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

MPC votes unanimously for a pause in Repo rate, while maintaining policy stance as 'Accommodative'

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HIGHLIGHTS

- As expected, the Monetary Policy Committee (MPC) voted unanimously to retain the Repo rate under the Liquidity Adjustment Facility (LAF) at 5.15%, in the Sixth Bi-monthly monetary policy statement for FY2020. Moreover, the Committee retained the stance of monetary policy as 'accommodative', also in a unanimous vote.

- With the status quo on the Repo rate, the Reverse Repo rate, Marginal standing facility (MSF) rate and bank rate were also kept unchanged at 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 stands at 18.25%, whereas the Cash Reserve Ratio (CRR) remained unchanged 4.0%.

- The MPC has placed its CPI inflation projection for Q4 FY2020 at 6.5%, substantially higher than its December 2019 forecast of 5.1-4.7% for H2 FY2020, with risks broadly balanced. Moreover, it has considerably revised its CPI inflation forecast for H1 FY2021 to 5.4-5.0% from its December 2019 forecast of 4.0-3.8%, with risks broadly balanced. This is expected to be followed by a base-effect led fall in the retail inflation to 3.2% in Q3 FY2021.

- The MPC has projected a pickup in GDP growth to 6.0% for FY2021 from 5.0% in FY2020. The growth projection for H1 FY2021 has been lowered to 5.5-6.0% from the forecast of 5.9-6.3% that had been made in the December 2019 policy review, and placed at 6.2% for Q3 FY2021.

- The average liquidity surplus under the LAF rose from ~Rs. 2.6 trillion in December 2019 to ~Rs. 3.2 trillion in January 2020, and Rs. 3.6 trillion in February 2020 (till February 5, 2020).

- The MPC noted that monetary policy transmission had been sizeable across various segments of the money market and the private corporate bond market. The transmission to fresh rupee loans still remains substantially higher than outstanding rupee loans. Encouragingly, the MPC noted that since the introduction of the external benchmark system, the weighted average lending rate (WALR) of domestic banks on fresh rupee loans for housing, vehicle loans and MSMEs had displayed some easing in October-December 2019.

Outlook: We anticipate that the stance of monetary policy will be retained as accommodative as long as the MPC perceives the output gap to be negative, regardless of the level of inflation. Moreover, the statement suggests the near certainty of at least one further rate cut. The timing of the same will depend on how quickly inflation appears to be reverting towards 4%. However, we continue to expect the magnitude of further monetary easing to be limited, as even with a favourable base effect, the Committee is projecting the CPI inflation to recede only to 3.2% in Q3 FY2021, which is just mildly lower than the actual print of 3.3% in H1 FY2020. In the meantime, we expect that further sector-specific measures may be announced by the Central Bank, aimed at spurring growth and removing constraints in specific stressed sectors, along with a continued push to improving the transmission of the 135 bps of rate cuts that were conducted in 2019. Given the dovish tone of today's policy statement, and with no further primary supply of G-sec expected until April 2020, we expect the 10-year G-sec yield to trade in a range of 6.4-6.6% in the rest of this fiscal year.

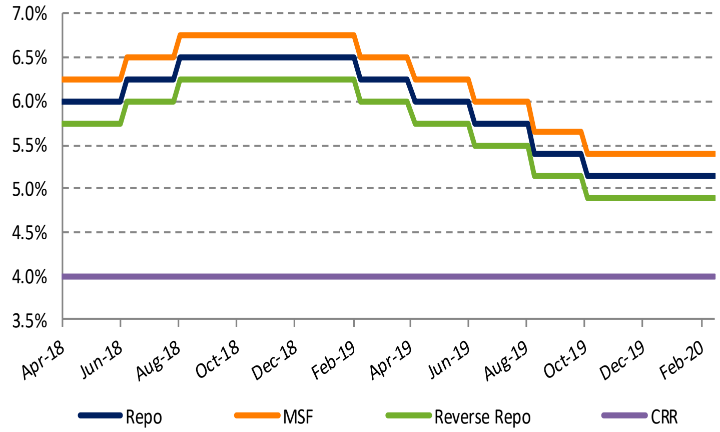
MPC votes for a pause in repo rate, maintains monetary policy stance at 'accommodative'

As expectated, the six-member MPC voted unanimously for a pause in the policy repo rate at 5.15% in the February 2020 policy review, while retaining the stance at 'accommodative' for as long as necessary to revive growth. The MPC also highlighted that there is monetary policy space for future action, while recognizing that the inflation outlook remains uncertain, even as economic activity is subdued.

The CPI inflation hardened for the fifth month in a row, to a 65-month high 7.4% in December 2019 from 5.5% in November 2019, breaching the upper threshold of the MPC's medium-term inflation target of 4%+/-2% after a gap of 40 months. The MPC noted that while onion prices are likely to ebb as supply conditions improve, the hardening prices of pulses and proteins will remain a risk. According to the MPC, other crucial factors that will determine the trajectory of inflation, include the volatility in crude prices, increase in input cost of services, higher customs duty, continued volatility in domestic financial markets due to both global and domestic factors etc. Moreover, the MPC highlighted that the core-CPI inflation would need to be carefully monitored, particularly, in light of the expected pass-through of revisions in mobile phone charges, the increase in prices of drugs and pharmaceuticals, as well as the impact of new emission norms. Taking these factors into account, the MPC has placed its CPI inflation projection for Q4 FY2020 at 6.5%, substantially higher than its December 2019 forecast of 5.1-4.7% for H2 FY2020, with risks broadly balanced. While assuming a normal monsoon, the MPC has considerably revised its CPI inflation forecast for H1 FY2021 to 5.4-5.0% from its December 2019 forecast of 4.0-3.8%, with risks broadly balanced. This is expected to be followed by a base-effect led fall in the retail inflation to 3.2% in Q3 FY2021.

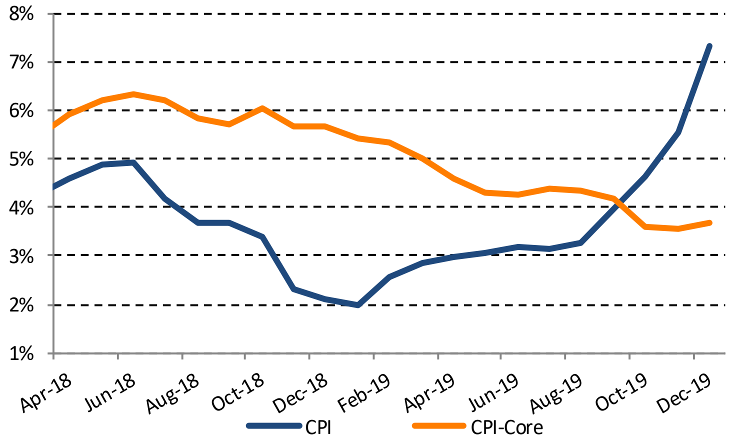
The MPC cautioned that despite some positive developments in a few lead indicators, economic activity is yet to gain broad-based traction. It highlighted several factors that may boost the GDP growth in FY2021, such as the favourable trends in rabi sowing, which may improve private consumption in rural areas. Moreover, the rise in food prices would shift the terms of trade in favour of agriculture, which would further support rural incomes. In addition, the easing trade tensions may support exports and investment activity, although the threat from the coronavirus may negatively impact tourism and global trade. As per the MPC, the improvement in monetary transmission and the pickup in financial flows to the commercial sector are likely to support consumption and investment demand. The Committee also stated that the rationalisation in personal income tax rates and spending measures announced in the Union Budget 2020-21, should support domestic demand. Overall, the MPC has projected a pickup in GDP growth to 6.0% in FY2021 from 5.0% in FY2020. The growth projection for H1 FY2021 has been lowered to 5.5-6.0% from the forecast of 5.9-6.3% that had been made in the December 2019 policy review, and placed at 6.2% for Q3 FY2021.

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 to credit market improving for fresh rupee loans, but transmission to outstanding rupee loans still lagging

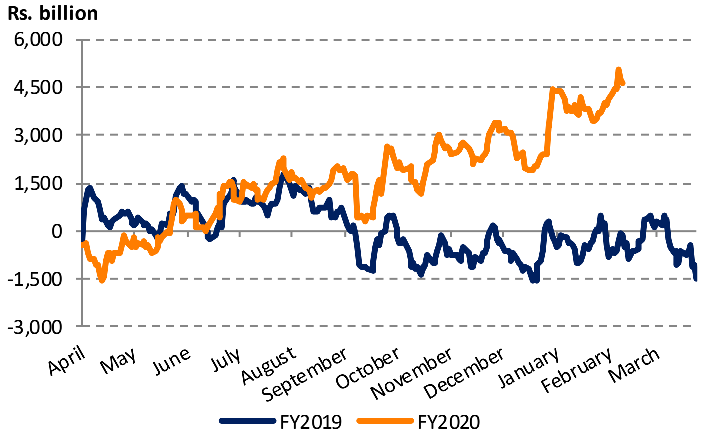
The average liquidity surplus under the LAF rose from ~Rs. 1.3 trillion in Q2 FY2020 to ~Rs. 2.0 trillion in October 2019, ~Rs. 2.4 trillion in November 2019 and Rs. 2.6 trillion in December 2019. This was partly on account of relatively lower credit offtake as compared to deposit accretion, substantial FPI inflows into the Indian equity markets, and purchases of US$ by the RBI in the spot market (in October-November 2019). Subsequently, the average liquidity surplus rose further to Rs. 3.2 trillion in January 2020, led by considerable redemption of G-sec during that month, and Rs. 3.6 trillion in February 2020 (till February 5, 2020).

The RBI also announced the Revised Liquidity Framework, in which it kept the weighted average call rate (WACR) as its operating target, retained the extant liquidity management corridor, and withdrew the liquidity provision target of 1% of NDTL. It said that a single 14-day term repo/reverse repo operation at a variable rate would act as the main liquidity management tool for managing frictional liquidity requirements, in addition to overnight and/or longer repo/reverse repo operations for fine-tuning liquidity requirements. Moreover, the RBI announced that it would conduct term repo operations of one-year or three-year tenors up to a total amount of Rs. 1 trillion from mid-February 2019, to improve monetary policy transmission. However, this may increase the magnitude of the liquidity surplus, going forward.

The daily weighted average call money rate eased from 5.61% in July 2019 to 5.07% in October 2019, reflecting the 135 bps reduction in the Repo rate, as well as the measures taken the by the RBI to improve transmission, such as introducing external benchmarking of banks' floating rate loans. Moreover, with the rise in the average liquidity surplus under the LAF, the daily call rates declined further to 5.00% in November 2019 and stood at 5.02% in December 2019. Subsequently, the daily call rates fell to 4.94% in January-February 2020 (till February 4, 2020) and traded closer to the reverse repo rate.

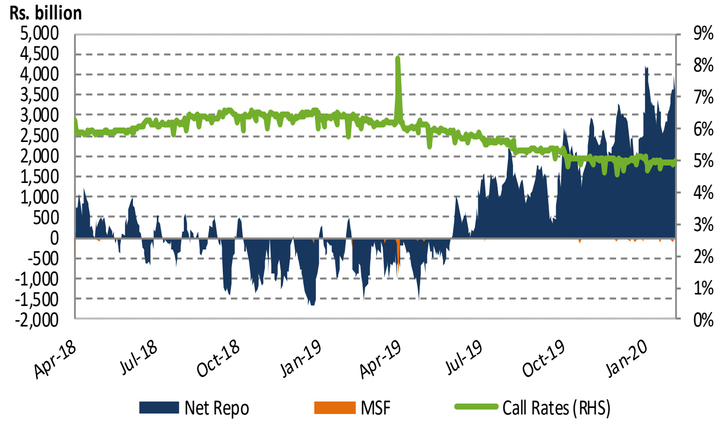
The MPC noted that monetary policy transmission had been sizeable across various segments of the money market and the private corporate bond market. As against the Repo rate cut of 135 bps since February 2019, there was considerable reduction during February-December 2019 in overnight call money markets (by 146 bps), 3-month CPs of NBFCs (by 190 bps), 5-year G-sec yield (by 73 bps), and 10-year G-sec yield (by 76 bps). However, while the WALR on fresh rupee loans by banks declined by 69 bps in February-December 2019, the same on outstanding rupee loans fell by a lower 13 bps. Nevertheless, the MPC noted that since the introduction of the external benchmark system, most banks have linked the lending rates for housing, personal and micro and small enterprises to the Repo rate. As a result, during October-December 2019, the WALRs of domestic banks on fresh rupee loans declined by 18 bps, 87 bps and 23 bps, respectively, for housing, vehicle loans and MSMEs, respectively.

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

1) Revised liquidity management framework

The key highlights of the revised framework are as under:

1. The weighted average call rate (WACR) will continue to be its operating target for liquidity management
2. The liquidity management corridor is retained, with the marginal standing facility (MSF) rate as its upper bound (ceiling) and the fixed rate reverse repo rate as the lower bound (floor), with the policy repo rate in the middle of the corridor
3. The width of the corridor remains unchanged at 50 basis points – the reverse repo rate being 25 basis points below the repo rate and the MSF rate 25 basis points above the repo rate.
4. The quantitative restriction for the daily fixed rate repo and four 14-day term repos being conducted every fortnight, is being withdrawn
5. Instruments of liquidity management will include fixed and variable rate repo/reverse repo auctions, outright open market operations (OMOs), forex swaps and other instruments
6. A 14-day term repo/reverse repo operation at a variable rate and conducted to coincide with the CRR maintenance cycle would be the main liquidity management tool for managing frictional liquidity requirements
7. The main liquidity operation would be supported by fine-tuning operations, overnight and/or longer, to tide over any unanticipated liquidity changes during the reserve maintenance period.
8. In addition, the Reserve Bank will conduct, if needed, longer-term variable rate repo/reverse repo operations of more than 14 days

In our view, the RBI’s emphasis on using 14-day term repo/reverse repo at variable rates as the main liquidity management tool, signals that banks will have to assess their short-term liquidity more accurately. Either they will have to find avenues to deploy short-term liquidity surplus elsewhere or they will need to reduce the unplanned outflows such as large withdrawal against a sanctioned limit by a borrower. This also means that borrowers of the banks will need to plan their liquidity better. Overall, this could lead to decline in short-term yields

2) Long-term Repo Operations (LTRO)

With a view to assure banks about the availability of durable liquidity at reasonable cost relative to the prevailing market conditions, and augment credit flows to the productive sectors, the RBI shall conduct term repos of one-year and three-year tenors for up to a total amount of Rs. 1 trillion at the policy repo rate. This will commence from the fortnight beginning on February 15, 2020.

In our view, despite a significant liquidity surplus in the banking system, banks are likely to opt for LTRO, as it will be a relatively longer liability as compared to overnight or shorter-term repos. This can create demand for medium tenor G-secs, which banks can pledge with the RBI under LTRO and hence will reduce yields across these tenors. This will enable banks to raise medium term funding at fixed rates.

3) Incentivising Bank Credit to Specific Sectors

Scheduled commercial banks will be allowed to deduct the equivalent of incremental credit disbursed by them as retail loans for automobiles, residential housing and loans to micro, small and medium enterprises (MSMEs), over and above the outstanding level of credit to these segments as at the end of the fortnight ended January 31, 2020 from their NDTL for maintenance of CRR. This exemption will be available for incremental credit extended up to the fortnight ending July 31, 2020.

In our view, the above exemption can reduce the negative carry for banks on the CRR maintained by banks. As per rough estimates, with ~6% cost of interest bearing funds and 4% CRR requirements on deposits, the banks will save a negative carry of ~25-30 bps on their funds deployed towards such incremental lending. Banks may choose to pass this on to the borrower by lowering the spreads over the Repo linked lending rate applicable to the borrower class mentioned above. Notwithstanding the expected benefit for banks and the borrowers, the incremental credit flow to MSMEs has remained muted with YoY growth of less than 1% as on December 20, 2019 despite a significant liquidity surplus in the banking system. Hence the actual credit growth because of the above move remains to be seen and will be driven by banks' appetite to take exposure to above borrower segments in slowing economy.

4) External Benchmarking of New Floating Rate Loans by Banks to Medium Enterprises

All new floating rate personal or retail loans and floating rate loans to micro and small enterprises (MSEs) extended by banks were linked to external benchmarks. With a view to further strengthening monetary transmission, it has been decided to link pricing of loans by scheduled commercial banks for the medium enterprises also to an external benchmark effective April 1, 2020. The guidelines for the same will be issued by RBI separately.

5) Extension of One-time Restructuring Scheme for MSME advances

A one-time restructuring of loans to MSMEs that were overdue but 'standard' as on January 1, 2019, was permitted till March 31, 2020 without an asset classification downgrade. In line with the union budget announcement of extending the above scheme by one more year, RBI has been decided to extend the benefit of one-time restructuring of GST registered MSMEs that were overdue but 'standard' as on January 1, 2020. This restructuring window will be available till December 31, 2020.

In our view, unlike the January 1, 2019 circular which permitted loan restructuring for all MSME irrespective of their GST registration status, the current announcement will encourage MSMEs to register under GST to opt for restructuring. Further, as per our estimates, the overall restructuring of loans as per January 1, 2019 was less than Rs 250-300 billion across banking industry out of total MSME credit of ~Rs 10 trillion. Further, given the recent slowdown in GDP growth, there has been instances of stressed cash flows for MSME borrowers and hence the scheme is positive for the borrower, though it could have a negative impact on credit culture and behavior of the borrower in longer term. Such restructuring has to be carefully undertaken for viable cases and to prevent evergreening of loans.

6) Guidelines on Projects under Implementation in Commercial Real Estate sector

RBI has permitted extension of date of commencement of commercial operations (DCCO) of project loans for commercial real estate, delayed for reasons beyond the control of promoters, by another one year to two years without downgrading the asset classification, in line with treatment accorded to other project loans for non-infrastructure sector. The detailed instructions will be issued shortly.

As per ICRA's estimate, a typical loan to developer is sanctioned with 4-5-year maturity with 18-24 months of moratorium and then scheduled repayments start. While the loan is under moratorium, there are prepayment clauses linked to sales volume. However, in an event of delay, the cash flows of builders get deployed towards loan repayment and in the process the project completion can suffer because of lack of funds. Such projects can benefit from above forbearance as it improves project completion and hence selling ability of developer, and also aid the asset quality of the lender. With this extension the developers may however be incentivized to hold on the selling price and not accelerate the sales by cutting the prices.

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