RBI's Second Bi-Monthly Monetary Policy Review (2019-20)

06 June 2019

Interest rates cut by 25 bps. Stance — 'Accommodative'

MPC cuts Repo Rate by 25 bps to 5.75%.

MPC chances stance from 'Neutral' at 'Accommodative'.

- MPC cuts Repo Rate by 25 bps to 5.75%.
- The reverse repo rate has also been cut by 25 bps to 5.50%.
- The rate for Marginal Standing Facility has been cut by 25 bps and stands at 6%.
- MPC chances stance from 'Neutral' at 'Accommodative'.
- MPC votes 6-0 to cut repo rate.
- MPC voted 6-0 to keep stance at 'Neutral'.
- CRR has remained unchanged at 4%.
- RBI has revised estimates for GDP growth for 2019-20 from 7.2% in April to 7%. The range would be 6.4% - 6.7% in H1:2019-20 & 7.2%-7.5% in H2:2019-20.
- A sharp slowdown in investment activity along with a continuing moderation in private consumption growth is a matter of concern.
- CPI inflation seen at 3-3.1 percent in H1 FY20; 3.4-3.7 percent in H2 FY20
- RBI to set up working group to review liquidity management framework
- RBI allows on-tap licensing of small finance banks
- RBI sets minimum leverage ratio at 4 percent for systemically important banks; 3.5 percent for all other banks.
- RBI would conduct an OMO purchase auction worth INR15000 Cr on June 13, 2019.

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India's GDP Story

Growth in manufacturing activity weakened sharply to 3.1% YoY from 6.4% YoY in the previous quarter.

The drag on aggregate demand from net exports increased in Q4 due to a sharper deceleration in exports relative to imports.

In the April policy, GDP growth for FY2019-20 was projected at 7.2% YoY – in the range of 6.8-7.1% YoY for H1 and 7.3-7.4% YoY for H2.

GDP - India's GDP growth for FY2018-19 has been estimated at 6.8% YoY, along with a sharp deceleration in Q4 GDP number to 5.8% YoY from 6.6% YoY in Q3 and 8.1% YoY in Q4 of FY2017-18. Gross fixed capital formation (GFCF) growth declined sharply to 3.6% YoY, after remaining in double digits in the previous five quarters. Private consumption growth also moderated. The drag on aggregate demand from net exports increased in Q4 due to a sharper deceleration in exports relative to imports. However, the overall slowdown in growth was cushioned by a large increase in government final consumption expenditure (GFCE).

On the supply side, agriculture and allied activities contracted, albeit marginally, in Q4 of FY2018- 19 due to a decline in rabi production. Growth in manufacturing activity weakened sharply to 3.1% YoY from 6.4% YoY in the previous quarter. Service sector growth, however, accelerated, supported by financial, real estate and professional services, and public administration, defence and other services.

High frequency indicators suggest moderation in activity in the service sector. Sales of commercial vehicles, tractors, passenger cars, and three and two wheelers contracted in April. Railway freight traffic growth decelerated. Domestic air passenger traffic growth contracted in March, but turned around modestly in April. Two key indicators of construction activity, viz., cement production and steel consumption, slowed down in April. The PMI services index moderated to 50.2 in May on subdued growth of new businesses.

Outlook: In the April policy, GDP growth for FY2019-20 was projected at 7.2% YoY – in the range of 6.8-7.1% YoY for H1 and 7.3-7.4% YoY for H2. According to the MPC, data for Q4 of FY2018-19 indicate that domestic investment activity has weakened and overall demand has been weighed down partly by slowing exports. Weak global demand due to escalation in trade wars may further impact India's exports and investment activity. Further, private consumption, especially in rural areas, has weakened in recent months. However, on the positive side, political stability, high capacity utilisation, the uptick in business expectations in Q2, buoyant stock market conditions and higher financial flows to the commercial sector augur well for investment activity. Taking into consideration the above factors and the impact of recent policy rate cuts, GDP growth for 2019 -20 is revised downwards by the MPC from 7.2% YoY in the April policy to 7.0% YoY – in the range of 6.4-6.7% YoY for H1 of FY2019-20 and 7.2-7.5% YoY for H2.

Inflation update

India's CPI inflation remained unchanged in April, at its March level of 2.9% YoY, with higher inflation in food and fuel groups being offset by lower inflation in items excluding food and fuel. The April food inflation print showed an increase to 1.4% YoY from 0.7% YoY in March. Within the food group, vegetables moved out of nine months of deflation. However, three sub-groups, viz., fruits, pulses and sugar, remained in deflation in April, though the extent of deflation moderated. Inflation in the fuel and light group rose to 2.6% YoY in April from the February trough of 1.2% YoY, pulled up by prices of liquified petroleum gas due to an increase in international prices. Inflation in subsidised kerosene also rose, reflecting the impact of the calibrated increase in its administered price. Electricity prices moved out of three months of deflation in April. CPI inflation excluding food and fuel fell sharply to 4.5% YoY in April from 5.1% YoY in March – the largest monthly decline since April 2017. The moderation in inflation was broad-based, with household goods and services, and personal care and effects sub-groups registering the largest fall in April.

Inflation expectations of households in the May 2019 round of Reserve Bank's survey declined by 20 basis points for the three-month ahead horizon compared with the previous round, but remained unchanged for the one-year ahead horizon. However, manufacturing firms participating in the Reserve Bank's industrial outlook survey expect input cost pressures to intensify on account of higher raw material costs and salaries in Q2. Input price pressures eased in both agricultural and industrial raw materials. Nominal growth in rural wages and in organised sector staff costs remained muted.

Outlook: In the bi-monthly monetary policy of April 2019, CPI inflation was projected at 2.4% YoY for Q4 of FY2018-19, 2.9-3.0% YoY for H1 of FY2019-20 and 3.5-3.8% YoY for H2 of FY2019-20. The headline inflation outcome in Q4 at 2.5% YoY was largely in alignment with the April policy projections. According to the MPC, the baseline inflation trajectory for FY2019-20 is shaped by several factors. First, the summer pick-up in vegetable prices has been sharper than expected, though this may be accompanied by a correspondingly larger reversal during autumn and winter. More recent information also suggests a broad-based pick-up in prices in several food items. This has imparted an upward bias to the nearterm trajectory of food inflation. Second, a significant weakening of domestic and external demand conditions appear to have led to a sharp broad-based decline of 60 bps in inflation excluding food and fuel in April; this has imparted a downward bias to the inflation trajectory for the rest of the year. Third, crude prices have continued to be volatile. However, its impact on CPI inflation has been muted so far due to incomplete pass-through. Fourth, near-term inflation expectations of households have continued to moderate. Taking into consideration these factors, the impact of recent policy rate cuts and expectations of a normal monsoon in 2019, the path of CPI inflation is revised by the MPC to 3.0-3.1% YoY for H1 of FY2019-20 and to 3.4-3.7% YoY for H2 of FY2019-20.

Key Notes from Monetary Policy

- Liquidity in the system turned into an average daily surplus of INR66,000 Cr in early June after remaining in deficit during April and most of May due to restrained government spending. RBI injected liquidity of INR70,000 Cr in April and INR33,400 Cr in May on a daily net average basis under the LAF. It conducted two OMO purchase auctions in May amounting to INR25,000 Cr and a US dollar buy/sell swap auction of US$5 billion for a tenor of 3 years in April to inject durable liquidity into the system.

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- Growth in eight core industries decelerated sharply in April, pulled down largely by coal, crude oil, fertilisers and cement. Credit flows from banks to large industries strengthened, though they remained muted for micro, small and medium industries. Based on early results of the Reserve Bank's order books, inventory and capacity utilisation survey (OBICUS), capacity utilisation (CU) in the manufacturing sector improved to 77% in Q4 from 75.9% in Q3; seasonally adjusted CU, however, slipped marginally to 75.2% in Q4 from 75.8% in Q3.

- India Meteorological Department (IMD) has predicted that south-west monsoon rainfall (June to September) is likely to be normal at 96 per cent of the long period average (LPA). The current weak El Niño conditions over the Pacific are likely to continue during the monsoon. However, currently prevailing neutral Indian Ocean Dipole (IOD) conditions may turn positive in the middle of the monsoon season and persist thereafter, which augur well for the rainfall outlook.

- Financial markets have been driven by uncertainties surrounding US-China trade negotiations and Brexit. In the US, the equity market has experienced some selling pressures since early May on escalation of trade tensions with China and recently, with Mexico. Equity markets in most EMEs have lost steam due to the waning risk appetite on rising geo-political uncertainties and weakening global trade prospects. Bond yields in the US picked up in April on better GDP data for Q1, but declined in May on subdued economic data and expectations of a dovish monetary policy stance.

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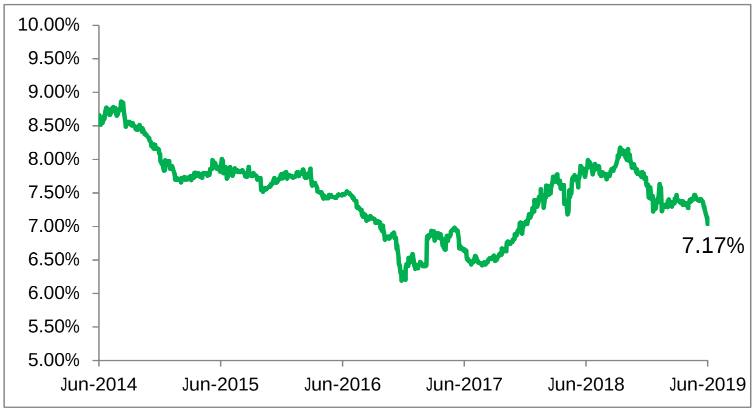
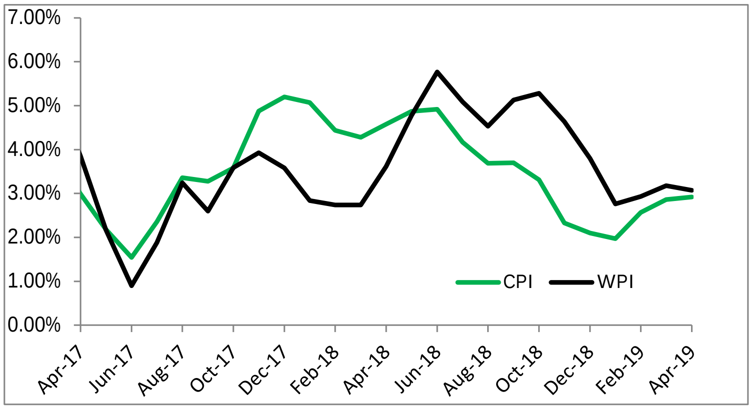
Indian Government 10 Year Bond Yield



India's CPI and WPI Trend



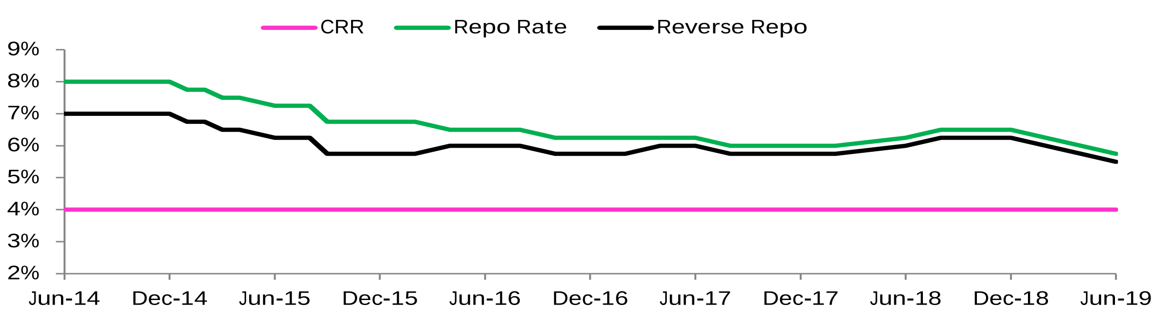
Key Quotes by MPC

- The MPC notes that growth impulses have weakened significantly as reflected in a further widening of the output gap compared to the April 2019 policy. A sharp slowdown in investment activity along with a continuing moderation in private consumption growth is a matter of concern

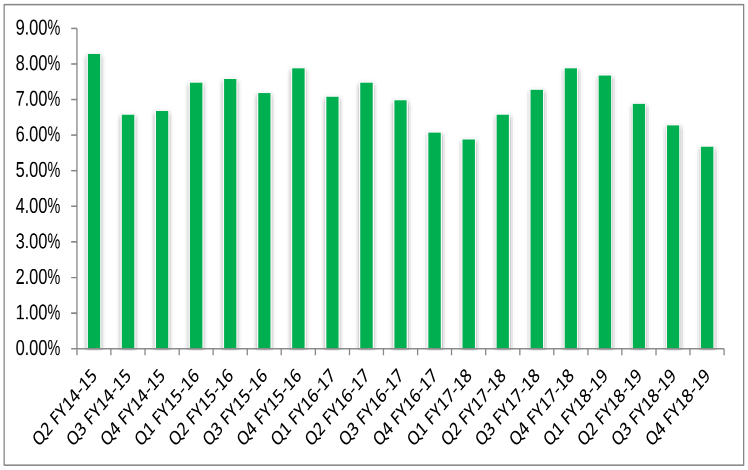
- Risks around the baseline inflation trajectory emanate from uncertainties relating to the monsoon, unseasonal spikes in vegetable prices, international fuel prices and their pass-through to domestic prices, geo-political tensions, financial market volatility and the fiscal scenario.

- High frequency indicators suggest moderation in activity in the service sector. Sales of commercial vehicles, tractors, passenger cars, and three and two wheelers contracted in April. Railway freight traffic growth decelerated.

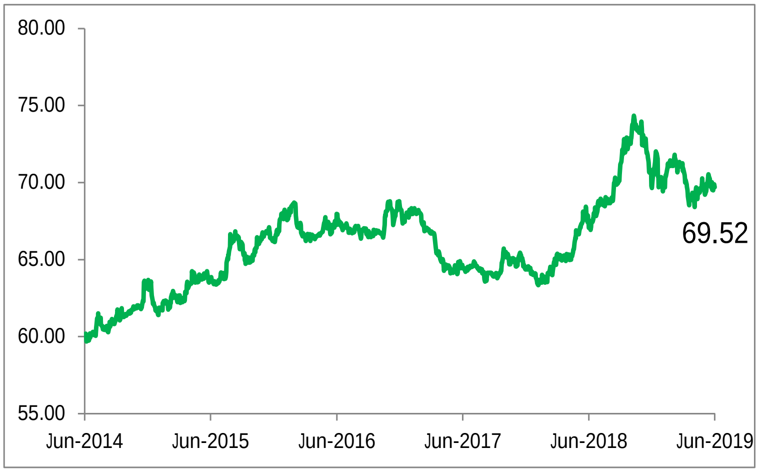
RBI's Monetary Policy Stance



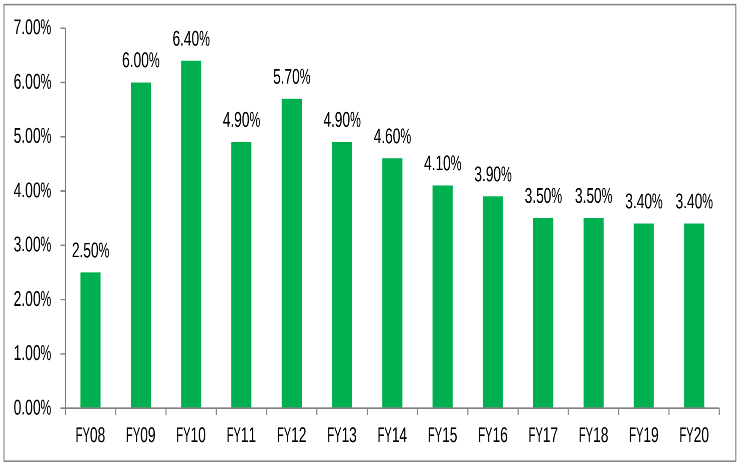
India's GDP Growth Trend



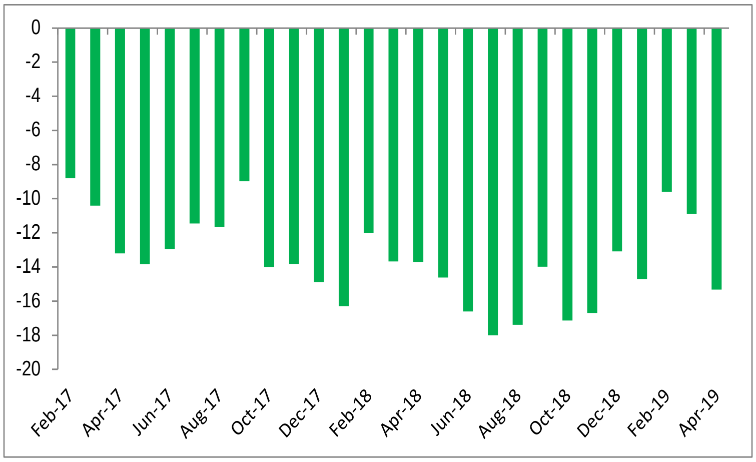
INR Vs US Dollar



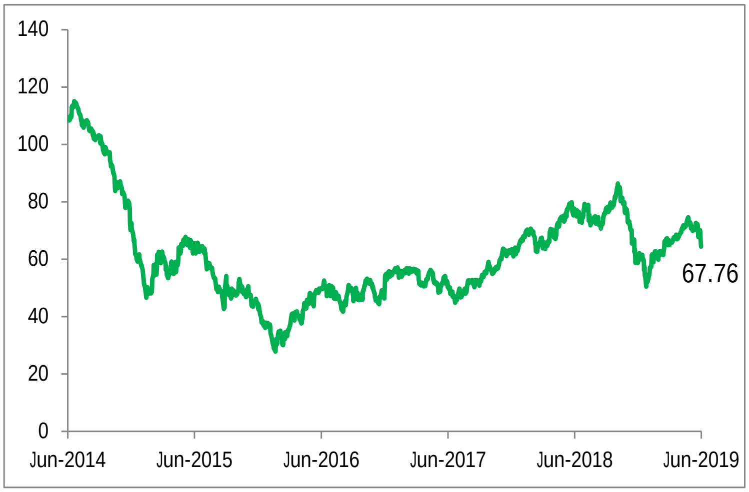
India's Fiscal Deficit Trend



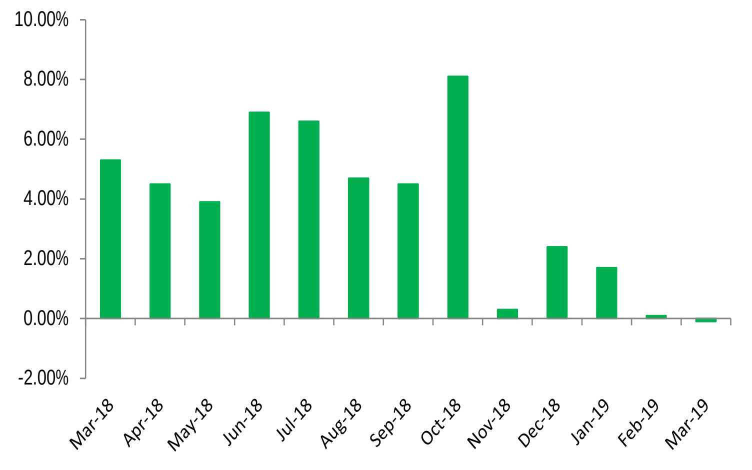
India's Trade Deficit Trend



Brent Crude Price Trend (In $/bbl)



India's Industrial Production Trend



Source: RBI, Bloomberg, SMIFS Research

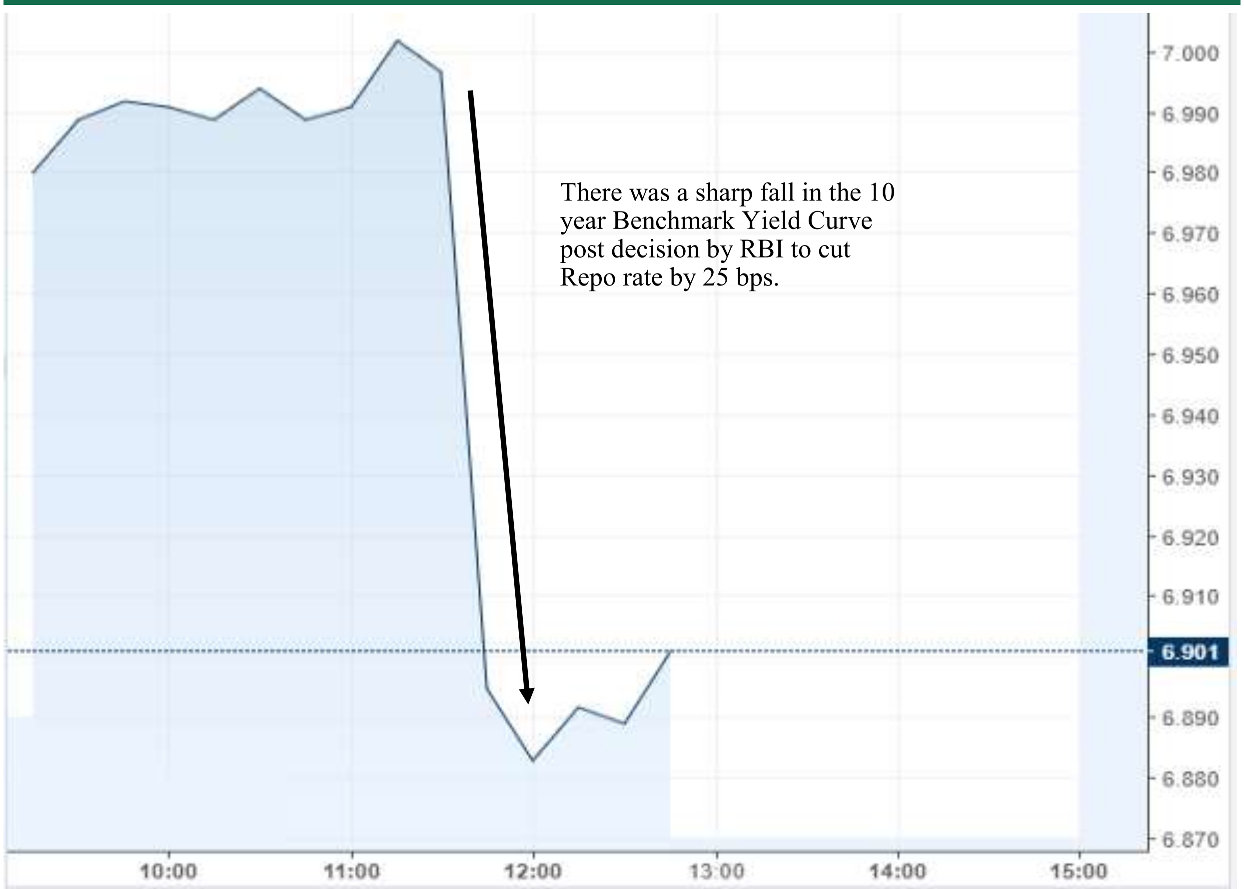
Market Impact

The cut in Repo rate by 25 bps, further highlightens the fact that the growth in the economy is slowing down & inflation is below estimates. Globally, many central banks have cut interest rates & have adopted dovish policy. The Accommodative policy by RBI is encouraging as the liquidity crunch could be tackled to some extent.

NBFCs & Auto stocks would be in focus, as the interest rate cut would help demand pick up. One point of concern would surely be the rate transmission by Banks & NBFCs.

The rate cut would also help the rural slowdown as consumption demand in the rural sector has remained flat.

Intraday Indian Government 10Y Bond Yield Chart



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