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

MPC delivers a Repo rate cut of 35 bps, maintains policy stance as 'Accommodative'

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HIGHLIGHTS

- The Monetary Policy Committee (MPC) voted for an unconventional cut of 35 basis points (bps) in the Repo rate under the Liquidity Adjustment Facility (LAF) to 5.40% from the prevailing 5.75%, in the Third bi-monthly monetary policy statement for FY2020. Moreover, the Committee retained the stance of monetary policy as 'accommodative'. The decision to reduce the policy rate and maintain the stance as accommodative was unanimous, although two of the six MPC members voted for a smaller rate cut of 25 bps.
- With a cut in the Repo rate, the Reverse Repo rate, Marginal standing facility (MSF) rate and bank rate were also revised lower by 35 bps to 5.15%, 5.65% and 5.65%, respectively.
- Previously, 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 18.50%, whereas the Cash Reserve Ratio (CRR) remained unchanged 4.0%.
- The MPC placed its CPI inflation at 3.1% for Q2 FY2020, while the inflation projection for H2 FY2020 was revised mildly upwards to 3.5-3.7% from 3.4-3.7% in June 2019, with the risks evenly balanced. Subsequently, it has projected the CPI inflation at 3.6% in Q1 FY2021.
- The MPC revised its GDP growth outlook mildly downwards to 6.9% for FY2020 (5.8-6.6% in H1 FY2020 and 7.3-7.5% in H2 FY2020) from the earlier forecast of 7.0% in June 2019 (6.4-6.7% in H1 FY2020 and 7.2-7.5% in H2 FY2020), with risks somewhat tilted to the downside.
- The RBI reiterated its commitment to meeting the day-to-day, as well as durable liquidity needs of the economy. 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: The unconventional 35 bps rate cut is a signal that the increasing evidence of a pervasive slowdown in economic growth has emerged as the MPC's chief concern, given that it expects inflation to remain under its medium-term target. While the stance was maintained as accommodative and the tone of the outlook was dovish, we expect that incremental data will crucially guide the MPC's decisions on additional rate cuts. The focus will now shift to improving transmission to Bank lending rates, with the systemic liquidity surplus in excess of 1% of NDTL. Several constraints to a pickup in economic growth, are unlikely to be removed by lower interest rates alone. Therefore, the Central Bank's steps need to be supplemented with policy changes and reforms aimed at spurring activity in various sectors.

The market will continue to monitor the evolving fiscal trends of the Government of India and parse the MPC's minutes to glean the outlook for additional monetary easing. However, the size and timing of the sovereign bond issuance would impart a disproportionate effect on the yields of Government securities (G-sec) in the remainder of 2019. ICRA expects the 10-year G-sec yield to trade in a range of 6.2%-6.6% in Q2 FY2020.

MPC votes for a rate cut and maintains monetary policy stance at 'accommodative'

The six member MPC voted for a cut of 35 bps in the Repo rate to 5.40% from 5.75%. While the decision to cut the Repo rate was unanimous, four members voted for a cut of 35 bps, whereas two members voted for a 25 bps cut. Moreover, the monetary policy stance was unanimously retained at 'accommodative'. The MPC also reiterated that its decision is in line with the objective of achieving the medium-term inflation target of 4%, while supporting growth.

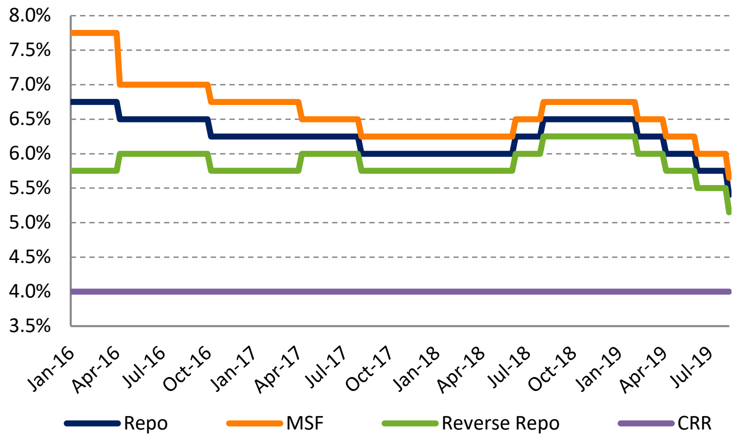
The CPI inflation had risen to an 8-month high 3.2% in June 2019 from 3.0% in May 2019, driven by an uptick in food inflation. The MPC noted that the latter may be sustained by price pressures in vegetables and pulses. Moreover, uneven distribution of monsoon rains could exert some upward pressure on the prices of food items, although this risk is likely to be mitigated by the recent recovery in rainfall, in the Committee's views. The Committee also highlighted the risk related to volatility in crude oil prices on account of geopolitical concerns. However, it pointed to the moderation in one year ahead inflation expectations of households and the expectation of manufacturing firms of an easing in output prices in Q2 FY2020. Taking these factors into account, and the impact of recent policy rate cuts, the MPC projected its CPI inflation forecast at 3.1% for Q2 FY2020, while the inflation projection for H2 FY2020 was revised mildly upwards to 3.5-3.7% from 3.4-3.7% in June 2019, with the risks evenly balanced. Further, CPI inflation for Q1 FY2021 was projected at 3.6%.

Recent global developments suggest that commodity prices may remain subdued in the near term, which would contain the inflation in manufactured products. However, the demand for various services is likely to remain sticky, which may prevent a substantial reduction in the core CPI inflation, in our view. Moreover, the recent spate of rains, that has led to flooding in parts of the country, may pose more of a risk than a benefit to food prices. Therefore, we remain cautious regarding the outlook for the CPI inflation.

The MPC noted that the domestic and global economic activity remains weak. In particular, the slowdown in domestic investment activity, coupled with moderation in private consumption were highlighted by the MPC as areas of concern, even as the decline in input costs and the impact of the cumulative monetary policy easing since February 2019 are expected to support economic activity. Taking these factors into consideration, the MPC revised its GDP growth outlook mildly downwards to 6.9% for FY2020 (5.8-6.6% in H1 FY2020 and 7.3-7.5% in H2 FY2020) from the earlier forecast of 7.0% in June 2019 (6.4-6.7% in H1 FY2020 and 7.2-7.5% in H2 FY2020), with risks somewhat tilted to the downside.

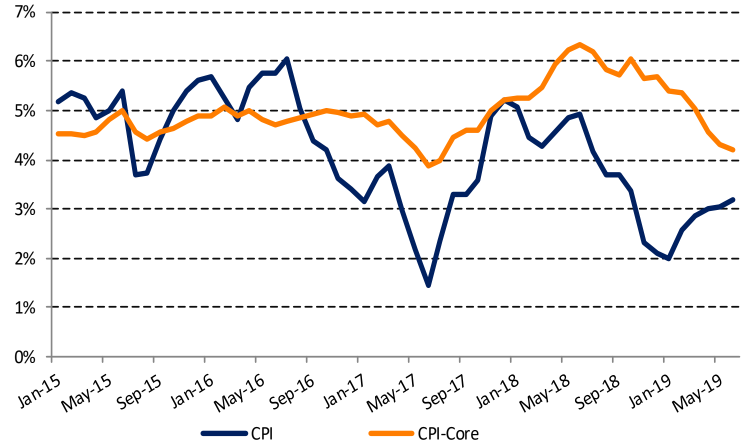
In our view, the outlook for domestic consumption, exports and private investments remains subdued, although Government spending may gather momentum in the post-Budget months. We expect the GDP growth in FY2020 may be restricted to around 6.6%.

Chart 1: Movement in Key Rates



Source: RBI; CEIC; ICRA Research

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



Source: CSO; CEIC; ICRA Research

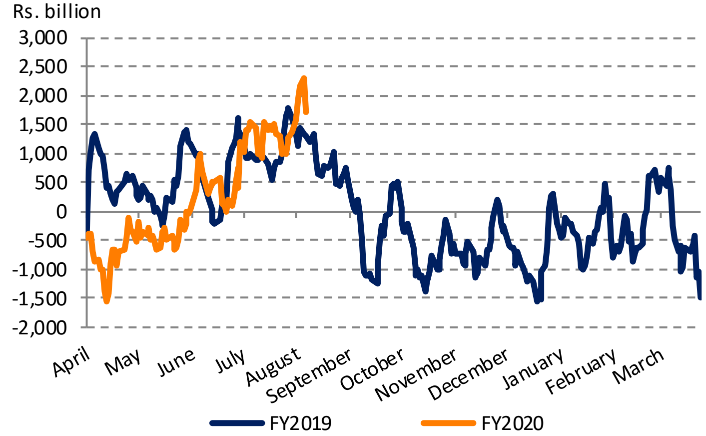
RBI highlights commitment to improving monetary policy transmission, and meet day-to-day, as well as durable liquidity needs of economy

The liquidity conditions went into surplus mode from June 2019, after remaining largely in deficit since September 2018. The daily average liquidity deficit under the LAF stood at Rs. ~727 billion in April 2019 and ~Rs. 366 billion in May 2019. However, the average liquidity under the LAF posted a surplus of ~Rs. 481 billion and ~Rs. 1.3 trillion, respectively, in June 2019 and July 2019, with the latter around 1% of NDTL. This turnaround was supported by durable liquidity infusion through OMO purchase of government securities by RBI of Rs 250 billion and Rs. 275 billion, respectively, in May 2019 and June 2019. In addition, the RBI's long-term US$/INR swap of US$5 billion, each in March 2019 and April 2019, infused durable liquidity into the banking system. Additionally, FII inflows in Q1 FY2019 supported liquidity, although this was followed by outflows in July 2019. Regardless of the latter, the liquidity surplus has risen to ~Rs. 2.1 trillion in August 2019 (till August 6, 2019).

The daily weighted average call money rates eased to 5.91% in Q1 FY2020 from 6.32% in Q4 FY2019, following the cumulative reduction of 75 bps in the Repo rate since February 2019. Additionally, the daily average call money rates declined from 6.08% in April 2019 to 5.76% during June 2019, and further to 5.61% during July 2019 and 5.63% in August 2019 (till August 6, 2019). With the rise in the average liquidity surplus under the LAF, the daily call rates have traded closer to the Reverse Repo rate of 5.50%. We expect the call money rates to continue trading closer to the Reverse Repo rate as the liquidity conditions are likely to remain in surplus in the remainder of this quarter.

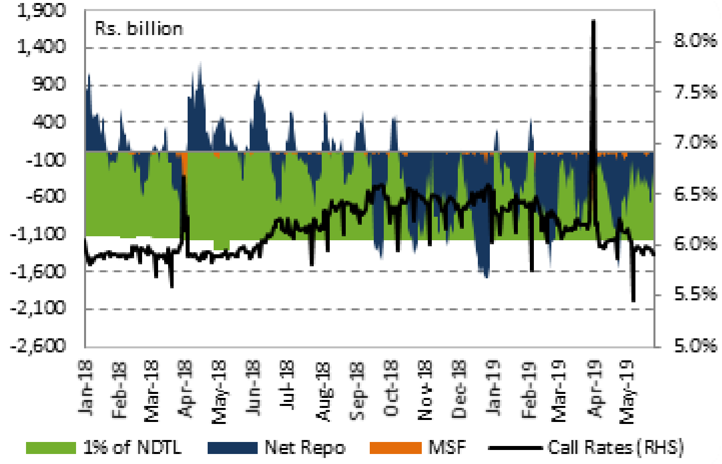
In June 2019, the RBI had announced the formation of an internal committee to review the Liquidity Management Framework. The recommendations of this committee, in addition to the trend in credit demand, deposit growth, Government spending and magnitude of FII inflows, will impact the systemic liquidity dynamics going forward. Given the accommodative stance of monetary policy, the recent rate cuts, as well as the focus on improving monetary policy transmission, we expect the RBI to maintain neutral to surplus liquidity conditions in FY2020.

Chart 3: Liquidity Infusion (-)/ absorption (+) (Net overnight & term Repos/Reverse Repos; MSF; MSS)



Source: RBI; 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.

Introduction of stripping/reconstitution facility for State Development Loans (SDLs)

The majority of SDL issuances have a 10-year maturity and SDLs typically witness limited liquidity in the secondary markets. In our view, introduction of stripping facility will create SDL instruments with varying maturities, which will help to improve investor interest, given that different classes of investors have varying investment horizons.

Reduction in risk weight for consumer credit except credit card receivables

Amid the ongoing slowdown in consumption, the reduction in risk weights may induce lenders to cut their lending rates, translating to lower EMIs for borrowers. With personal loans of Rs 6 trillion outstanding as on June 2019, a 25 bps reduction in risk weight may also reduce the capital requirements of banks by Rs 125 billion and add 14 bps to their capital ratios. The growth in personal loans remains high with 19% YoY growth during FY2019. Further, the share of personal loans in overall retail loans of bank has increased to 27% in July 2019 of retail loans as compared to 19% as on March 2009.

Harmonisation of single counterparty exposure limit for banks' exposure to single NBFCs with general single counterparty exposure limit

As per the prevailing norms, a Bank's exposure to a single NBFC was restricted to 15% of its Tier I capital, while for entities in the other sectors the exposure limit is 20% of Tier I capital of the Bank, which can be extended to 25% by Banks' Boards. As a step towards harmonisation, the exposure limit to a single NBFC has been raised to 20% of the Tier-I capital of Banks.

As per our estimates, the total Tier 1 capital of the Banking system is estimated at Rs. 10 trillion. A 5% increase in single counterparty exposure will allow Banks to undertake additional exposure of Rs. 500 billion and hence an overall exposure of Rs. 2 trillion to a single NBFC. As per our estimates, none of the NBFCs will potentially have such a huge exposure to banking system. However, it may enable some of the individual Banks, who may be breaching single NBFC exposure limit to extend fresh funding.

Credit to the Priority Sector – Permitting banks to on-lend through NBFCs

Bank lending to NBFCs (other than MFIs) for on-lending to agriculture (investment credit) up to Rs 1 million; MSME up to Rs 2 million and housing up to Rs 2 million per borrower (up from Rs 1 million at present) will now be eligible to be classified as priority sector lending.

In our view, priority sector lending tag for bank lending to NBFCs, which on-lend to agriculture, housing and MSMEs, is positive for the incremental credit flow to these sectors. This will additionally improve the available sources of funding, especially for the new-age mid and small-sized NBFCs at a relatively lower cost, while improving the banks' ability to meet their priority sector lending targets.

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ABOUT ICRA

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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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