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

MPC delivers a repo rate cut of 25 bps in line with market expectations, changes policy stance from "Neutral" to "Accommodative"

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HIGHLIGHTS

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

- The Monetary Policy Committee (MPC) voted unanimously for a cut of 25 basis points (bps) in the Repo rate under the Liquidity Adjustment Facility (LAF) to 5.75% from 6.00% in the Second bi-monthly monetary policy statement for FY2020. Moreover, the Committee also changed the stance of monetary policy unanimously to 'accommodative' from 'neutral', indicating that a rate hike was off the table for future MPC decisions.
- 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 5.50%, 6.00% and 6.00%, 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 was to be revised to 18.75%, whereas the Cash Reserve Ratio (CRR) remained unchanged 4.0%.
- The MPC revised its CPI inflation forecast upwards to 3.0-3.1% for H1 FY2020 from the previous forecast of 2.9-3.0% in April 2019. However, the inflation projection for H2 FY2020 was revised downwards to 3.4-3.7% from 3.5-3.8% in April 2019, with the risks broadly balanced.
- The MPC revised its GDP growth outlook downwards to 7.0% for FY2020 (6.4-6.7% in H1 FY2020 and 7.2-7.5% in H2 FY2020) from the earlier forecast of 7.2% in April 2019 (6.8-7.1% in H1 FY2020 and 7.3-7.4% in H2 FY2020), with risks evenly balanced.
- The RBI has guided to maintain comfortable liquidity conditions and assured that necessary measures for maintaining comfortable liquidity will be taken. In this regard, despite no announcements in previous policy, RBI undertook open market operations (OMO) purchases of Rs 250 billion during May 2019 and announced further OMO purchase of Rs 150 billion for June 2019. With resumption of government spending after general elections and improved FII flows, the liquidity conditions under LAF, with daily average deficit of Rs 700 billion in April 2019 and Rs 334 billion in May 2019 improved to surplus in first week of June 2019. Given the accommodative stance of monetary policy as well as cut in policy rates, we expect RBI to maintain surplus liquidity conditions for better transmission of monetary policy action in banks' lending rates.

Outlook: Following the latest rate action, the benchmark repo rate now stands at 5.75% and is lowest in last 9 years. The vote of MPC members was unanimous and in favour of the rate cut along with change in stand from neutral to accommodative. This clearly highlights the shift in preference towards growth, as inflation indicators are likely to remain within the targeted band. With the change in policy stance, further rate cuts cannot be ruled out, but we believe the MPC would continued to remain data dependent, the impending budget announcements and the progress of monsoon.

While the today's cut of 25bps was factored in the yield on new 10-Year government security (7.26 10Yr 2029), the yields declined by approx. 9 bps to close at 6.93%, which was presumably driven by the change in policy stance, thereby opening scope for further rate cuts. Going ahead, we expect the 10-year G-sec yield to trade in a band of 6.8-7.3% during H1FY2020. An upward movement in crude oil prices and fiscal slippage in upcoming budget or weak monsoon will remain as the key risk that could push up G-sec yields, whereas continued liquidity enhancement measures, strong monsoons and further decline in crude oil prices, which will keep inflation within guided levels may cool-off the yield further.

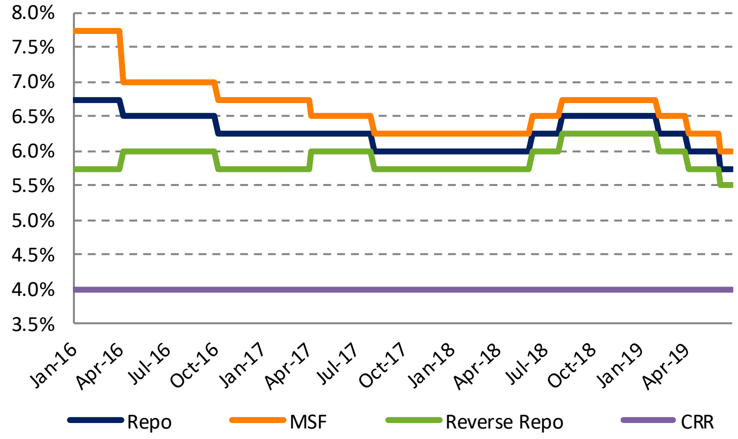
MPC votes unanimously for a rate cut and a change in monetary policy stance to 'accommodative'

The MPC voted unanimously for a cut of 25 bps in the repo rate to 5.75% from 6.00%. Moreover, the monetary policy stance was also changed unanimously to 'accommodative' from 'neutral', indicating that a rate hike was off the table for future rate actions. The MPC also reiterated that its decision was in line with the objective of achieving the medium-term inflation target of 4%, while supporting growth. It revised its inflation forecast upwards to 3.0-3.1% for H1 FY2020, while revising the same downwards for H2 FY2020 to 3.4-3.7%, with the risks broadly balanced. The baseline GDP growth forecast was also revised downwards to 7.0% for FY2020 from the earlier estimate of 7.2% in April 2019 policy review, with risks evenly balanced.

The CPI inflation stood at 2.9% in April 2019, similar to the print in March 2019, with an uptick in food and fuel inflation, offsetting the dip in the print for pan, tobacco and intoxicants, clothing and footwear, housing, and miscellaneous items. Core CPI inflation (excluding food and beverages, fuel and light, petrol and diesel for vehicles) recorded a broad-based easing to 4.6% in April 2019 from 5.0% in the previous month. The MPC noted that sharper-than-anticipated pickup in vegetable prices, and the broader uptick in the prices in several food items imparted an upward bias to the near-term food inflation trajectory. In contrast, the weakening in the demand conditions imparted a downward bias to the MPC's inflation trajectory for the rest of the year. Additionally, the MPC also noted that the volatility in crude oil persisted, whereas the household inflation expectations continued to moderate. Taking these factors into account, and assuming a normal monsoon, the MPC revised its CPI inflation forecast upwards to 3.0-3.1% for H1 FY2020, with broadly balanced risks, from the previous forecast of 2.9-3.0% in April 2019. However, the inflation projection for H2 FY2020 was revised downwards by the MPC to 3.4-3.7% from 3.5-3.8% in April 2019, with the risks broadly balanced.

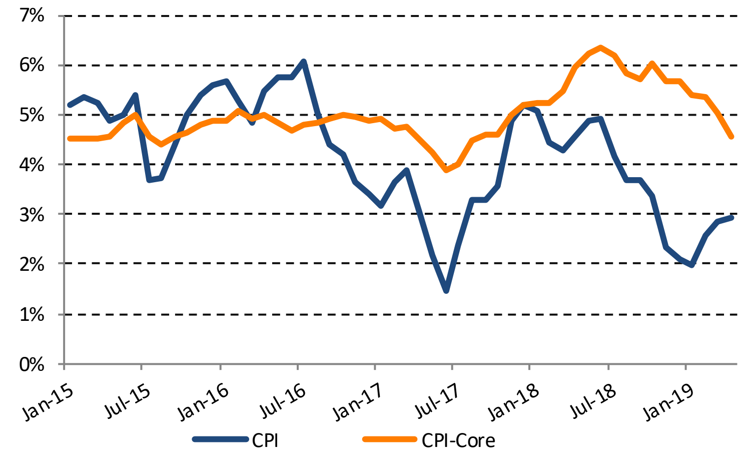
On the growth front, the MPC noted that the output gap had widened compared to the April 2019 policy review. Various factors dictated the MPC's view on growth concerns, such as sluggish investment activity; weakening global growth and exports; threat from escalating trade wars etc. In particular, the slowdown in investment activity, coupled with moderation in private consumption were highlighted by the MPC as main areas of concern. However, factors such as political stability, high capacity utilization and pickup in business expectations were a positive for the growth outlook. Taking these factors into consideration, the MPC revised its GDP growth outlook downwards to 7.0% for FY2020 (6.4-6.7% in H1 FY2020 and 7.2-7.5% in H2 FY2020) from the earlier forecast of 7.2% in April 2019 (6.8-7.1% in H1 FY2020 and 7.3-7.4% in H2 FY2020), with risks evenly balanced.

Chart 1: Movement in Key Rates



Source: RBI; ICRA Research

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



Source: CSO; ICRA Research

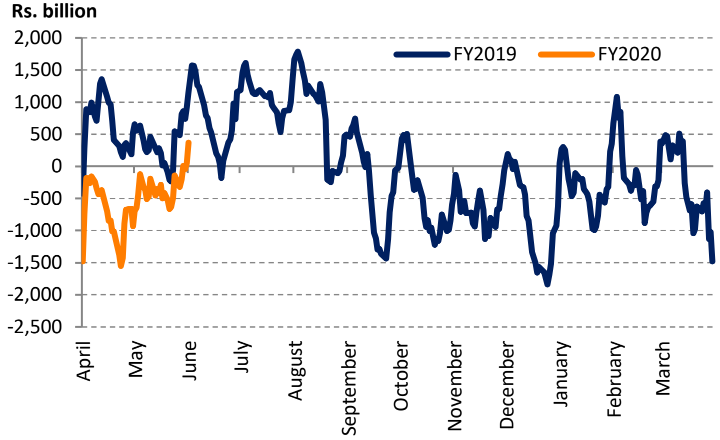
RBI guides to maintain comfortable liquidity, proposes to set up working group to review liquidity management framework

The liquidity conditions remained largely in deficit during April and May 2019, despite the first quarter of financial year being a lean period for credit demand. Restrained government spending because of recently concluded general election remained as one of key factor for liquidity deficit during these months. However, supported by improved FII flows during May 2019, liquidity infusion through open Market Operations (OMO) purchase of government securities by RBI of Rs 250 billion during May 2019 and infusion of Rs 345 billion (US$ 5 billion) through long-term foreign exchange swaps between banks and RBI, reduced the liquidity deficit. The daily average liquidity deficit under the liquidity adjustment facility (LAF) of RBI stood Rs 700 billion during April 2019 and Rs 334 billion during May 2019. Further, in the ongoing month, with continued FII flows and presumably resumption of government spending, the system has turned in daily average surplus of Rs 660 billion during first week of June 2019. In line with its stance of maintaining comfortable liquidity as well as upcoming advance tax payment by June 15, 2019, RBI has already announced a further OMO purchase of Rs 150 billion for June 13, 2019.

Cumulatively, RBI conducted OMO purchases of Rs 2.98 trillion during FY2019 to infuse durable liquidity in banking system apart from ~Rs 690 billion through long-term foreign exchange swaps during March and April 2019. ICRA expects that, if the trend of FII inflows remain stable, which in-turn will be driven by macro-economic factors like softness in crude oil prices, satisfactory monsoons, corporate earnings and upcoming Union budget announcements, then the domestic liquidity conditions may remain supportive and need for large scale liquidity infusion by RBI may not be required. With accommodative stance of monetary policy and recent rate cuts in policy rate, we expect RBI will continue to maintain neutral to surplus liquidity conditions for better transmission of policy rates in banks' lending rates.

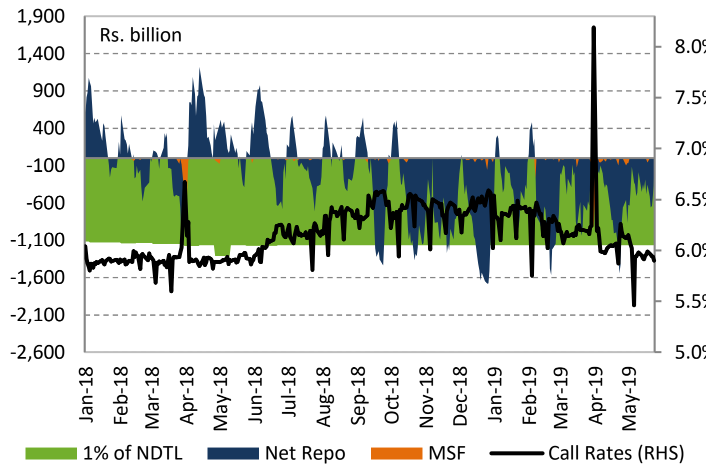
The daily weighted average call money rates during Q1FY2020 (till June 4, 2019) stood at 5.99% as compared to 6.31% during Q4FY2019 and 6.41% during Q3FY2019. The decline in call money rates during Q1FY2020 was outcome of the 25bps cut in the repo rate to 6.00% on April 4, 2019, but because of tighter liquidity conditions, call money rate stood close to repo rate instead of reverse repo rate of 5.75%. Within Q1FY2020, the daily average call money rates stood at 5.92% during May 2019 as compared to 6.08% during April 2019 because of tighter liquidity conditions in April 2019. With cut in the policy rates and RBI's stance of maintaining comfortable liquidity, we expect the call money rates to decline and trade relatively lower than repo rate of 5.75% till next policy review.

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.

Leverage ratio for banks i.e. Tier 1 / Exposure reduced

Presently, as per the RBI guidelines, Indian Banks are monitored against a minimum leverage ratio (Tier 1 / Total Exposures) of 4.5%

To align the leverage ratio with Basel Committee on Banking Supervision (BCBS), which has finalized the minimum leverage ratio of 3%, RBI has reduced the leverage ratio for Indian Banks. Accordingly, the leverage ratio for domestic systemically important banks has been reduced to 4.0% and 3.5% for other banks. The final guidelines in this regard will be issued in this month.

In our view, reduction in leverage ratio, will improve their ability of some banks to support growth in their exposure, however the same will be driven by additional exposures being of lower risk weights, such that they are able to maintain their capital ratios while reducing leverage ratio.

On tap licensing of Small finance banks (SFBs)

To enhance the banking facilities to small borrowers and to encourage competition, RBI has proposed to issue draft guidelines for “on-tap” licensing for small finance banks (SFBs) by August 2019.

The guidelines for small finance banks in private sector were issued in November 2014 and there were 72 applicants which applied for SFB license, of which ten entities were granted the license in August 2015. All these ten entities are operating as of now.

In our view, availability of on-tap license for small finance banks is positive, especially for entities operating in micro-finance segment as this can improve their liability profile and provide them with sustainable growth model.

Working Group for core investment companies (CICs)

Core Investment Companies are in the business model of a holding company with more than 90% of their assets in form of investments in group companies. Given some of the recent developments and need to strengthen the corporate governance framework of CICs, RBI has proposed to set up a working group to review the regulatory guidelines and supervisory framework applicable to CICs.

Working group to review liquidity management framework

RBI had last released its liquidity management framework in August 2014 and it has decided to constitute an internal working group to review the framework to:

a) Simplify the current liquidity framework
b) Communicate the objectives, quantitative measures and toolkit of liquidity management by RBI

The report is expected to be submitted by July 2019.

In our view, during last few quarters, supported by various liquidity infusion measures, the overall liquidity deficit has remained within the RBI targeted levels of 2% of net demand and time liabilities; however, the extent of volatility has been high. The proposal to review of liquidity management framework is hence positive, as there is a need for greater clarity on the usage of various tools or liquidity levels at which various triggers for liquidity infusions get activated to improve the transparency of the liquidity framework.

Retail participation in Government securities market

Currently stock exchanges (in addition to other intermediaries) are allowed as permitted aggregators/facilitators for submitting the bids from retail investors towards their subscription in primary auction of Government of India (GoI) securities. RBI has now proposed to extend the same facility for retail investor participation in state development loans (SDLs).

In our view, this is a positive move and will ease the retail investors investment process in SDLs and create additional demand for SDLs, especially given the relatively lower credit risks in SDLs and better yield than GoI securities.

Removal of charges for RBI-operated payment systems

RBI has decided to waive off the charge it levies on banks for transactions routed through its payment system, i.e. RTGS and NEFT. Many of the banks, in turn recover these charges from its customers. RBI will issue instructions to banks to pass on these benefits in turn to customers.

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ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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