Monetary Policy Review

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Economy Update

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RBI Changes Stance To Neutral And Cuts Rates By 25bps

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) voted unanimously to change its stance to neutral, while four members of the MPC voted for a rate cut. Dr. Chetan Ghate and Dr. Viral V. Acharya voted to keep the policy rate unchanged. We, along with consensus, had expected a change in the stance to neutral, to be subsequently followed by rate cuts. Lower-than-expected inflation, concerns over sluggishness in domestic growth, and slowing global growth aided the RBI's decision for a rate cut. The central bank has revised downwards its inflation forecast for 4QFY19 to 2.8% from 2.7%-3.2% for 2HFY19 earlier. The inflation forecast for 1HFY20 has also been lowered to 3.2%-3.4% from 3.8%-4.2% earlier. Our forecasts are lower at 2.6% for 4QFY19, and 3.1% for 1HFY20. Our forecast for 3QFY20 at 4.0% is a tad higher than the RBI's 3.9%. Moreover, 3-month ahead inflation expectations have softened by 80bps, while it has softened by 130bps for the 12-month ahead period. GDP growth for FY19 is pegged at 7.2% by the Central Statistical Office (CSO) compared with the RBI's earlier forecast of 7.4%, while the RBI's forecast for FY20 stands at 7.4%. Our numbers for FY19 and FY20 stand at 7.2% and 7%, respectively. The MPC statement noted that the output gap has opened up modestly as actual output inched lower than its potential. Investment activity is recovering, but supported mainly by public spending on infrastructure. The need is to strengthen private investment activity and buttress private consumption. With the latest 25bps rate cut, we see room for another 25bps cut in 1QFY20 (mostly in April 2019) with inflation likely to remain muted in 1HFY20. The RBI does not see near-term risks to inflation from the interim budget proposals to boost farm income. The MPC statement noted that several proposals in the interim Union budget for 2019-20 are likely to boost aggregate demand by raising disposable income, but the full effect of some of the measures is likely to materialise over a period of time. However, in our view, the scope for sustained rate cuts may be curtailed by lower transmission capability on the part of banks. With the credit-to-deposit ratio at around 77.8%, banks will have to keep rates high to garner deposits, which also reduces their ability to cut lending rates. In addition, inflation will inch back up to 4% level in 2HFY20, which implies that the window for rate cuts remains limited.

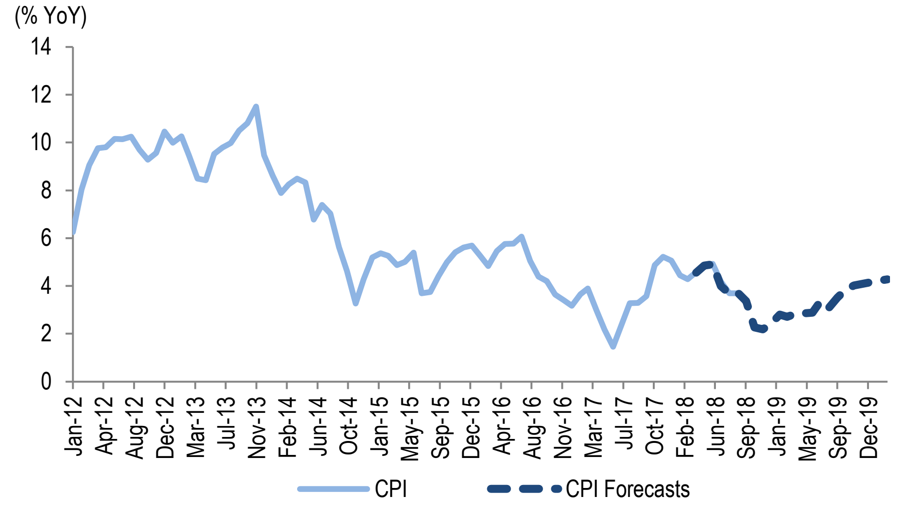
With benign inflation, growth concerns come to the fore: Lower-than-expected inflation, concerns over sluggishness in domestic growth, and slowing global growth aided the RBI's decision for a rate cut. The central bank has revised downwards its inflation forecast for 4QFY19 to 2.8% from 2.7%-3.2% for 2HFY19 earlier. The inflation forecast for 1HFY20 has also been lowered to 3.2%-3.4% from 3.8%-4.2% earlier. Our forecasts are lower at 2.6% for 4QFY19 and 3.1% for 1HFY20. Our forecast for 3QFY20 at 4.0% is a tad higher than the RBI's 3.9%. Moreover, 3-month ahead inflation expectations have softened by 80bps, while it has softened by 130bps for the 12-month ahead period. As RBI Governor Mr. Shaktikanta Das put it, the change in stance to neutral provides flexibility to address concerns over sustained growth, as long as inflation remains benign. GDP growth for FY19 is pegged at 7.2% by the CSO compared with the RBI's earlier forecast of 7.4%, while the RBI's forecast for FY20 stands at 7.4%. Our numbers for FY19 and FY20 stand at 7.2% and 7%, respectively. The MPC statement noted that the output gap has opened up modestly as actual output inched lower than its potential. Investment activity is recovering, but supported mainly by public spending on infrastructure. The need is to strengthen private investment activity and buttress private consumption.

One more rate cut likely, but see limited room for sustained easing: With a 25bps rate cut, we see room for another 25bps rate cut in 1QFY20 (mostly in April 2019) with inflation likely to remain muted in 1HFY20. The RBI also stated that headline inflation is likely to remain soft in the near term, reflecting the current low level of inflation and the benign food inflation outlook. The RBI does not see near-term risks to inflation from the interim Union budget for 2019-20 proposals to boost farm income. The MPC statement noted that several proposals in the interim budget are likely to boost aggregate demand by increasing disposable income, but the full effect of some of the measures is likely to materialise over a period of time. In addition, as we had pointed out in our earlier report: Inflation: A New Normal?, benign food inflation generally tends to pull down inflation expectations (Exhibit 2). The upside risk to inflation beyond the near term mainly stems from possibility of a spike in vegetable prices, uncertainty around crude oil price and monsoon-related uncertainty. Monsoon-related uncertainty may weigh on the policy at the MPC's June 2019 meeting, and consequently we see high probability of a rate cut in April 2019 rather than in June. However, in our view, the scope for sustained rate cuts may be curtailed by lower transmission capability on the part of banks. With the credit-to-deposit ratio at around 77.8% (Exhibit 3), banks will have to keep rates high to garner deposits, which also reduces their ability to cut lending rates. In addition, inflation will inch back to the 4% level in 2HFY20, which implies that the window for rate cuts remains limited.

Core inflation will soften, but may not fall below 5%: The RBI noted that the recent unusual pick-up in the prices of healthcare and education could be a one-off phenomenon, but it must be closely watched. We expect core inflation to soften, but not beyond 5% level. In post-reform India, core inflation has never really fallen below 5% (Exhibit 4), which in our view, limits the ability to cut real rates drastically. The RBI reiterated that it does not target any particular level of real rates, but Dr. Viral Acharya pointed out that it is more appropriate to measure real rates with respect to core inflation, which implies that even with the repo rate at 6% and core CPI around 5%, the real rate will be at a comfortable 1%, although it will be higher when compared against headline inflation.

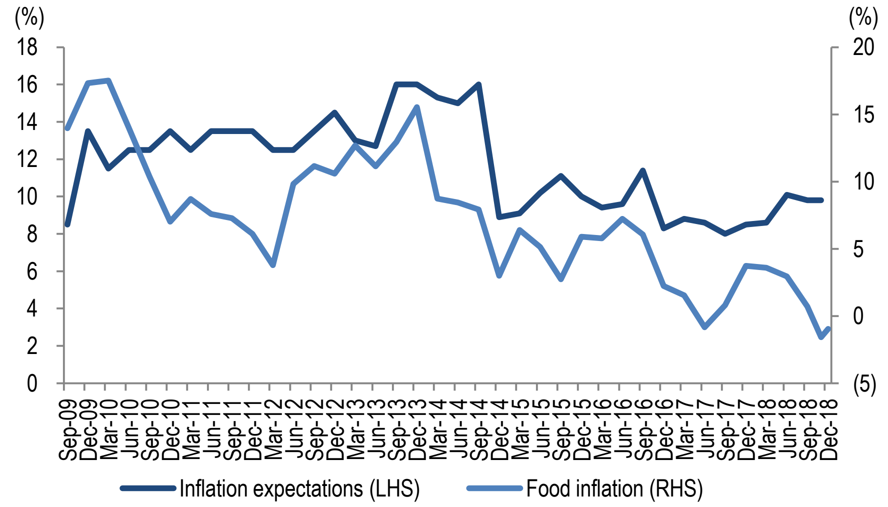
Regulatory easing supportive: In other positive developments, the 20% exposure limit to a single corporate entity for foreign portfolio investment in corporate bonds will be relaxed. This is likely to help revive flows into the corporate bond market. Bank lending to NBFCs will be permitted to be risk-weighted based on their assigned ratings (as is the case with other corporates), in contrast to the 100% risk weight applied currently. This move is likely to encourage bank lending to NBFCs, while easing borrowing costs for NBFCs at the margin. Resolution applicants under the Corporate Insolvency Resolution Process will also be allowed to avail of External Commercial Borrowing (ECB) to repay existing lenders. The collateral-free lending limit for agriculture has been increased to Rs160,000 from Rs100,000 earlier, which is positive for consumption.

Exhibit 1: Benign near term inflation outlook opens up space for another 25bps rate cut



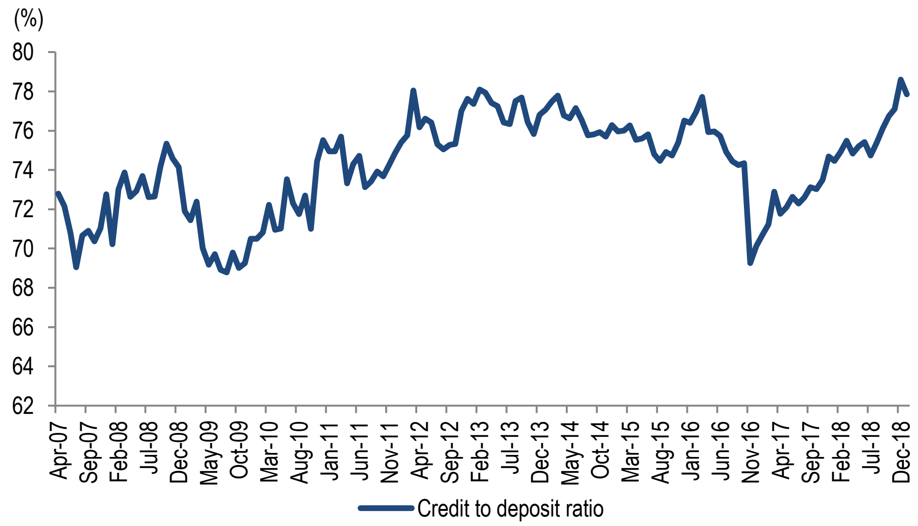
Source: Central Statistical Office or CSO, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 2: Fall in food inflation tends to pull down inflation expectations



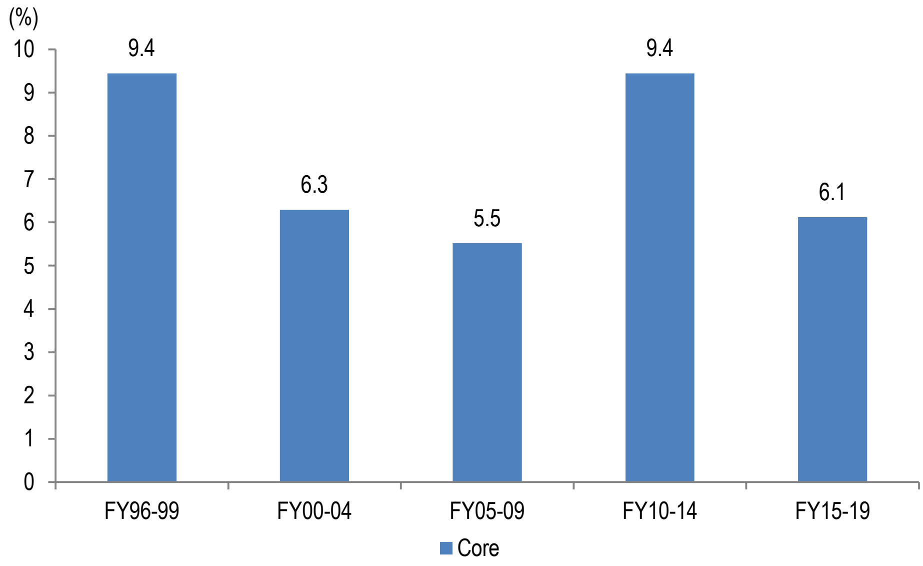
Source: RBI, CSO, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 3: High credit-to-deposit ratio limits room for transmission



Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 4: Sustained rate cut may not be possible as core inflation has not fallen below 5% in post-reform period



Source: CSO, CEIC, Nirmal Bang Institutional Equities Research

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