Economics

DBS Flash

India: RBI's dovish turn

DBS Group Research 7 February 2019

Radhika Rao
Economist

Eugene Leow
Rates Strategist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *The RBI cut the repurchase rate by 25bp to 6.25%, along with a change in the stance to 'neutral' from 'calibrated tightening'.*
- *Inflation projections were cut sharply. FY20 inflation is seen averaging below the 4% target.*
- *The policy panel looked past the stickiness in core inflation and expansionary fiscal policy.*
- *The Governor's remarks that "there is room to cut" were telling*
- *We see a shallow rate-cut cycle ahead.*
- *We revise our call to include a 25bp cut in April, before rates stabilise.*
- *Our call of bullish bond-curve steepening risks remains on the table.*

In the first policy review under new Governor Shaktikanta Das, the **RBI monetary policy panel cut the repurchase rate by 25bp to 6.25%, along with a change in the stance to 'neutral' from 'calibrated tightening'.** This compares with our expectation for a pause on rates but a change in stance. The decision to change the stance was unanimous, while voted 4-2 in favour of a cut, with Chetan Ghate and Viral Acharya casting dissent votes.

Table: Snapshot of RBI's projections

Meeting	Inflation	Growth
February'18	5.1% in Q4 FY18; 5.1-5.6% in H1 FY19 & 4.5-4.6% in H2	FY18: 6.6% (GVA) FY19: 7.2% (GVA)
April'18	4.5% in Q4 FY18; 4.7-5.1% in H1 FY19 & 4.4% in H2	FY18: 6.6% (GDP) FY19: 7.4%
June'18	4.8-4.9% in H1 FY19; 4.7% in H2 (incl HRA)	FY19: 7.4% (GDP)
August'18	4.8-4.9% in H1 FY19; 4.8% in H2 (incl HRA); 5.0% in Q1 FY20	FY19: 7.4% (GDP); H1 7.5-7.6%; H2 7.3-7.4% Q1 FY20 - 7.5%
October'18	3.9-4.5% in H2 FY19; 4.8% in Q1 FY20	FY19: 7.4% (GDP); Q2: 7.4%; H2: 7.1-7.3% Q1 FY20 - 7.4%
December'18	2.7-3.2% in H2 FY19; 3.8-4.2% in 1H FY20	FY19: 7.4% (GDP); 1HFY20 - 7.5%
February'19	2.8% in 4QFY19; 3.2-3.4% in 1H FY20	FY20: 7.4% (GDP); 1HFY20 - 7.2-7.4%

Source: RBI press release, DBS

Economic assessment: Benign inflation provided the room for the RBI panel to take a growth-supportive stance**. Inflation projections were cut sharply, with the accompanying language highlighting that risks are broadly balanced around the central trajectory**. Headline inflation projection was cut to 2.8% in the March 2019 quarter (vs earlier 2HFY19 at 2.7-3.2%). For the first half of FY20, inflation is now seen at 3.2-3.4% and 3.9% in the December 2019 quarter, suggesting a higher likelihood that full-year FY20 inflation might average below the 4% inflation target. The central bank highlighted these to back the revisions: a) food inflation - the short-term outlook was seen as benign, despite adverse base effects; b) moderation in the fuel and electricity groups; c) while core inflation is elevated, the central bank opined that the "unusual pick-up in the prices of health and education" was seen as temporary phenomenon; d) stable outlook for crude oil prices; e) moderating inflation expectations; e) dissipating impact of the housing rent allowance increases.

While we assumed that the slippage in fiscal targets in the Interim Budget lowered the odds of a rate cut, the RBI panel opined that while the budget proposals might boost aggregate demand by raising disposable incomes, the impact might only materialise in the medium-term and are not an imminent risk to the inflation outlook.

Despite this favourable view on the inflation trajectory, we view incipient risks on a few fronts – receding base effects are likely to lift inflation towards 4% by end-year, food prices could mean revert after this current phase of disinflation, with a cobweb phenomenon in the production cycle, and pipeline risks from an expansionary budget ahead of the general elections due in April-May.

GDP growth projection was revised down modestly. FY20 GDP growth is seen at 7.4%, with 1H in 7.2-7.4% range (vs 7.5% in the December review) and 7.5% in December 2019 quarter. Risks were seen as balanced, influenced by: a) strong credit growth and financial flows, but is yet to be broad-based; b) net trade could get a boost from weaker rupee and softer oil prices; c) trade tensions might moderate. We add, that the higher fiscal deficit target and pro-consumption bias in the budget also provides more headroom for public-sector spending support to continue. Nonetheless, base effects and moderate near-term consumption trends pave the way for FY19 growth to ease from 8.2% in the June 2018 quarter to below 7% by March 2019 quarter.

We also recall recent upward revisions in the past three years of growth data. FY18 growth now stands revised to 7.2% YoY, up from 6.7% estimated earlier. Gross Value Added (GVA) now stands revised to 6.9% vs 6.5%. FY17 growth was raised to 8.2% YoY vs 7.1% estimated earlier. Revision to the FY18 GDP growth was modest to 8% vs 8.2% earlier. These revisions suggest that the impact of demonetisation and GST rollout was not as severe as earlier estimated.

Policy outlook

The RBI policy panel surprised with a rate cut on 7 February, looking past the stickiness in core inflation and impact of an expansionary fiscal policy. The wide cushion on real rates vs the region also provided the RBI with sufficient justification. Governor Das's remarks that "there is room to cut" suggests this is not a one and done easing. A sharp revision in the inflation outlook and limited spillover seen from a slippage in fiscal targets, paves the way for a shallow rate-cut cycle. We revise our call to include a 25bp cut in April, before rates stabilise.

Highlights of the non-rate measures included -

Full list is available here

- **External commercial borrowings:** Relaxed the end-use restrictions for resolution applicants under the Corporate Insolvency Resolution Process (CIRP) under Insolvency and Bankruptcy Code (IBC), which will allow these entities to use the proceeds to repay INR term loans of the target company.
- In a bid to support well-rated NBFCs, rated exposures of banks to all **NBFCs is likely to be risk-weighted** as per the ratings assigned by the accredited rating agencies, similar to corporates. Guidelines will be available later this month.
- With a view to simplify and **harmonise various NBFC categories** involved in credit intermediation, entities like Asset Finance Companies (AFC), Loan Companies, and Investment Companies, will be merged into a single category. This will help simplify regulatry frameworks, and provide the companies with more operational flexibilty.
- **A Task Force on offshore INR markets** is likely to be set-up to streamline the process of gradual opening up of the FX market and also to benefit from a wider range of participants and views.
- RBI scrapped the existing rule that no Foreign Portfolio Investor can hold more than 20% of its corporate bond portfolio to a single corporate; this will help attract a wider spectrum of investors to the domestic corporate debt market.

Market implications

On the markets, we retain our call for further bond-curve steepening. Yields on the longer-end of the curve will be underpinned by the centre's sizeable borrowing program, while demand from domestic banks is likely to remain modest (given excess SLR holdings and recent cuts). Short-tenor papers might benefit from a dovish central bank policy. Better liquidity conditions and the prospect of another rate cut (DBSf: another 25bps cut by 2Q) should drive the 3M INR reference rate lower in the coming months. The current spread between the 3M rate and the overnight repo rate is wide, hovering above 100bps despite signs of improvement in banking system liquidity. This is not sustainable. Less strict rules on foreign portfolio investments and a less hawkish Fed should drive foreign funds to INR assets. In any case, look for the 3M Mibor to fall below 7% as the seasonal 1Q liquidity tightness fades.

DBS forecasts

		2019 Q1	Q2	Q3	**Q4**
India	3m Mibor	7.35	7.00	6.90	**6.80**
	2Y	6.80	6.65	6.50	**6.50**
	10Y	7.30	7.40	7.50	**7.50**
	10Y-2Y	50	75	100	**100**

%, eop, govt bond yield for 2Y and 10Y, spread bps

For the rupee, a combination of broader dollar strength, arising from stronger incoming data from the US (which strengthens our expectations of further rates hikes) and domestically, higher political premia are likely to keep the currency under pressure.

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 6878-2072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).