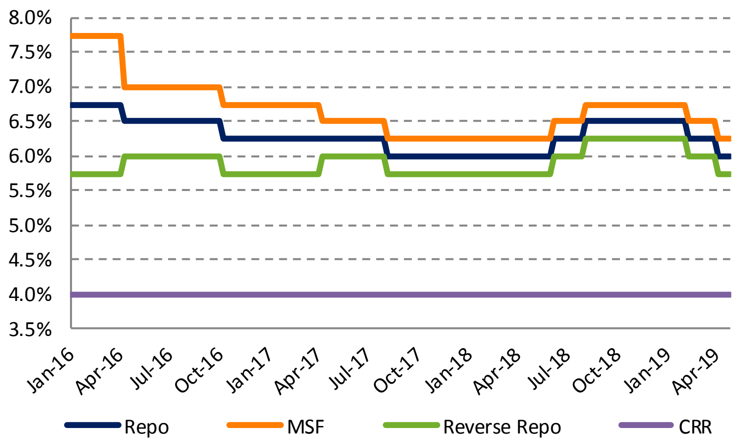
MPC votes for a rate cut, while retaining the monetary policy stance at neutral

In line with expectations, the MPC voted for a cut of 25 bps in the repo rate to 6.00% from 6.25%, by a vote of 4:2. However, the monetary policy stance was retained at neutral, by a vote of 5:1, indicating that future rate action would be data dependent. The MPC also reiterated its focus on achieving the medium-term inflation target of 4%, while supporting growth. It revised its inflation forecast downwards to 2.4% for Q4 FY2019, and 2.9-3.0% for H1 FY2020, while placing the inflation projection for H2 FY2020 at 3.5-3.8%, with risks broadly balanced. However, the baseline GDP growth forecast was revised downwards to 7.2% for FY2020 from the earlier estimate of 7.4% in February 2019 policy review, with risks evenly balanced.

The CPI inflation rose to 2.6% in February 2019 from 2.0% in January 2019, reflecting narrower food disinflation. However, core CPI inflation (excluding food and beverages, fuel and light, petrol and diesel for vehicles) eased marginally to 5.35% in February 2019 from 5.41% in the previous month. While the MPC revised its CPI inflation forecast downwards, it nevertheless, listed several uncertainties which may impact the inflation outlook. For instance, the MPC noted that although the short-term outlook for food inflation remained benign, the probability of El Niño effect, as well as the risk of a sudden reversal in vegetable prices, may put pressure on the inflation trajectory. Moreover, the significant softening in fuel items, such as electricity, may not be sustainable in the longer-term. It also highlighted the uncertainty on the outlook for oil prices (both upside and downside), as well as the volatility in financial markets, would influence inflation dynamics. Lastly, the MPC underscored the need to closely monitor the fiscal situation of the Indian government. On balance, assuming a normal monsoon, the MPC revised its CPI inflation forecast downwards to 2.4% in Q4 FY2019 and 2.9-3.0% in H1 FY2020, from the forecasts of 2.8% and 3.2-3.4%, respectively projected in February 2019. Subsequently, the inflation projection for H2 FY2020 was placed at 3.5-3.5%, with broadly balanced risks.

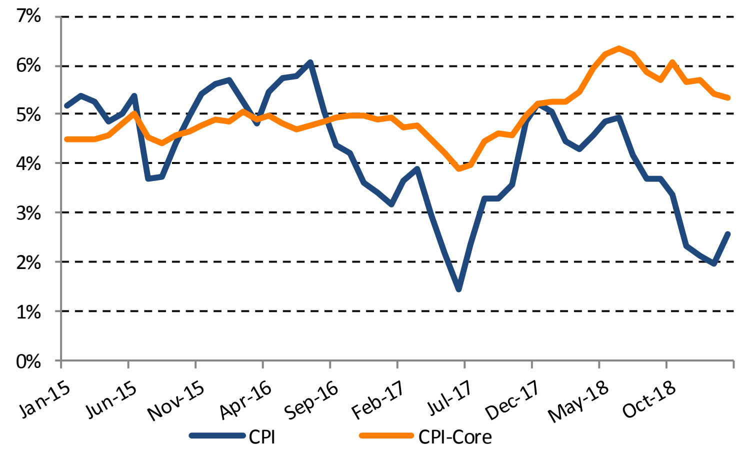
On the growth front, the MPC underscored the need to strengthen the domestic economy by spurring private investment. The MPC noted that while the output gap was negative, the domestic economy was facing headwinds. Domestic investment activity was displaying signs of slowdown. In addition, weakening global growth may adversely impact India's exports. In contrast, factors such as higher financial flows to commercial sector, increased public spending in rural areas, and rise in disposable incomes due to tax benefits, would positively impact economic activity. Moreover, business expectations continue to be optimistic. Taking into consideration these factors, the MPC revised its GDP growth outlook downwards for H1 FY2020 to 6.8-7.1% from the earlier forecast of 7.2-7.4% given in February 2019, while placing its forecast for H2 FY2020 at a higher 7.3%-7.4%. For FY2020, the MPC revised the GDP growth forecast to 7.2% from 7.4% projected in February 2019, with risks evenly balanced.

Chart 1: Movement in Key Rates



Source: RBI; ICRA Research

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



RBI guides to maintain comfortable liquidity, however no explicit statement to undertake open market operations by purchase of government bonds to infuse liquidity

The liquidity conditions remained largely in deficit during Q4FY2019 with very few days of surplus liquidity in the banking system. On a daily-average basis, the liquidity infusion under the liquidity adjustment facility (LAF) of RBI stood at Rs 513 billion during Q4FY2019 and was lower than Rs 831 billion during Q3FY2019 but higher than Rs. 162 billion infusion during Q2FY2019. The easing of liquidity conditions during Q4FY2019 was supported by Open Market Operations (OMO) purchase of government securities by RBI of Rs. 1.125 trillion during the quarter (Rs. 500 billion in January, Rs. 375 billion in February and Rs. 250 billion in March), reversal in foreign institutional investor (FII) flows with inflows of ~Rs. 554 billion during Q4FY2019 and infusion of Rs 345 billion (US$ 5 billion) through long-term foreign exchange swaps between banks and RBI.

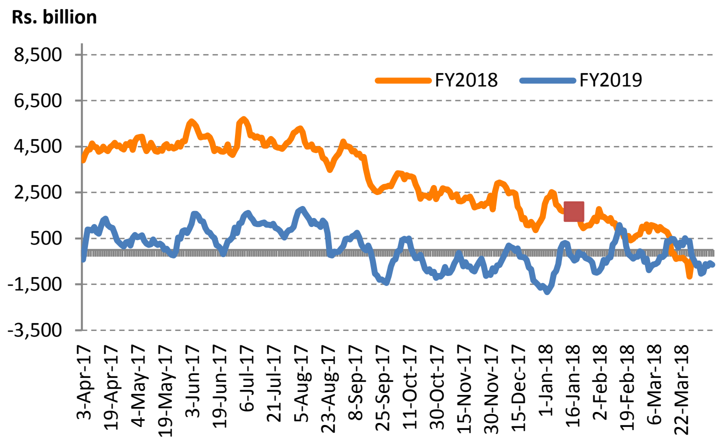
Cumulatively, RBI conducted OMO purchases of Rs 2.98 trillion during FY2019 to infuse durable liquidity in banking system. RBI has guided to maintain comfortable liquidity conditions by using appropriate tool and in a step towards this, it has already announced another long-term foreign exchange swap between banks and RBI for infusion of US$ 5 billion for April 2019.

While the FII flows have reversed during Q4FY2019, however they may remain sensitive to macro-economic events like surge in crude oil prices, weak monsoons or weak earnings of corporate sector. Further the outcome of upcoming general elections can also pose risk to sustained FII flows and a reversal of flows may tighten the domestic liquidity conditions. Further the currency with public is expected to grow at faster pace during Q1FY2020 given the trend during election season as well as the crop harvest season. These factors coupled with sustained demand of credit from banking channel is expected to keep the liquidity in deficit mode. The extent of such deficits is expected to be lower during Q1FY2020, given that incremental growth in credit during first quarter generally remains negative. With neutral stance of monetary policy and recent rate cuts in policy rate, we expect RBI will continue to address liquidity issues by infusing durable liquidity, if required for better transmission of policy rates in banks' lending rates. Jan = 6.36, 6.27, 6.31

The daily weighted average call money rates during Q4FY2019 declined to 6.31% as compared to 6.41% during Q3FY2019 after the cut in REPO rate during February 2019. Within Q4FY2019, the daily average call money rates stood at 6.36% during January; 6.27% during February and 6.31% during March, indicating that the rates during February and March were marginally higher than the Repo rate of 6.25% because of tighter liquidity conditions. 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 6.00% during rest of the quarter.

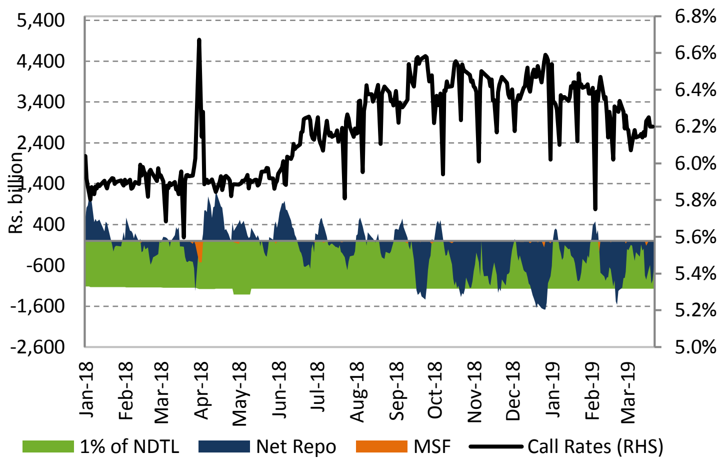
Chart 3: Liquidity Infusion (-)/ absorption (+)

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



Source: CEIC; ICRA Research

Chart 4: Call money rates



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.

Increase in carve out from SLR holdings for computing LCR

Presently, the assets allowed as Level 1 High Quality Liquid Assets (HQLAs) for the purpose of computing the liquidity coverage ratio (LCR) of banks include:

(a) Government securities in excess of the minimum SLR requirement, and

(b) Within the mandatory SLR requirement at 15% of the bank's net demand and time liabilities (including 2% which can be availed as marginal standing facility

RBI, today increased the carve out of the Level 1 HQLA within the mandatory SLR requirement by 2% from 15% to 17%

Increased carve out from the SLR holdings will reduce their requirements to hold excess SLR for liquidity requirements and support their ability for credit growth. However, this will reduce the demand for government bonds and pose upward pressure on government bond yields.

Further, the scope for future carve outs from the SLR holdings of banks for meeting the LCR requirements will be limited as the total carve will increase to 17% by April 2020 as against the requirement of SLR holdings of 18% by June 2020.

Committee on Development of Housing Finance Securitisation Market and a Task force on the Development of Secondary market for Corporate Loans

With a view to create well-functioning securitisation markets for mortgage originators and better management of credit and liquidity risks for the buyers (which are typically the banks), RBI has proposed to constitute a committee that will suggest best international practices in mortgage securitisation markets and propose the measures to develop these markets in India.

Similarly, to manage the credit risks and liquidity risks of various credit intermediaries (like banks, NBFCs), RBI proposes to set up a task force to propose measures for development of secondary markets for the loans originated from these intermediaries for onward purchase by asset reconstruction companies, private equity funds, alternate investment funds etc.

The report on both the above measure by the committee and task force is proposed to be submitted to RBI by August 2019.

In our view, both the above announcements are positive from long-term development in credit supply mechanism by attracting of wider set of investors, given the current model of credit supply in both these segments is largely to originate the loan and hold till maturity.

Linking of banks' lending rates to external benchmark

RBI had earlier proposed that the new loans for the small borrowers extended by banks from April 1, 2019 to be linked to external benchmark rates to improve the transparency and the faster transmission of policy rates in the lending rates of the banks. However, it has decided to hold further discussions with the stakeholders and work out an effective mechanism for rate transmission given the issues such as management of interest rate risks by banks and time requirement for upgradation of information technology infrastructure.

In our view, the decision to defer the benchmarking of lending rates on smaller loans to external benchmarks was expected to improve transparency in the lending rates for the borrowers, even though it would have created challenges for the banks given the liabilities for Indian banks are largely fixed rate in nature. Increased depositor education to improve their acceptability of floating rate deposits needs to done first before moving on to external benchmarking of loans and mitigate the interest rate risks for the banks.

Countercyclical Capital Buffer (CCCB)

The Basel III capital regulations for banks require banks to maintain CCCB, if decided by RBI depending on the circumstances, which include credit-GDP growth apart from credit-deposit ratio, non-performing assets growth, industrial growth outlook and interest coverage ratios. Based on its assessment, RBI has not activated the CCCB requirements for the banks.

Decision to not activate the CCCB is largely in line with the expectations as the bank's YoY credit growth of 14.4% as on March 15, 2019 remains at acceptable levels and not showing any signs of overheated economy. We expect CCCB to be activated only once the credit growth reaches beyond 20-25% levels reflecting overheating and excess credit supply. At the highest level, activation of CCCB can increase the capital requirements of the banks by 2.5% of their risk weighted assets and increase the overall CRAR requirements from 11.5% to 14%.

Permitting G-sec trading through international Central Securities Depositories (ICSDs)

Union government had announced in its budget of 2014-15 for allowing international settlement of Indian debt securities. RBI in consultation of government has initiated discussions with ICSDs to permit their non-resident clients to transact in government securities.

In our view, given the project supply of debt from the central and state governments and adverse demand supply dynamics because of large supply, the above move will attract more set of investors in government debt securities and will be helpful in creating more demand for government bonds thereby reducing the supply pressure on domestic markets and controlling of bond yields. Also, it will reduce the crowding out of the private sector investments because of large borrowing programme of Indian Government.

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