Economics

DBS Flash

India: RBI breaks from convention, cuts by 35bps

Economics/Growth/Monetary policy/Rates/India

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- *The Reserve Bank of India eases policy further with a 35bps cut, an odd-sized cut hinted by Governor Das at an IMF event in April*
- *Growth projections were cut, inflation is seen sub-target in the next four quarters*
- *Measures were taken to support non-banks and personal loans*
- *An easier monetary stance offsets a constrained fiscal room*
- ***Implications for forecasts**: We still see room for at least another 15-25bps cuts in rest of FY20 (with room for more), as growth assumptions are revised lower*
- ***Implications for investors**: Reaction to global turmoil has been asymmetric between INR bonds vs the Rupee*

Breaking from convention, RBI's monetary policy committee (MPC) voted to lower the Repo rate by 35bp to 5.4% vs consensus at 25bps cut. The reverse repo rate was lowered by a similar quantum, while cash reserve ratio was held unchanged.

Governor Das justified the bigger cut as a balance between doing more than a routine 25bp, but less than 50bps which might have been perceived as aggressive. **He had discussed the likelihood of odd-sized rate moves in an IMF event in April 2019** (speech). Calling for the need to think out of the box by challenging the conventional wisdom, he had said "in a situation in which the central bank prefers to be accommodative but not overly so, it could announce a cut in the policy rate by 35 basis points if it has judged that the standard 25 basis points is too little, but its multiple, i.e., 50 basis points is too much."

Wednesday's move mirrored that thought, opening the MPC to move away from the conventional 25-50bp to explore 10-35bp going forward. While a rarity in the region (Taiwan's CBC cuts by 12.5bps and China by -20bp before moving to 25bp), central banks in advanced economies have trimmed rates by various sizes of 5-35bps in the past.

Economic assumptions: The MPC expects weak growth, policy rate cuts and (assumption) of a normal monsoon to keep **inflation at sub-target in next four quarters** – 3.1% in 2QFY20, and 3.5-3.7% in 2H. CPI in 1QFY21 is seen at 3.6%. Risks were seen from a) rainfall uncertainty, b) unseasonal spikes in vegetables,

c) fiscal, and d) global – oil, geo-political tensions and market volatility.

Table: Snapshot of RBI's projections

Meeting	Inflation	Growth
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%
June'19	3.0-3.1% in 1HFY20; 3.4-3.7% in 2H	FY20: 7.0%; 1H - 6.4-6.7%; 2H - 7.2-7.5%
August'19	3.1% in 2Q FY20; 3.5-3.7% in 2H; 3.6% in Q1 FY21	FY20: 6.9% (1H - 5.8-6.6%; 2H - 7.3-7.5%); 1QFY21 in 7.4%

Source: RBI, DBS

Growth forecast was dialled down for a fourth consecutive rate review, with FY20 real GDP seen at 7.0%, with 1H at 5.8-6.6% and 2H at 7.3-7.5%. Into FY21, the first quarter is expected to see at 7.4%. We are in midst of reviewing our growth estimate at 6.8% for FY20 and expect downward revisions to the central bank's projections in the upcoming reviews. Outlook is cautious as they continue to see weak growth impulses and thereby a wide output gap.

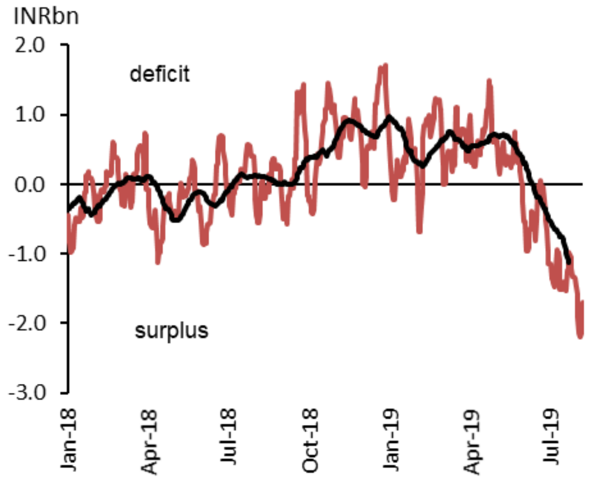
Policy outlook

The MPC's move to revise down growth projections and inflation expected to stay sub-target until mid-2020 reflect the central bank's dovish bias. Indian benchmark rate cuts have been frontloaded and fallen by the most (110bps) amongst Asian peers and hence the committee might prefer to be data-dependent going forward.

We see room for at least another 15-25bp cuts in rest of FY20 (with room for more), as growth assumptions are likely to be revised lower in subsequent rate reviews.

Prevailing liquidity conditions are already in surplus (of ~INR2trn) and have been maintained such, suggesting an unofficial shift in stance. Intuitively, surplus liquidity during a rate cutting cycle and vice versa during rate hikes helps with transmission. Plans to link lending rates to external benchmarks, in a bid to expedite the transmission process, remains deferred. In the interim, extent of transmission will rely on the respective banks' balance sheet strength, deposits size, and anticipated duration of the rate-cutting cycle. Transmission has been better in the bond markets though that arguably is less beneficial to stakeholders' vs banks' lending rates.

Banking system liquidity back in surplus



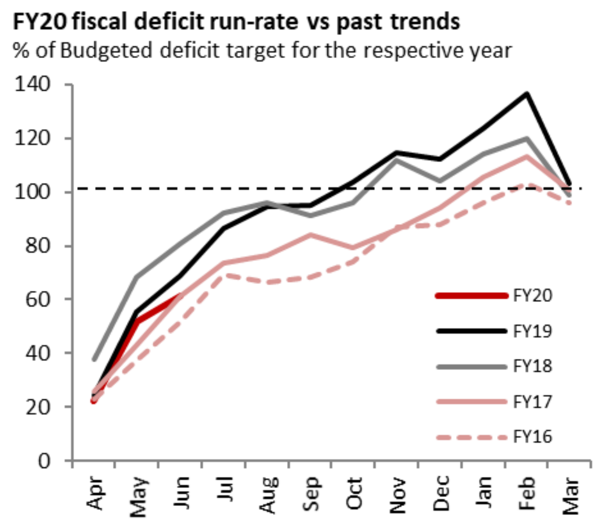
Source: Bloomberg, DBS

For the markets, as we noted here, reaction to global turmoil has been asymmetric between

INR bonds vs the Rupee. Our FX Strategist maintains his call for the INR to gradually weaken this year. In contrast, INR 10Y bond yields are likely to be stable, caught between a weak currency and a sharp decline in US yields.

Weak 1Q FY20 fiscal deficit tracks past trends

In this light, FY20 fiscal trends have come under the scanner. **The fiscal deficit target in 1Q FY20 (Apr-Jun19) totalled 61% of the budgeted estimate for the year**. While consistent with recent years' trend, this year's deterioration was not as troubling as FY18 and FY19 (see chart below). This might also be because elections held in 1Q this year slowed disbursements, helped to contain the extent of fiscal slippage at the margin.

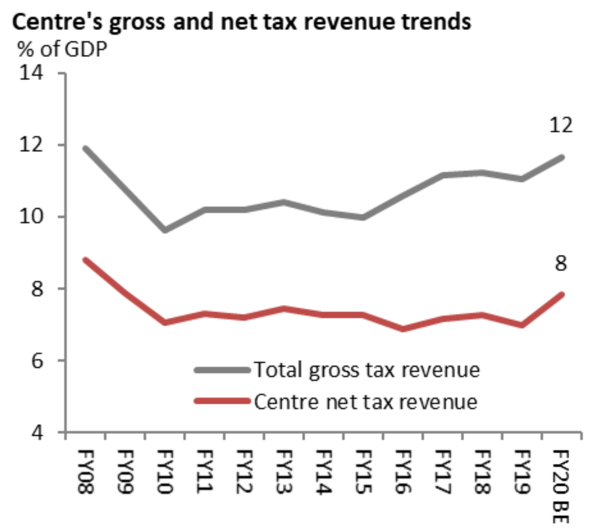


Source: CEIC, data transformations are by DBS Group Research

Routinely, the fiscal run-rate deteriorates in the first three quarters before moderating in the last quarter. Expenditure starts early, helped by an early passage of the annual Budget. Revenue flows are seasonal and kick in mostly in the final quarter, with any subsequent shortfall managed by curtailing expenditure.

Revenues are likely to be under scrutiny

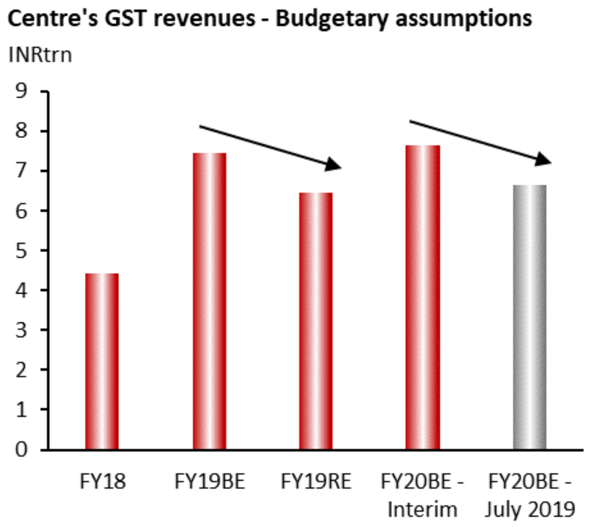
For the year, revenues are likely to come under scrutiny after last year's shortfall. The chart below shows that tax revenue assumptions as a percentage of GDP for FY20, are optimistic compared to recent years.



Source: CEIC, Press, DBS

While gross tax collections are off for a slow start in FY20, GST collections, divestment and dividends (cumulatively accounting for a third of total receipts) are under scrutiny to bridge the fiscal gap.

July 2019 marked the second anniversary of the Goods and Services Tax rolled out in 2017. Encouragingly, July's Budget dialled down GST assumptions for the centre at INR6.6trn (3.1% of GDP) for FY20 vs INR7.6trn in February's interim and actual receipts of sub-INR6trn in FY19.



Source: Budget documents, DBS

While the implementation of a common tax regime pre-assumes tax buoyancy and revenue neutrality, these are still to play out with the current GST system. Considering its enormity and complexity, the rollout was commendable, but the mechanism is still being fine-tuned. In addition, the number of items in the highest 28% and 18% slabs are lower this year compared to last year, hurting collections.

So far this FY, monthly receipts have fallen short of the required run rate of INR1.1trn. June's INR999bn was lower than the average INR1trn in April-May. With FY20 collections soft, the revised GST projections (centre and state at ~INR13.7trn) appear optimistic.

The FY20 divestment target has been pegged at a record high of INR1.05trn (0.5% of GDP) vs FY19's INR850bn. In the past two years, actual collections have surpassed estimates, and even exceeded INR1trn one year. Bulk of these receipts included M&A deals within state owned companies (e.g. ONGC buying a stake in HPCL in FY18 etc.) and two exchange traded funds – Bharat 22 and CPSE-ETFs. Elsewhere, a few strategic sales have attracted mixed responses.

For this year, the authorities are likely to consider a mix of strategic sales and sale of non-core assets of public sector companies, including land parcels, telecom towers etc. Other avenues to raise funds include reducing the centre's stake in companies below the crucial 51% mark as well as line-up the initial public offerings of selected companies, including Goa Shipyard, Mazagon Dock Shipbuilders, amongst others. In the interim, ETFs have proven to be a good avenue to rake in early proceeds; a recent tranche of CPSE ETF was oversubscribed and expected to bring in INR100bn (~9.5% of budgeted target). A few big-ticket assets have also been lined-up, with its success crucial to achieving this year's target.

Dividend payouts, particularly from the RBI, is a matter of keen interest. Of the cumulative INR1.1trn (0.5% of GDP) expected from the RBI, state run banks and financial institutions, INR900bn is due as the central bank's dividends. Add to this, windfall gains from a one-off transfer of RBI's surplus is also awaited. Ex-RBI Governor Bimal Jalan-led committee has been tasked with a decision in this regard.

The central bank typically announces the first tranche of dividends after its books close in June-July, with an interim budget in the March quarter the subsequent year.

In all, reliance on these sources of revenues has risen this year. A shortfall akin to FY19 will need spending cuts later in the year to meet the budget deficit of -3.3% of GDP.

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