MONETARY POLICY REVIEW

04 October 2019

Room for another rate cut

RBI reduced repo rate by 25bps thus taking cumulative rate cuts by the central bank to 135bps since Feb'19. A sharp reduction in growth now estimated at 6.1% in FY20 (6.9% earlier) justifies the rate cutting cycle. Inflation has and is expected to remain below RBI's target of 4%. While another 25bps repo rate cut is likely in Dec'19, it will bring real policy rates in the range of 1-1.25% (3.7% inflation in FY21) thus putting an end to the rate cut cycle. Accommodative liquidity conditions will continue for transmission.

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Inflation forecast revised upward: RBI has revised its Q2FY20 projection upward to 3.4% from 3.1% in Aug'19. This is mainly driven by higher than estimated food inflation. However, other forecasts remain unchanged at 3.5-3.7% for H2FY20 and 3.6% for Q1FY21. Food inflation is likely to ease on the back of better than expected monsoon, reservoir levels (115% of last years' average) and adequate buffer stocks of pulses. Additionally, global slowdown is estimated to keep crude prices in check. However, upside risks to inflation may emerge from higher crude prices in the event of a geo-political crisis. The new forecasts are in line with our projection of 3.5% and 3.7% for FY20/ FY21.

FY20 growth forecast at 6.1%: RBI lowered its GDP forecast for FY20 by 80bps to 6.1% as Q1FY20 GDP growth at 5% was much lower than RBI's estimate of 6.8% (Apr'19 MPR). MPC noted that muted domestic demand and sluggish exports continue to impinge on the growth outlook. However, recent economic measures by the government such as easing FDI norms, bank recap and corporate tax cuts are positive for growth. Coupled with a cumulative 135bps cut in policy rates and better transmission in the future (3-4 quarter lag) , growth is expected to pick up to 6.9% in H2FY20 and 7% in FY21.

Widening output gap implies room for more cuts: The negative output gap has widened further and inflation is expected to remain below RBI's target of 4% in the medium-term. MPC members noted that they will continue with accommodative stance as long as it is necessary to revive growth. Thus RBI will be reducing repo rate further in Dec'19 as aggregate demand remains below trend. We expect another 25bps cut in repo rate taking the cumulative rate cuts to 160bps since Feb'19. With inflation expected at 3.7% in FY21, real policy rate is expected to stabilise at 1-1.25% level implying an end to current policy rate cutting cycle.

KEY HIGHLIGHTS

- RBI cuts repo rate by 25bps, stance remained unchanged at accommodative.
- Inflation forecast at 3.5-3.7% for H2FY20 and 3.6% for Q1FY21.
- GDP forecast lowered to 6.1% in FY20 from 6.9% earlier.

Regulatory announcements

- RBI has increased the household income limit for borrowers of NBFC-MFIs from Rs 1lakh and Rs 1.6lakh for rural areas and urban/semi urban areas respectively to Rs 1.25lakh and Rs 2lakh respectively. Furthermore, lending limit for eligible borrowers has been raised to Rs 1.25lakh from Rs 1lakh presently.
- RBI has accepted the following recommendations of the Task Force on Offshore Rupee Markets: 1) domestic banks can offer foreign exchange prices to non-residents at all times out of their Indian books, either through a domestic sales team or overseas branches, 2) rupee derivatives (with settlement in foreign currency) can be traded in International Financial Services Centres (IFSCs).
- The scope of non-interest bearing Special Non-Resident Rupee (SNRR) account has been expanded to include persons resident outside India to open such accounts to facilitate rupee denominated ECB, trade credit and trade invoicing. Restriction on the tenure of SNRR account, currently at 7 years will also be removed.
- To further promote digital payments, the collateralised liquidity support for NEFT system will be provided on a 24*7 basis for public from Dec'19.
- RBI has also decided to institutionalise an internal ombudsman scheme at the large non-bank PPI issuers (entities who have more than 10mn pre-paid payment instruments outstanding).
- In line with the recommendation of the Committee on Deepening of Digital Payments, RBI has proposed to release more detailed information on digital payment data covering the payment systems authorised by RBI.
- RBI has also proposed the creation of an Acceptance Development Fund (ADF) in Tier III and Tier IV centres for growth of acceptance infrastructure for cards in the country.
- Each State/UT Level Bankers Committees (SLBCs/ UTLBCs) has been mandated to identify one district in their respective States/UTs on a pilot basis for 100% digitisation. The identified district may be allocated to a bank with significant footprint.

FIG 1 – BASE LINE ASSUMPTIONS IN MPR

Indicator	April 2018 MPR	October 2018MPR	April 2019 MPR	October 2019 MPR
Crude Oil (Indian Basket)	US$ 68 per barrel during FY19	US$ 80 per barrel during H2FY19	US$ 67 per barrel during FY20	US$ 62.6 per barrel
Exchange rate	Current level	72.5/US$	69/US$	71.3/US$
Monsoon	Normal for 2018	9% below LPA	Normal for 2019	10% above LPA
Global growth	3.9% in 2018 & 3.9% in 2019	3.9% in 2018 & 3.9% in 2019	3.5% for 2019 & 3.6% in 2020	3.2% in 2019 & 3.5%in 2020
Fiscal deficit	To remain within BE FY19 Centre: 3.3% Combined: 6.0%	To remain within BE FY19 Centre: 3.3% Combined: 5.9%	To remain within BE FY20 Centre: 3.4% Combined: 5.9%	To remain within BE 20BE Centre: 3.4% Combined: 5.9%
Domestic macroeconomic/ structural policies during the forecast period	No major change	No major change	No major change	No major change

Source: RBI, Monetary Policy Report

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