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

MPC delivers a Repo rate cut of 25 bps, maintains policy stance as 'Accommodative'

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HIGHLIGHTS

- In line with our expectations, the Monetary Policy Committee (MPC) voted for a cut of 25 basis points (bps) in the Repo rate under the Liquidity Adjustment Facility (LAF) to 5.15% from the prevailing 5.40%, in the Fourth 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 one of the six MPC members voted for a larger rate cut of 40 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 25 bps to 4.90%, 5.40% and 5.40%, 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% in October 2019, whereas the Cash Reserve Ratio (CRR) remained unchanged 4.0%.
- The MPC revised its CPI inflation forecast for Q2 FY2020 to 3.4% from 3.1% in August 2019, while the inflation projection for H2 FY2020 was retained at 3.5-3.7%, with the risks evenly balanced. In addition, it retained its projection for CPI inflation in Q1 FY2021 at 3.6%.
- The MPC revised its GDP growth outlook significantly downwards to 6.1% for FY2020 (5.3% in Q2 FY2020 and 6.6-7.2% in H2 FY2020) with risks evenly balanced, from the earlier forecast of 6.9% in August 2019 (5.8-6.6% in H1 FY2020 and 7.3-7.5% in H2 FY2020), whereas the GDP growth forecast for Q1 FY2021 was revised downwards to 7.2% from 7.4%.
- The RBI noted that the liquidity conditions were in surplus in August 2019 and September 2019, while highlighting the staggered and incomplete monetary policy transmission. Going forward, cyclical factors such as the upcoming harvest, festive and marriage season, and state elections may compress the liquidity surplus in H2 FY2020.

Outlook: The MPC's decision to retain the accommodative stance for as long as necessary to revive growth, is a strong signal that further rate cuts are not off the table. While the first advance estimate of kharif output is similar to last year's level for some crops, we are apprehensive that the late surge in rainfall, flooding in various states and the delayed withdrawal of the monsoon may have damaged the standing crops. This may modestly push up the CPI inflation in the next few months. However, it is unlikely to emerge as a significant risk. The upcoming GDP growth print for Q2 FY2020 is likely to crucially influence whether a sixth consecutive rate cut is announced in the December 2019 policy review, as well as the magnitude of the reduction, in our view.

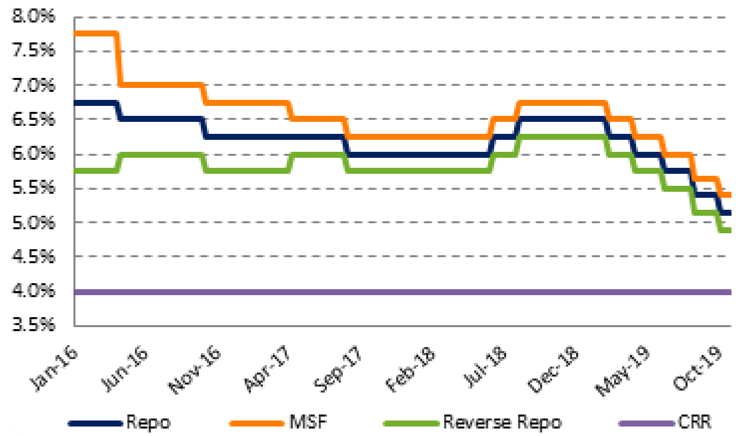
MPC votes for a rate cut and maintains monetary policy stance at 'accommodative'

The six member MPC voted for a cut of 25 bps in the Repo rate to 5.15% from 5.40%. While the decision to cut the Repo rate was unanimous, five members voted for a cut of 25 bps, whereas one member voted for a 40 bps cut. Moreover, the monetary policy stance was unanimously retained at 'accommodative'. Significantly, the Committee enunciated that it would retain the accommodative stance for as long as necessary to revive growth.

The CPI inflation inched up to a 10-month high 3.21% in August 2019 from 3.15% in July 2019, driven primarily by a sharp uptick in the inflation for food and beverages. While vegetable prices have risen following the flooding in various states, they are likely to reverse once winter supplies enter the market. The MPC noted that the outlook for food inflation had improved considerably since the August 2019 policy review, with kharif output in 2019 estimated to be close to last year's level for some crops. However, we are apprehensive that the late surge in rainfall and the delayed withdrawal of the monsoon may have damaged the standing crops. The MPC highlighted that the sobering impact of the subdued global growth outlook would keep prices of commodities, including crude oil, in check. Moreover, weakness in domestic demand as well as the pricing power of producers, would restrain inflation in output prices. However, the Committee underscored the impact of volatility in emerging market currencies, which may modestly add to imported inflation. Taking these factors into account, and the impact of recent policy rate cuts, the MPC has only revised its CPI inflation forecast for Q2 FY2020, to 3.4% from 3.1%, while the estimates for H2 FY2020 and Q1 FY2021, have been retained at 3.5-3.7% and 3.6%, respectively, with risks evenly balanced, despite the impact of the policy rate cuts and rising inflationary expectations of households.

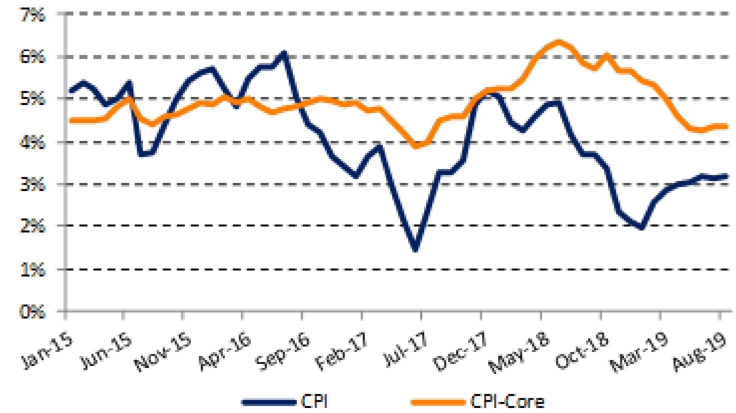
Various high frequency indicators suggest persistent weakness in domestic demand. Moreover, the outlook for exports is muted given the slowdown in global growth and ongoing trade tensions. However, the MPC noted that the recent measures announced by the Government of India, in conjunction with the decline in input costs and the impact of the cumulative monetary policy easing since February 2019, are expected to support economic activity and boost domestic demand. Taking these factors into consideration, the MPC revised its GDP growth outlook significantly downwards to 6.1% for FY2020 (5.3% in Q2 FY2020 and 6.6-7.2% in H2 FY2020) with the risks evenly balanced, from the earlier forecast of 6.9% in August 2019 (5.8-6.6% in H1 FY2020 and 7.3-7.5% in H2 FY2020), with risks to the downside. In addition, the GDP growth forecast for Q1 FY2021 was revised downwards to 7.2% from 7.4% in August 2019.

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

Monetary policy transmission incomplete and staggered despite surplus systemic liquidity

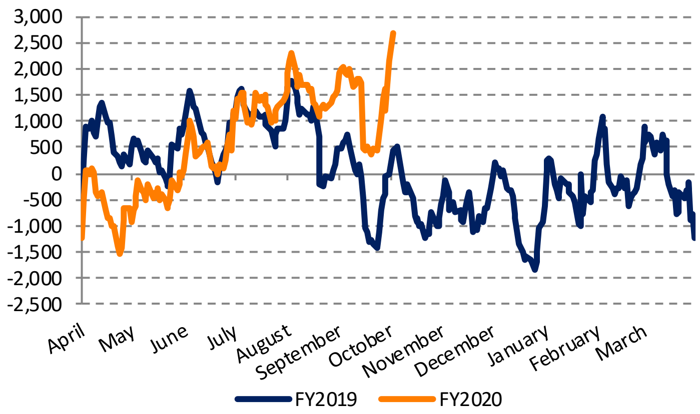
The magnitude of the systemic liquidity surplus has risen sharply in the recent months. For instance, the average liquidity surplus under the LAF rose from ~Rs. 481 billion in June 2019 to ~Rs. 1.29 trillion in July 2019, with the latter around 1% of NDTL. Subsequently, the daily average liquidity surplus rose further to ~Rs. 1.34 trillion in August 2019, on the back of a pickup in government spending, which had led to a drawdown in the GoI's cash balances, as well as a rise in incidents of availing the Ways and Means Advances (WMA) facilities. Following this, the average liquidity surplus eased to ~Rs. 1.17 trillion in September 2019, with the payment of advance taxes, before rising sharply to ~Rs. 2.4 trillion in October 2019 (till October 3, 2019).

The daily weighted average call money rate eased from 5.91% in Q1 FY2020 to 5.61% in July 2019 and 5.38% in August 2019, reflecting the cumulative reduction of 110 bps in the Repo rate since February 2019. Subsequently, the daily average call money rate declined further to 5.32% in September 2019, following the measures taken the by the RBI to improve monetary policy transmission, such as introducing external benchmarking of banks' floating rate loans. With the rise in the average liquidity surplus under the LAF, the daily call rates fell further to 5.24% in October 2019 (till October 3, 2019), and traded closer to the Reverse Repo rate of 5.15% during that period. However, the MPC highlighted that the monetary transmission remained staggered and incomplete, as reflected by the 29 bps fall in the weighted average lending rate (WALR) on fresh rupee loans of commercial banks during February-August 2019, and the 7 bps rise in the WALR on outstanding rupee loans during the same period, despite the considerable reduction in the Repo rate.

The RBI's internal committee to review the Liquidity Management Framework, formed in June 2019, submitted its report for deliberations and comments from stakeholders and the public. The committee recommended the desirable level of system liquidity to be a small deficit of 0.25-0.5% of NDTL of the banking system. However, it conceded that the liquidity framework could be used flexibly if financial conditions warranted a situation of liquidity surplus to keep the call money rate close to the policy repo rate. Moreover, the Monetary Policy Report released by the RBI, along with the MPC statement, underscored that ensuring faster monetary transmission to banks' lending rates was a key priority of the RBI.

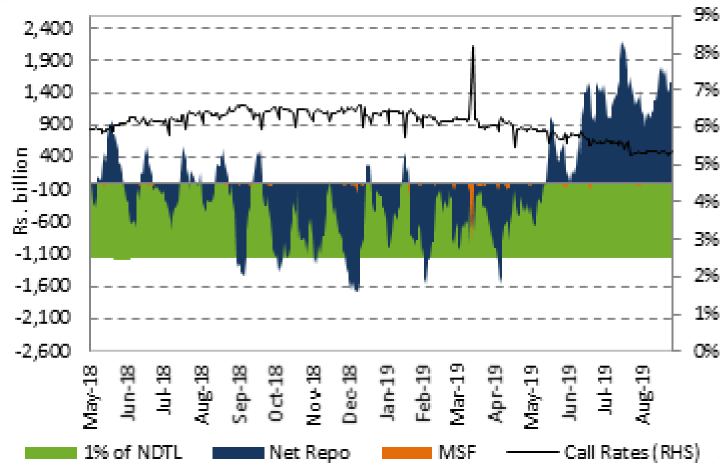
Going forward, cyclical factors such as the upcoming harvest, festive and marriage season, and state elections may compress the liquidity surplus in H2 FY2020.

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.

Increase in lending limit in micro finance sector to Rs 1.25 lakh per borrower from existing Rs 1.00 lakh

The income and loan limits for a non-banking financial company (NBFC) in micro finance business was last revised in 2015. Taking into consideration the credit delivery by NBFC-MFIs to those in the bottom of the economic pyramid RBI has proposed to revise the income and lending limits as under:

Income Limit: - Increase the annual household income limit for borrowers from the current level of Rs 1.00 lakh for rural areas and Rs 1.60 lakh for urban/semi urban areas to Rs 1.25 lakh and Rs 2.00 lakh, respectively.

Lending Limit: - Increase the lending limit from Rs 1.00 lakh to Rs 1.25 lakh per eligible borrower.

In our view, the increase in income limits is positive as it will increase the number of eligible borrowers with higher income levels for being eligible for microfinance loans. Moreover, increase in lending limit is also a positive from credit availability perspective, however this also poses risks of over-leveraging by the borrowers if the increase is not supported by higher income levels. Accordingly, the lenders must maintain abundant caution while extending higher ticket loans to borrowers and restrict such loans only to borrowers in their subsequent borrowing cycle, where the repayment track record of the borrower is established.

RBI will issue detailed guidelines in this regard shortly.

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