Economics

DBS Flash

India: RBI leaves door open for another neutral cut

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- *RBI's second Repo rate cut (by 25bp to 6%) today effectively unwound the cumulative 50bp hikes in 2018*
- *The committee maintained its neutral policy stance, in line with our expectations, and reinforced its data-dependent bias*
- *Inflation and GDP projections for FY20 were lowered*
- *Inflationary expectations are anchored*
- *Our base case is for a third 25bps cut in June. A delay to August is equally compelling, if the RBI looks to factor in July's full-year Budget while awaiting clarity on the monsoon*
- *Concerns over limited policy transmission and liquidity shortfall remain*
- *Non-rate announcements included an increase in the carve-out of the liquidity coverage ratio, delay in plans to peg lending rates to external benchmarks, and easing GSec trading for non-residents*

The Reserve Bank of India (RBI) monetary policy panel cut the repurchase rate by 25bp to 6.0% at its second successive rate review on Thursday. This unwound the cumulative 50bp hikes in 2018. Policy stance was left unchanged at 'neutral', along our expectations, which reflected the committee's bias to remain data-dependent and non-committal on the path, given interim uncertainty. The vote to change the rate saw a 5-2 split, with Chetan Ghate and Viral Acharya casting the dissent votes to keep rates unchanged.

Economic assessment: **The central bank lowered its growth and inflation projections.** The outlook suggests the central bank expects inflation to stay below 4% in FY20, with 1H cut to 2.9-3% and 3.5-3.8% in second half of the year. For FY21, the base case assumes inflation at 3.8-4.1%. Our forecasts are for inflation to average 3.5% in FY19 and 3.8% in FY20. For this year, risks are balanced, while the bank highlighted these upside risks: a) crude oil price direction; b) fiscal slippages at the general government level; c) El Nino risks in 2019. If monsoon is deficient, the RBI foresees 30bp downside risk to growth in FY20 and 50bp increase in inflation vs its baseline; d) sharp and unexpected rebound in food prices (see second box).

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%; 1HFY20 - 7.2-7.4%
April'19	2.9-3.0% in 1HFY20; 3.5-3.8% in 2H	FY20: 7.2%; 1H - 6.8-7.1%; 2H - 7.3-7.4%

Source: RBI, DBS Group Research

On growth, the central bank lowered its forecast to align with the statistics agency, with FY20 GDP growth seen at 7.2%; which breaks down to 6.8% in 1Q, 7.1% in Q2, 7.3% in Q3, and 7.4% in Q4. For 2020-21, real GDP growth is seen in the region of 7.3-7.5%.

Baseline assumptions - RBI

Factors	Oct'18 MPR*	Apr'19 MPR
Oil	$80pb in H2 FY19	$67pb in FY20
Monsoon	9% below LPA in 2018	Normal for 2019
Global growth	3.9% in 2018	3.5% in 2019; 3.6% in 2020
Exchange rate	USDINR: $72.5	USDINR: $69
Fiscal Def tgt (% GDP)	Combined FY19 - 5.9% of GDP	Combined FY19 - 5.9% of GDP

* Monetary Policy Report

Source: RBI, DBS Group Research

Moderating inflationary expectations to comfort the RBI

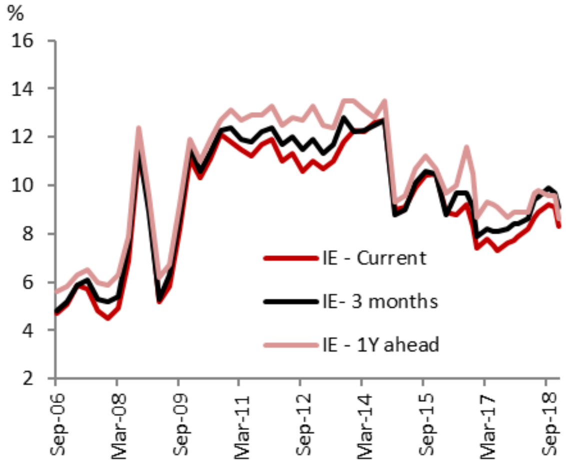
The RBI also took comfort from ongoing moderation in inflationary expectations, which have evolved favourably in recent months.

Prior to the switch to an inflation-targeting framework, inflationary expectations were stubbornly elevated and unanchored, particularly between 2009 and 2013 (see chart). This was a period when high food prices prevailed, and monetary policy was accommodative, leaving real rates in negative. Elevated inflationary expectations saw supply shocks swiftly morph into second-order effects, spilling over as generalised pressures and feeding into wage decisions.

Since the inflation-targeting framework was adopted, trends have turned favourable. For FY19, inflationary expectations have moderated, given their adaptive nature, owing to strong disinflation in the food segment, while monetary policy was tight, leaving real rates in positive territory. Three-month ahead inflation expectations in the March 2019 round were lower by 160 bps vs September 2018 round. One-year ahead inflation expectations in the March 2019 round softened by 170 bps and 50 bps from September 2018.

This is likely to leave policymakers with more confidence that, notwithstanding supply shocks, reducing rates might not necessarily feed into inflationary risks in the short-term.

RBI survey - Inflation Expectations (IE) soften



Source: CEIC, DBS Group Research

Policy guidance

Policy guidance was not as dovish as markets expected. This explained the kneejerk disappointment in the 10Y INR bond yields and rupee price action. That the stance was maintained at 'neutral' underscores our expectations the committee prefers to stay data-dependent, but with a dovish bias. Downward revisions in economic projections coupled with remarks that the 'the output gap remains negative' and the need for 'domestic growth impulses' suggest that the door remains open for further policy easing. **We expect another rate cut, with June as our base case. An argument for the cut to be delayed to August is equally strong if the RBI sees reason in factoring in the full-year budget due in July and awaits a clearer picture on monsoon developments.**

Barring a move in carving out an additional 2% from the Statutory Liquidity Ratio (SLR), there were no fresh moves aimed at liquidity or jumpstarting policy transmission.

Banking system liquidity has been in net deficit in recent months, hindering an efficient transmission process (see here). Considering limited clarity on liquidity, **recent gains in the INR sovereign bonds have proved fleeting.** The supply pipeline remains the main dampener, with any relief hinging on the frequency and quantum of liquidity support (more swaps, bond buybacks etc.). To recall, the central government plans to borrow 62% of the record FY20 borrowings, in first half of the year. Add to this, states will borrow INR1.1trn in 1QFY20 (i.e. June quarter) vs INR 0.77trn same time last year.

Rising supply comes at a time when banks' appetite to buy bonds is constrained by a high loans-deposit ratio. Foreign portfolio investors returned to the debt markets last month. While this might be at risk if global yields rebound, rising oil prices are also a headwind – Brent prices are past USD69pb this week, back to November 2018, and up 37% from December low.

In all, 2Y/10Y term premium is likely to stay wide as short-tenor yields stay anchored on a dovish RBI, while the longer-end of the curve remains elevated heading into a busy issuance calendar.

Non-rate measures

Alongside the rate decision, highlights of non-rate measures included (full list is available here https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=46724) :

1) The RBI increased the carve-out of liquidity coverage ratio (LCR) from the SLR by 2% percentage points of the net demand and time liabilities (NDTL). This lowers the need for banks for step up bond purchases to meet regulatory norms but is also a negative for the bond markets. This increases the need for the central bank to maintain a supportive role in the debt markets, as was the case in FY19. The pre-set timetable for carve-out limits will rise from 15.5% in April 2019 to 17% in April 2020.

2) On the aspect of pegging borrowing costs to external benchmarks, the RBI opined that the proposal will require further consultations and hence the rollout is not imminent. Showing a conciliatory hand, India's largest public sector bank set the (transmission) ball rolling last month, as certain segments of loans were pegged to the repo rate. More banks were expected to follow suit, but the scale of adherence will be guided by their respective balance sheet strength, deposits size, and anticipated duration of the rate-cutting cycle.

3) Recognising the benefits of an active secondary market in loans, the Reserve Bank will set up a Task Force to study the relevant aspects including best international practices and propose measures for developing a thriving secondary market for corporate loans in India.

4) In light of the Supreme Court's recent decision to strike down the RBI's February 2018 circular, Governor Das highlighted that the RBI will reissue fresh instructions to the domestic banks to lower non-performing ratios and seek a speedier resolution of stressed assets. No timeline was set for the new set of instructions.

5) Opening up a new channel for non-residents to participate in government bond transactions, the RBI proposed implementation of international settlement of these securities through International Central Securities Depositories (ICSDs). Operational details will be made available after discussions with government and securities regulator.

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