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Status quo now doesn't preclude future cuts

Contrary to expectations of a 25bps cut, the RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy rates unchanged as it awaited clarity on the impact of fiscal/monetary measures taken thus far on the economy, evolution of the inflation trajectory and forthcoming Union Budget. An 'accommodative' stance has been retained, however, keeping the window open for further monetary easing, as the output gap has widened further—reflected in a sharp cut in FY20 GDP growth forecasts—fifth time in a row—to 5% from 6.1%/6.9% in Oct/Aug 2019). A sharp food-led spike in headline inflation over the last couple of months and consequent rise in inflationary expectations also precluded the MPC from cutting rates at this juncture, with the MPC expecting inflation to remain well above the 4% target in the near-term. The statement also included several developmental/regulatory measures for strengthening regulation and supervision, broadening and deepening financial markets and improving the payment and settlement systems.

Barring near-term concerns, the MPC expects inflation to fall back to sub-4% by Q1FY21. This, along with a sustained weakness in domestic economic activity, is likely to pave way for further monetary easing, even as the timing remains uncertain. Transmission to money markets and shorter-end of the corporate bond segment has been quite swift but not so much into the credit market; the introduction of an external benchmark system is expected to expedite the process. We see today's pause as temporary in nature and expect another 25-50 bps easing 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 fifth bi-monthly monetary policy review of the fiscal, citing near-term concerns on the inflation trajectory. It also awaits clarity on the impact of fiscal and monetary measures taken thus far, evolving food inflation dynamics and its second-order impact and the outcome of the forthcoming Union Budget before cutting rates further. 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 emerges as a near-term concern**: The inflation trajectory in the first half of the fiscal fared broadly in-line with the RBI's projections. However, the recent spike in the headline inflation, thanks to an upsurge in food inflation (led by vegetables), has been higher than expected, translating into a sharp rise in inflationary expectations. The MPC expects food inflation to remain elevated over the next few months, leading to an increase in the forecasts for headline inflation from 3.5-3.7% for H2FY20 to 4.7-5.1% now. However, the MPC expects food inflation to cool-off in Q1FY21 as supply improves, pegging the headline inflation at 3.8-4.0% for H1FY21. Core inflation, on the other hand, is expected to remain sub-4% amid weak domestic demand conditions. Key downside risks to inflation outlook includes a sustained rise in food inflation, volatile crude oil prices and financial market volatility.

- **GDP growth projection sees sharp downward revision for yet another time**: Following a significantly lower-than-projected growth in Q2FY20, the MPC further reduced its GDP growth forecast for FY20–the fifth time in a row, and yet again at a very steep pace—expecting it at 5.0% vs. 6.1% earlier (7.0%/7.2%/6.9% in the June/April/August policy)—4.9-5.5% in H2FY20 (6.6-7.2% earlier) and 5.9-6.3% in H1FY21.

  The third quarter has also started on a weak note as also witnessed from several high frequency indicators such as auto sales (domestic passenger car sales register negative growth for the 12th consecutive month), monthly trade performance (decline in import bill in October steepest in 39 months), and industrial growth (eight-core infrastructure sector contracted at the steepest pace in the new series), suggesting continued weakness in domestic and external demand conditions. On the positive side, the MPC expects monetary and fiscal measures taken thus far to slowly revive sentiments and spur demand in the economy.

- **Transmission swift in money markets, not so much in the credit market:** Monetary transmission has improved over last month, particularly in money markets and shorter-end of the corporate bond segment. The overnight call money rate and 3-month CP rates for NBFCs have come off by 137bps and 218bps as against 135bps cut in the policy rates in the fiscal thus far. However, transmission in the credit market (bank lending rates) has remained muted. The weighted average lending rate (WALR) on fresh rupee loans has declined by 44bps since February, while WALR on outstanding rupee loans has increased by 2bps. However, transmission is expected to gather pace over the next few months, supported by the recent introduction of the external benchmark system (banks mandated to link their lending rates to an external benchmark).

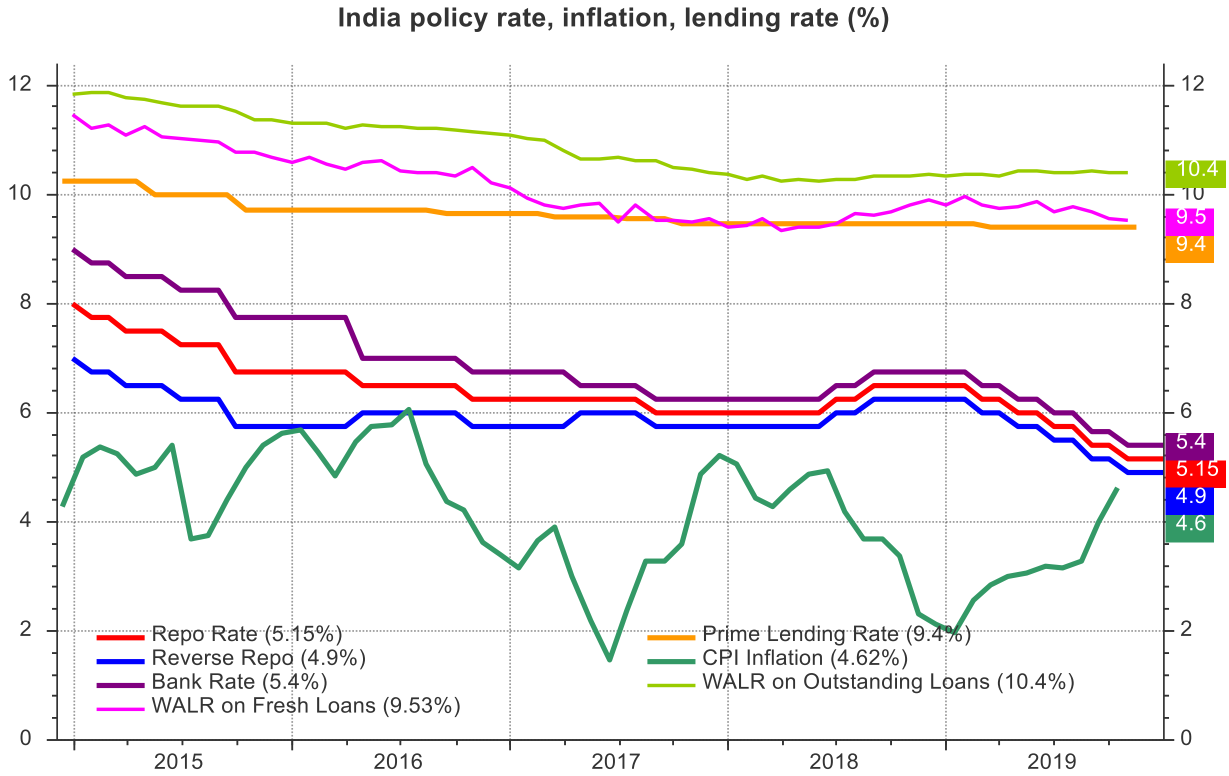
- **Monetary easing to resume following a temporary pause:** We see today's pause as temporary in nature. The sharp cut in growth forecasts by the MPC acknowledges the seriousness of current economic slowdown, with an impending recovery expected to be shallow and gradual. Further, inflation is expected to fall again in Q1FY21 following an expected temporary spike over the next few months, partly supported by a favourable base. This is likely to keep the room open for further monetary easing; we expect another 25-50bps cut in policy rates in the current easing cycle, *ceteris paribus.*

Figure 1: Current policy rates

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

Source: RBI

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



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

Figure 3: Transmission has been swift in the short-tenor corporate segment over last one month…

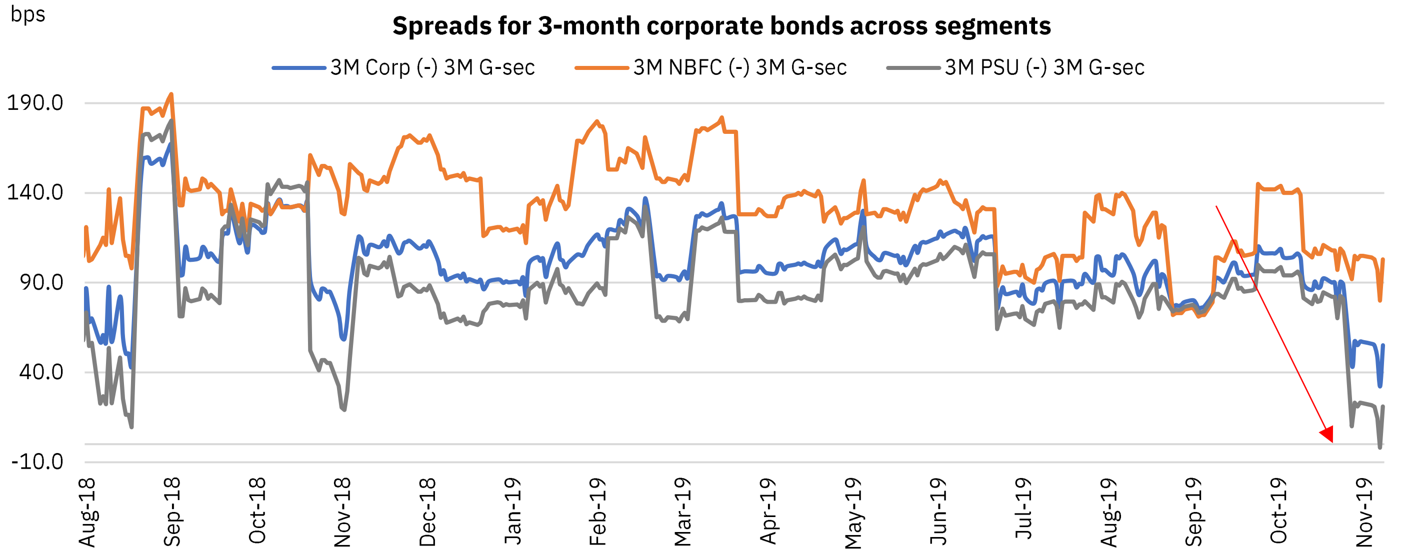
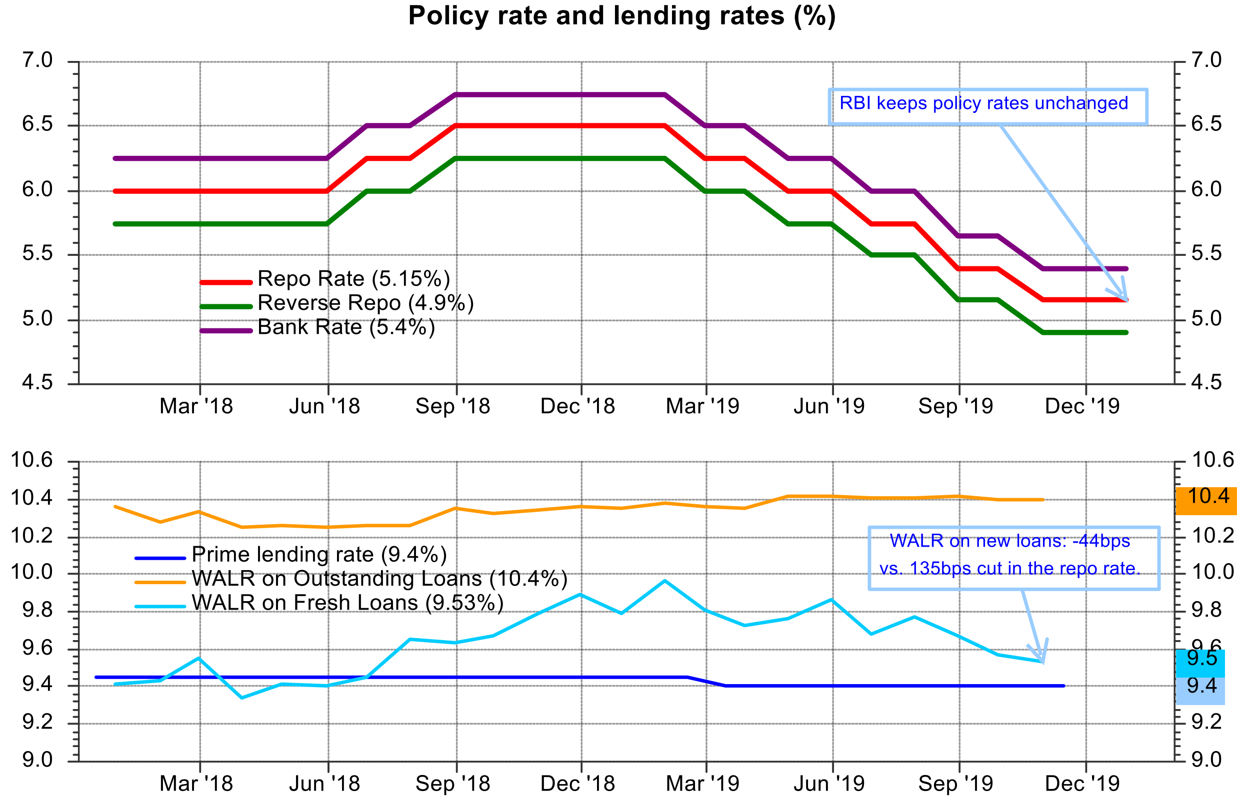
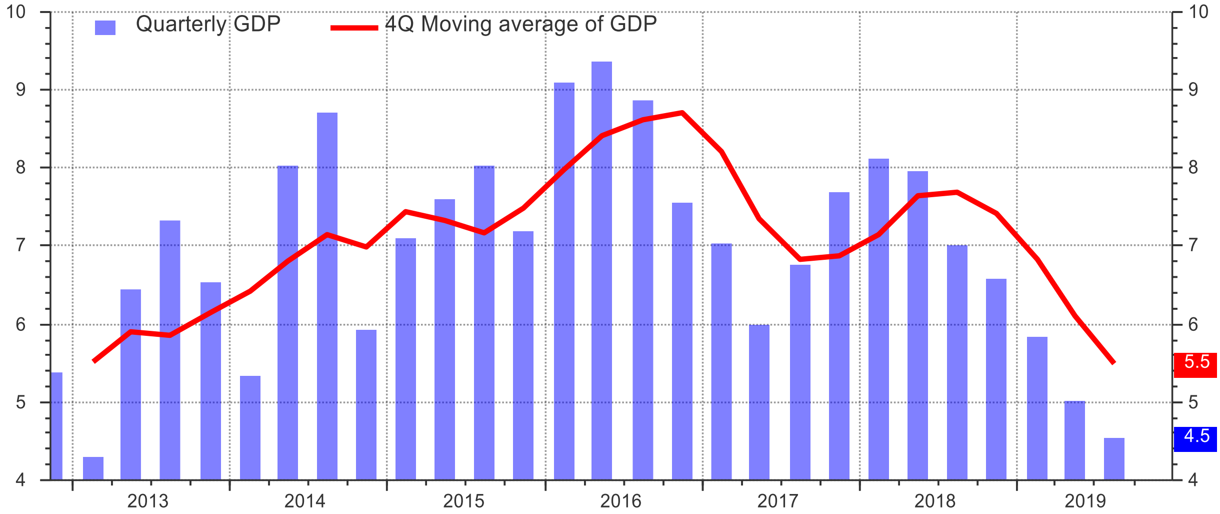


Figure 4: …but has remained weak in the credit market: 'New loan' WALR -44bps, 'Old loan' WALR +2bps vs. policy cuts of 135bps in 2019 thus far



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

Figure 5: Q2FY20 GDP growth fell to six-and-a-half year lows



Source: RBI, Refinitiv Datastream, NSE

Figure 6: A snapshot of monetary policy statements in FY20 thus far

	April 2019	**June 2019**	**August 2019**	**October 2019**	**December 2019**
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.
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%.
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%.
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.
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.
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%
Stance	Neutral	Accommodative	Accommodative	Accommodative	Accommodative

Source: RBI, NSE

Decoding the Developmental and Regulatory Policies

Sr. No	Policy	What does it mean?	Implications
Regulation and Supervision			
1	Exposure limits and priority sector lending norms for Primary (Urban) Cooperative Banks	Amendment of certain regulatory guidelines relating to Urban Cooperative Banks (UCBs), primarily relating to exposure norms for single and group/interconnected borrowers, promotion of financial inclusion, priority sector lending, etc. A draft circular to be issued shortly.	Will help in reducing concentration risk in the exposures of UCBs and strengthen their role in promoting financial inclusion.
2.	Reporting to Central Repository of Information on Large Credits (CRILC) for UBCs	UCBs with assets of Rs 50bn and above shall be brought under the CRILC framework with a view to build a similar database of large credits extended by UCBs. Detailed instructions will be issued by December 31, 2019.	Will help in strengthening offsite supervision and early recognition of financial distress in UBCs.
3.	Comprehensive Cyber Security Framework for UCBs	A comprehensive cyber security framework prescribed for UCBs, as a graded approach, making it mandatory for UCBs to implement progressively stronger security measures based on the nature, variety and scale of digital offerings. Detailed guidelines to be issued by December 31, 2019	Will help in bolstering cyber security preparedness, making them better equipped to address cyber security threats
4.	Creation of a Self-regulatory Body (SRB) for secondary bond markets	A self-regulatory body would be set up to develop secondary bond markets, with responsibilities, *inter-alia*, including standardising documents, covenants and practices related in secondary market transactions.	Will help in promoting the growth of secondary market for corporate loans.
5.	International Financial Service Centre Banking Unit (IBU)	IBUs will be allowed to open foreign currency current accounts of their corporate borrowers and accept fixed deposits in foreign currency in tenor less than one-year from non-bank entities.	Will facilitate ease of operations of IBUs.
7.	Review of NBFC-P2P directions	The aggregate exposure limit of a lender to all borrowers at any point of time, across all P2P platforms, increased to Rs 5mn vs. Rs 1mn earlier. The current requirement of operating escrow accounts by bank-promoted trustee for transfer of funds has been done away with.	Will provide next push to the P2P lending platforms and help provide more operational flexibility.
	Baseline Cyber Security Controls for ATM Switch application service providers	RBI-regulated entities will be mandated to include certain baseline cyber security controls in their contractual agreements with ATM Switch application service providers. Detailed guidelines to be issued by December 31, 2019.	Will strengthen the ecosystem and reduce vulnerability to cyber threats.
Financial markets			
2.	Final guidelines on hedging of foreign exchange risk by residents and non-residents	Important changes include: 1) Users allowed to undertake OTC currency derivative transactions upto US$10m without underlying exposure, 2) Banks allowed some discretion to pass on gains on hedging transactions, 3) Strengthening safeguards.	Will facilitate ease of hedging of foreign exchange risk and effective risk management.
3.	New Pre-Paid Payment Instruments (PPI)	A new type of PPI introduced for purchase of goods and services up to a limit of Rs 10,000, limited to making only digital payments. Detailed instructions to be issued by December 31, 2019.	Will help in further promoting digital payments.

Source: RBI, NSE

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