

Insights – Monetary Policy Review

Fourth consecutive rate cut accompanied by accommodative policy stance

August 7, 2019

No matter how widely expected the Monetary Policy Committee (MPC)'s decision became, it is the quantum of rate cut and continuation of accommodative stance that was a welcome move. Though expectations of rate cut even in non-multiples of 25 basis points (bps) or larger rate cut have been there since last policy review, the series of rate cut, now fourth in a row and an unconventional cut of 35 bps clearly signals a change in approach. With this rate cut (cumulative 110bps since February), the repo rate now stands at 5.40% which is lowest since July 2010. The decision to lower policy repo rate and retain accommodative stance was unanimous, however, four members voted to reduce the repo rate by 35bps and two members by 25bps.

In the view of moderate inflation, which has remained within MPC's target of 4% for close to a year now and benign inflation outlook, rate cut was warranted to support subdued economic activity. The MPC noted that growing global headwinds coupled with escalating trade tensions posed additional downside risks to the weak economic growth. More importantly, it acknowledged that need to address growth concerns by boosting aggregate demand, especially private investment, remains high at this juncture while staying consistent with the inflation mandate. The policy review narrated the similar concerns and thus revised its growth estimates downwards for 2019-20 to 6.9% from 7.0% in the June policy, in the range of 5.8%-6.6% for H1 2019-20 and 7.3%-7.5 % for H2 2019-20 with risks somewhat tilted to the downside. The GDP growth for Q1 2020-21 is projected at 7.4%.

The growth projection was revised down along with the benign inflation outlook. The inflation is projected to remain within its target over a 12-month ahead horizon. Accordingly, MPC estimated CPI inflation at 3.1% for Q2 2019-20 and 3.5% -3.7% for H2 2019-20, with risks evenly balanced. The CPI inflation for Q1 2020-21 is projected at 3.6%. The policy statement cited various factors which would influence the inflation trajectory going forward, namely, uptick in food inflation though risk will be mitigated by improving rainfall distribution, volatile crude oil prices, benign inflation outlook excluding food & fuel and moderating inflation expectations of households for one year ahead.

Meanwhile, the liquidity conditions within the banking system turned into large surplus in June-July 2019 on back of government spending, forex inflows and seasonal inflows in currency in circulation. The RBI absorbed liquidity of Rs. 51,710 crores in June, Rs. 1,30,931 crores in July and Rs. 2,04,921 crores in August (up to August 6, 2019) on a daily net average basis under the Liquidity Adjustment Facility (LAF). Further, it conducted two Open Market Operation (OMO) purchase auctions amounting to Rs. 27,500 crores in June, thereby injecting durable liquidity into the system.

On another front, RBI announced two important measures to address the liquidity squeeze faced by Non-Banking Financial Companies (NBFCs). Firstly, it revised guidelines on large exposure framework (LEF); bank's exposure limit to single NBFC has been raised to 20% of Tier-I capital of the bank from 15% earlier. The second measure has been with regard to credit to the priority sector. It has decided to allow, subject to certain conditions, bank lending to registered NBFCs (other than Micro finance Institutions) for on-lending to Agriculture (investment credit) up to Rs. 10.0 lakhs; Micro and Small Enterprises up to Rs. 20.0 lakh and housing up to Rs. 20.0 lakh per borrower (up from Rs. 10.0 lakh at present) to be classified as priority sector lending.

Market Outlook

With subdued growth and inflation dynamics domestically and beginning of monetary easing globally, there were all the plausible reasons to believe successive round of rate reduction(s). We had expected the MPC members to push through higher doses of rate reduction and address liquidity concerns faced by NBFCs and housing finance companies as well.

Given slowing growth and high real interest rates, we feel that MPC is likely to continue the rate reductions (though at a much lower pace) and attempt to push the lower rates into the economy. However, drop in repo rate do not always guarantee lower borrowing cost and hence we feel RBI will remain vigilant on liquidity conditions. It will not refrain from infusing liquidity, as and when required, so as to help lower cost of deposit of the banks and enabling them to price their loans cheaper.

In this environment we urge investors to start selecting funds in alignment with their investment horizon and marginally longer depending on their individual risk appetite. Some additional fund duration over investors investment horizon should work favorably, as the risk

return matrix is tilted towards lower rates. We expect the actions of RBI to create additional demand for gilts and bonds in this environment.

The risks to this view emanate from higher government borrowing calendar of FY20. However, it may get neutralized through creation of higher demand for gilts and bonds by infusing liquidity into the system by RBI, OMO and/or from higher demand for Indian bonds from foreign investors amidst low rates globally.

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