Spike in inflation keeps RBI on pause; accommodative stance retained

The RBI's Monetary Policy Committee (MPC) expectedly decided to keep the policy rates unchanged in the wake of recent spike in headline inflation and uncertain future trajectory. An 'accommodative' stance has been retained, however, keeping the window open for further monetary easing, as economic growth remains weak, even as the recent measures announced by the Government, particularly related to rationalisation of personal tax rates and higher rural and infrastructure spending, bodes well for domestic demand. While the MPC expects vegetable inflation to normalise, the recent build-up in prices for non-vegetable food items is likely to sustain, thereby imparting upward bias to overall food prices. As such, the RBI has significantly increased its inflation forecasts to an avg. of 5% for 2020. Besides status quo on rates, the RBI also announced a slew of measures to improve credit flows to certain sectors (auto, housing, MSMEs), reinforce monetary transmission by introducing Rs 1trn LTRO (Long-term Repo Operations) for one- and three-year tenors, and strengthen regulation.

Inflation is expected to remain above the RBI's 4% target for good part of this year, falling to sub-4% only in Q3FY21, supported by a high base. Further, growth is expected to recover, albeit modestly, on the back of a recovery in rural demand, easing global uncertainty, further improvement in monetary transmission and pro-growth measures announced in the Budget. Having said that, clear signs of a broad-based recovery are missing at this juncture. With the MPC acknowledging that with an accommodative stance, we see monetary easing resuming in the latter part of this year and expect another 25-50bps cut in the current cycle, *ceteris paribus*.

- **MPC unanimously decides to take a pause but remains accommodative for as long as necessary**: The RBI's Monetary Policy Committee (MPC) maintained status quo on policy rates in its sixth bi-monthly monetary policy review of the fiscal, citing a sharp surge in headline inflation over the last few months and an uncertain trajectory ahead. Further, while some high-frequency indicators have turned positive recently, the MPC awaits more data to ascertain its sustainability. As such, the repo, reverse repo and bank/Marginal Standing Facility (MSF) rates remain unchanged at 5.15%, 4.9% and 5.4% respectively. The MPC, however, decided to retain the 'accommodative' stance for as long as necessary, acknowledging the availability of space for future action.

- **Inflation trajectory remains uncertain**: The inflation trajectory in H1FY20 fared broadly in-line with the RBI's projections. However, a sharp surge in onion prices owing to unseasonal rains in Oct-Nov'19 led to a spike in headline inflation to 5.8% in Q3FY20 vs. RBI's projection of 5.1%. While the MPC expects onion prices to fall as fresh arrivals from late *Kharif* and *Rabi* harvests hit the market, increase in non-vegetable food items, particularly pulses and milk, may sustain in the near-term. Moreover, adjustment to telecom tariff hikes, increase in prices of drugs and pharmaceuticals, impact of new emission norms and increase in custom duties on final consumption goods are likely to impart upward bias to core inflation trajectory, even as weak demand conditions may limit the impact.

  On the positive side, the recent correction in crude oil prices bodes well for headline inflation. The MPC has increased its inflation forecasts from 5.1-4.7% for H2FY20 projected in December to 6.5% for Q4FY20. For H1FY21, the headline inflation estimate has been revised upwards from 3.8-4.0% to 5.0-5.4%, with the MPC expecting it to fall to 3.2% in Q3FY21 on a low base. Key downside risks to inflation outlook includes a sustained rise in food inflation, volatile crude oil prices and financial market volatility.

- **GDP growth expected to recover modestly in FY21 to 6.0%**: The MPC expects growth to recover modestly to 6.0% in FY21 from 5% in FY20. This is likely to be led by a) an improvement in rural demand in the wake of improved *Rabi* prospects and better terms of trade following the recent spike in food prices, b) recovery in exports, supported by easing global uncertainties, partly offset by the breakout of Coronavirus, c) continued monetary transmission in the credit market and d) rationalisation of personal income tax rates and a pick-up in rural and infrastructure spending in the Union Budget, thereby supporting consumption demand.

  Having said that, the MPC acknowledged that the output gap remains negative, and while several high frequency indicators have registered an improvement in the recent months, signs of a broad-based recovery are missing at this juncture.

- **Transmission improving in the credit market:** Monetary transmission has further improved over last month in money market as well as corporate bond market. While the overnight call money rate and 3-month CP rates for NBFCs have come off by 146bps and 190bps respectively as against 135bps cut in the policy rates since February 2019, 5-year and 10-year G-sec yields have fallen by 73bps and 75bps respectively. Transmission in the credit market (bank lending rates) has also improved. The weighted average lending rate (WALR) on fresh rupee loans has declined by 69bps during February-December 2019, while WALR on outstanding rupee loans has fallen by 13bps.
- **Development and regulatory policies announced:** The statement also included several developmental/ regulatory measures for improving credit flows to certain sectors, reinforcing monetary transmission, strengthening regulation and supervision, broadening and deepening financial markets and improving the payment and settlement systems. Some of the key announcements are as follows:
  - **Reinforced liquidity management:** The RBI has decided to withdraw of a one-sided target of liquidity provision of 1% of net demand and time liabilities (NDTL). Adequate liquidity will now be provided to banks as per market conditions without any ceiling.
  - **Improvement in monetary transmission:** The RBI has also announced introduction of Long-term Repo Operations (LTRO) facility comprising of 1-year and 3-year term repos up to a total amount of Rs 1trn at the policy repo rate. This will provide slightly long-term liquidity to the banking system at policy rate, thereby bringing down their cost of funds and consequently improving monetary transmission.
  - **Easier credit flow to specific sectors:** a) Banks are exempted from maintaining CRR against incremental credit to auto, residential housing and MSMEs up to the fortnight ending July 31st, 2020, thereby providing credit boost to these sectors, b) Loans to medium enterprises by SCBs linked to an external benchmark effective April 1st, 2020, c) One-time restructuring of GST-registered MSMEs that were in default as on January 1, 2020 extended to December 2020 from March 2020, d) Date of commencement of commercial operations (DCCO) of project loans for commercial real estate extended by another one year without downgrading the asset classification. This would provide a much-needed relief to real estate financing companies, e) Regional Rural Banks (RRBs) allowed to act as merchant acquiring banks, using Aadhaar Pay and POS terminals.
  - **Financial market development:** a) All rupee interest rate derivative transactions of market makers and their related entities globally shall be accounted for in India, thereby encouraging higher non-resident participation as well as improve transparency and regulatory oversight, b) Constituent details would be included in the Constituent Subsidiary Ledger (CGSL) accounts of the G-sec registry to improve retail participation, and c) Directions regarding exchange of initial margin for NCCDs will be issued by June 2020.
- **Space for further monetary easing remains open:** We expect the RBI to remain on pause in the near-term as headline inflation is expected to remain north of the RBI's 4% target for good part of this year, thanks to elevated non-vegetable inflation and some pick-up in core inflation owing to higher telecom tariffs and negative impact of emission norms. However, we don't see this as a reflection of a meaningful improvement in domestic demand. With an impending recovery expected to be shallow and gradual, room for further monetary easing would open once inflation trajectory turns comfortable. We expect another 25-50bps cut in policy rates in the current easing cycle, *ceteris paribus.*

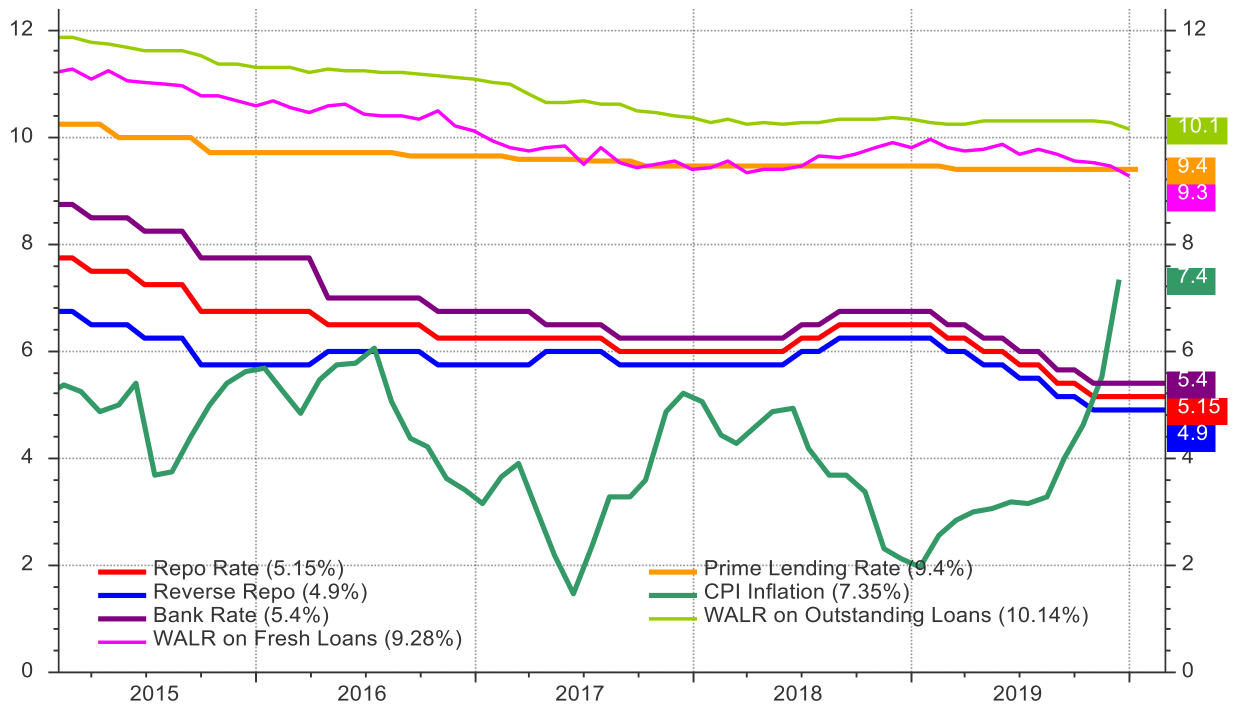
Figure 1: Current policy rates

Key rates	Current value
Repo Rate	5.15%
Reverse Repo Rate	4.9%
Marginal Standing Facility (MSF) Rate	5.4%
Bank Rate	5.4%
Cash Reserve Ratio (CRR)	4%
Statutory Liquidity Ratio (SLR)	18.5%

Source: RBI

Figure 2: Policy rates kept unchanged; cumulative easing stands at 135bps since the start of 2019

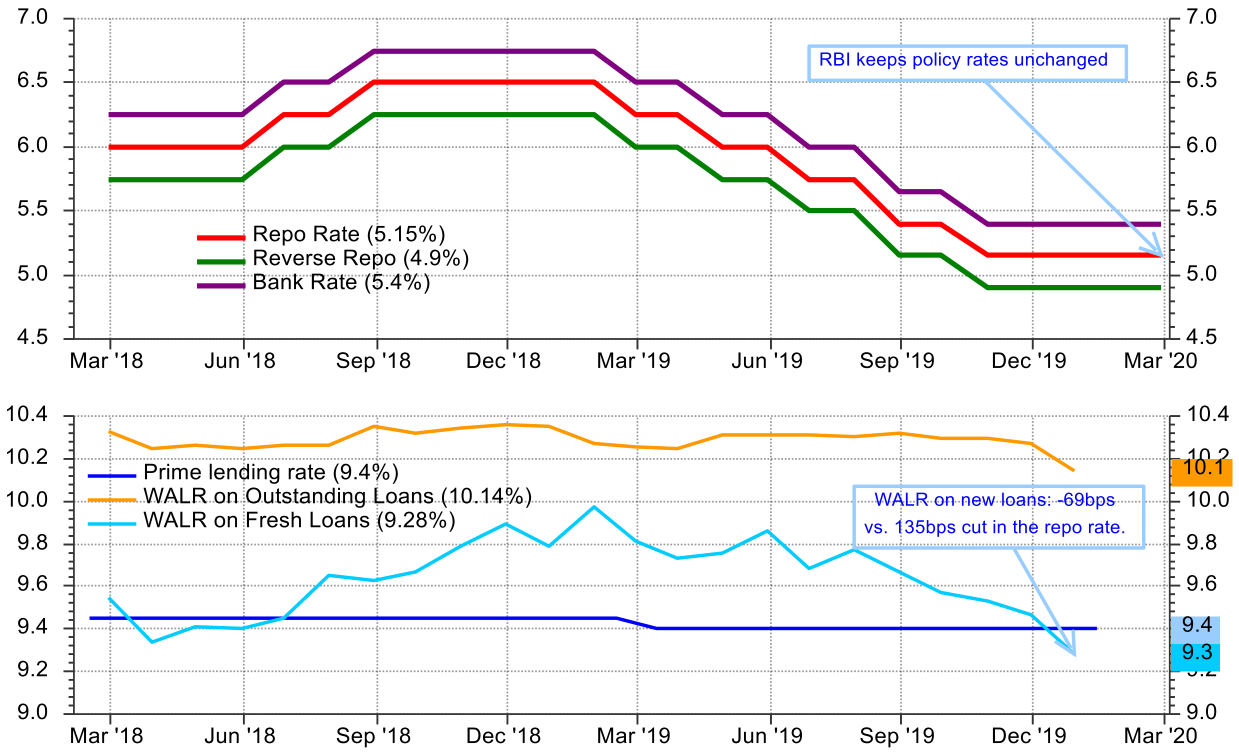
India policy rate, inflation, lending rate (%)



Source: RBI, Refinitiv Datastream, NSE. WALR: Weighted Average Lending Rate

Figure 3: Monetary transmission has improved in the credit market: 'New loan' WALR -69bps, 'Old loan' WALR -13bps vs. policy cuts of 135bps during February-December 2019

Policy rate and lending rates (%)



Source: RBI, Refinitiv Datastream, NSE. WALR: Weighted Average Lending Rate

Figure 4: A snapshot of monetary policy statements in FY20 thus far

	April 2019	June 2019	August 2019	October 2019	December 2019	February 2020
Global growth	Global activity remains soft. Bond yields in Germany/ Japan feel further into the negative zone, with central banks signalling softer stances.	Global economic activity has been losing pace after a marginal improvement in Q12019, reflecting further slowdown in trade and mfg. activity.	Global economic activity has slowed down further amidst elevated trade tensions and geo-political uncertainty. Bond yields have declined sharply.	Trade/geo-political tensions continue to weigh on global growth. Central banks became more accommodative with inflation remaining below targets across major DMs/ EMs	Global activity has remained subdued, though some signs of resilience are becoming visible. Trade concerns have abated.	Global economic activity has remained slow-paced but is getting differentiated across geographies. US-China trade relations have improved
Domestic growth	Growth fell for 3rd quarter in a row in Q3FY19. Output gap remains negative, with the economy facing headwinds, especially on the global front. FY20 GDP forecast cut from 7.4% to 7.2%.	Growth impulses have weakened, with a sharp slowdown in investment and consumption demand. FY20 GDP est. cut from 7.2% to 7.0%.	Growth outlook remains bleak, with both consumption and investment activity remaining weak, even as lower input costs augurs well for growth. FY20 GDP est. cut from 7.0% to 6.9%.	High-frequency indicators point to continued weakening of manufacturing and services sector activity. FY20 GDP growth forecast slashed from 6.9% to 6.1%.	Economic activity has weakened further, and output gap remains negative. FY20 GDP growth forecast cut sharply from 6.1% to 5%.	Economy continues to be weak and the output gap remains negative. Some high-frequency indicators have turned around, but their sustainability is uncertain.
Inflation	Lower-than-expected core inflation imparting downward bias to headline inflation. An increase in crude oil prices since the last policy is a risk. CPI inflation est. revised downwards to 2.4% in Q4FY19, 2.9-3.0% in H1FY20 and 3.5-3.8% in H2.	Inflation remains below the target even after accounting for the expected transmission of the past two rate cuts. CPI inflation estimate revised to 3.0-3.1% in H1FY20 (2.9-3.0% earlier) and 3.4-3.7% in H2 (3.5-3.8% earlier).	Inflation has evolved in-line with RBI's projected trajectory and is expected to remain within the target over a 12-month ahead horizon. Headline inflation estimated at 3.1% for Q2FY20 and 3.5-3.7% for H2FY20.	Inflation trajectory remains benign; to remain within 4% target over next 12 months. Q2FY20 forecast raised from 3.1% to 3.4% amid near-term pressures from crude and vegetable prices. H2FY20 forecast retained at 3.5-3.7%.	CPI inflation surged in Oct on higher food inflation. Expected to remain elevated in the near-term. H2FY20 inflation forecast raised from 3.5-3.7% to 4.7-5.1%.	Inflation overshot RBI's target by 70bps in Q2 and surged further on higher onion prices. Expected to remain elevated in the near-term. Avg. inflation in 2020 expected at 5%.
Liquidity	Liquidity turned into deficit in Feb-Mar due to build-up of govt. cash balances. Liquidity needs were met through OMO purchases. WACR remained broadly aligned with the policy repo rate.	Liquidity turned into surplus in early June after remaining in deficit during April and May due to restrained govt. spending. WACR traded 6bps above the repo in April and 6bps lower in May.	Liquidity was in huge surplus in Jun/July due to return of currency to banking system, drawdown of excess CRR, OMO buying/fx operations by RBI. WACR traded 14bps lower than repo in July.	Liquidity remained surplus in Aug/Sep despite an expansion of CIC and forex operations by RBI. WACR traded below the repo rate by an avg. of 8bps in August and 6bps in Sep.	Liquidity remained in surplus despite festival-led demand. WACR traded below the repo rate by an avg. 8bps in Oct and 10bps in Nov.	Liquidity remained in huge surplus in Jan. WACR traded below the repo rate by an avg. 10bps in Dec and 19bps in Jan.

Transmission		Transmission of cumulative cuts of 50bps in Feb/April 2019 was 21 bps to the weighted average lending rate (WALR) on fresh rupee loans.	Transmission has improved marginally with WALR on fresh rupee loans falling by 29 bps during the current easing phase so far (February-June 2019)	Transmission has remained staggered and incomplete. WALR on new loans has come down 29bps during Feb-Aug 2019 vs. policy cut of 110bps.	Transmission has been swift in money markets but weak in credit market. 'New loans' WALR has fallen by 44bps vs. 135bps cut in policy rates.	Transmission has been very swift in money & corp. bond markets and has picked up in credit market as well. 'New loans' WALR has fallen by 69bps and on old loans has fallen by 13bps during Feb-Dec'19
Rate action	-25bps. Repo: 6.0%; Reverse Repo: 5.75%	-25bps. Repo: 5.75%; Reverse Repo: 5.5%	-35bps. Repo: 5.4%; Reverse Repo: 5.15%	-25bps. Repo: 5.15%; Reverse Repo: 4.9%	No change. Repo: 5.15%; Reverse Repo: 4.9%	No change. Repo: 5.15%; Reverse Repo: 4.9%
Stance	Neutral	Accommodative	Accommodative	Accommodative	Accommodative	Accommodative

Source: RBI, NSE

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