Insights – Monetary Policy Review

Growth revival takes precedence. MPC opts for fifth straight rate cut with policy stance remaining accommodative

October 4, 2019

Following the government's recent measures to prop up the economy, and MPC's continued efforts since beginning of the calendar year directed towards growth revival, today's decision came as a no surprise. The MPC opted for another rate cut, the fifth in a row, reducing the repo rate by 25 basis points (bps) in its latest policy review. The rate cuts have now aggregated to 1.35% (135 bps) so far in the calendar year. With this rate cut, the repo rate now stands at 5.15%, the lowest in decade (since April 2010). The six-member MPC unanimously voted for reducing the repo rate and maintaining the policy stance to accommodative. However, one member voted to reduce the repo rate by 40bps.

The series of rate cuts come in the backdrop of moderate inflation and prolonged slowdown warranting intensified efforts to restore the growth momentum. Since the measures undertaken by the government has been focussed to ease supply side pressures and may not address sluggish consumption in the immediate term, the need to lower repo rate and thus bring down the lending rates, are seen to help boost consumption and investment. Further, in a move to make its interest rate decisions more effective and ensure faster transmission of policy rate cuts to borrowers, the RBI has already mandated banks to link their retail and Micro, Small and Medium Enterprises (MSME) loans to external interest rate benchmarks from October 1. Separately, in a move to improve credit availability in rural and semi-urban areas, it increased the household income limit for borrowers of Non-Banking Finance Company (NBFC)- Micro Finance Institutions (MFIs) from current level of Rs. 1 lakh for rural areas and Rs. 1.60 lakhs for urban/semi urban areas to Rs. 1.25 lakh and Rs. 2.00 lakh, respectively. The lending limit is increased from Rs. 1.00 lakh to Rs. 1.25 lakh per eligible borrower.

The MPC had the policy space to address growth concerns as headline inflation has remained lower than the median inflation target of 4%, so far. The headline inflation, measured by Consumer Price Index (CPI), has stayed in the range of 2%-3.2% during the calendar year, with latest inflation recorded at 3.21% in August. The MPCs' recent assessment also noted that inflation is expected to remain below target in the remaining period of 2019-20 and Q1 2020-21. Its inflation projections are retained at 3.5%-3.7% for H2

2019-20 and 3.6% cent for Q1 2020-21, although the inflation estimate is revised slightly upward to 3.4% for Q2 2019-20. The policy review also stated that there are some upward price pressures on vegetables, but price pressures in CPI excluding food and fuel are likely to be muted.

Meanwhile, the policy statement cited concerns with regard to the growth outlook and sharply recalibrated its growth prognoses. Real GDP growth for 2019-20 is revised downwards from 6.9% in August policy to 6.1% – 5.3% in Q2 2019-20 and in the range of 6.6%-7.2% for H22019-20 with risks evenly balanced. The GDP growth for Q1 2020-21 is also revised downwards to 7.2%.

Even as growth concerns remained high, another key economic parameter i.e. liquidity in the system remained supportive. Overall liquidity remained in surplus in August and September despite expansion of currency in circulation and forex operations by the RBI draining liquidity from the system. The RBI absorbed liquidity of Rs. 1,40,497 crores in August and Rs. 1,22,392 crores in September on a daily net average basis under the Liquidity Adjustment Facility (LAF).

Though MPC has been working towards better transmission of rates into the system, so far the monetary transmission has remained staggered and incomplete. According to the policy document, as against the cumulative policy repo rate reduction of 110 bps during February-August 2019, the weighted average lending rate (WALR) on fresh rupee loans of commercial banks has declined by 29 bps. However, the WALR on outstanding rupee loans increased by 7 bps during the same period.

Market Outlook

We feel that the slowing domestic growth is a function of both slowing global growth and slowing domestic consumption. Headline CPI for CY20 is expected to be comfortably well within 4% due to benign oil prices, drop in core inflation and soft food prices (although there is some observed rise in vegetable prices in the recent period). The drop in core inflation in India to ~ 4% levels in the recent months after staying at over 5.5% for the last few years highlights the slowing domestic consumption.

Thus, with slowing growth and high real interest rates, RBI is likely to continue the rate reduction and attempt to push lower rates into the economy. However, drop in repo rate do not always guarantee lower borrowing cost and hence we feel RBI may continue to infuse liquidity so as to help lower the deposit rates of the banks and enabling them to price their loans cheaper.

In this environment we feel investors can start selecting funds in alignment with their investment horizon and longer depending on their individual risk appetite. Some additional fund duration over an investors investment horizon may 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.

Any upward revision in borrowing calendar of Government for FY20 may pose a risk to this view. However, it may get neutralized through creation of higher demand for gilts and bonds by infusing liquidity into the system by RBI, OMO, long-term repo and/or from higher demand for Indian bonds from foreign investors amidst low rates globally and the recent transfer of higher reserves from RBI to government.