MONETARY POLICY REVIEW

06 June 2019

Rate cut cycle to continue

RBI surprised with a change in stance to accommodative from neutral while reducing policy rate by 25bps. While we thought RBI may want to wait for monsoon and Budget before it extends its rate cut cycle, the Q4 GDP print and dip in oil prices seems to have tilted the balance. With growth likely to remain below 7% and inflation below 4%, we expect RBI to further reduce policy rate by another 25bps in Aug'19 or Oct'19. The key risks to the view are volatile oil prices, below normal monsoon or change in fiscal projections.

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Stance changed to accommodative: In a surprise move, MPC with a 6-0 vote changed its stance to accommodative from neutral. The change in stance means rate hikes are off the table and liquidity will on an average be positive rather than negative or zero. This will result in better transmission of cumulative 75bps of rate cuts done by RBI since Feb'19. System liquidity has been in deficit since Jun'18 and just moved into positive territory in Jun'19.

FY20 growth forecast at 7% from 7.2%: RBI reduced its GDP forecast for FY20 to 7% (6.6% in H1FY20 and 7.4% in H2FY20) led by dip in exports and domestic growth momentum. Both consumption and investment activity has slowed down from H2FY19. Rural spending is likely to revive with coverage of PM-KISAN to 14.5mn rural households and uptick in farm prices seen off-late (WPI food inflation at 4.9%). Investment will revive with a lag as capacity utilization is already at 77% now. On the inflation front, RBI has revised its near-term forecast upwards by 10bps (H1FY20) while reducing H2FY20 forecast by 10bps. While recent decline in oil prices (-13% since last policy) is positive from an inflation standpoint, monsoon will decide the food inflation trajectory. Our CPI forecast remains at 3.5% and 3.7% for FY20 and FY21.

Rate cut cycle not over: Given the domestic and global growth dynamics, we believe GDP growth will be lower at 6.8% than RBI's trajectory of 7%. In addition, a 3.4% fiscal deficit by the Centre in FY20 (same as FY19) implies government spending will have a neutral impulse for growth. States may have to ramp-up their spending to kick-start growth. Thus for private investment cycle to revive, real interest rates are likely to fall even further. Thus we believe there is more room for accommodation in the current cycle with a likelihood of rate cut in Aug'19 or Oct'19 policy. The key risks to our view is sharp jump in global oil prices, below normal monsoon and higher fiscal deficit projections.

KEY HIGHLIGHTS

- RBI cuts repo rate by 25bps, stance changed to accommodative from neutral.
- Inflation projections for FY20 revised downward to 3.1% from 3.3% earlier.
- GDP forecast also revised lower at 7% for FY20 from 7.2% earlier.

Regulatory announcements

- In an effort to harmonise with Basel III standards, RBI has decided to keep the minimum Leverage ratio at 4% for Domestic Systematically Important Banks (DSIBs) and 3.5% for other banks.
- To enhance credit access to small borrowers and encourage competition within small finance banks, RBI has proposed to issue draft guideline for 'on tap' Licensing of Small Finance Banks by the end of Aug'19.
- With the objective to review regulatory guidelines and supervisory framework of Core Investment Companies (CIC), RBI has decided to constitute a working group. This is likely to strengthen corporate governance framework of CICs.
- RBI has decided to constitute an Internal Working Group to review the existing liquidity management framework and propose measures for a simplified framework, which would clearly communicate the objectives, quantitative measures and toolkit of liquidity management by RBI.
- In an effort to develop a comprehensive money market, RBI would rationalize existing regulations covering different money market products. This in turn would improve transparency and safety of money markets.
- RBI has decided to allow Specified Stock Exchanges to act as aggregators or facilitators to aggregate the bids of their stockbrokers or other retail participants and submit a single consolidated bid under the non-competitive segment of the primary auctions of SDLs. The measure will be implemented in consultation with the respective State governments. This would improve retail participation in the GSec market and will also increase the underlying market's depth and liquidity.
- Recognizing the need to push the digital funds movement, RBI has decided to waive off any charges on transaction processed through RTGS and NEFT and the benefits of the same should be passed on to the consumers.
- RBI has decided to constitute a committee which is expected to address the issue of ATM charges and fees.

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