MONETARY POLICY REVIEW

07 August 2019

Unconventional rate cut

RBI surprised with a 35bps reduction in policy rates (4-2 vote) while maintaining an accommodative stance. Two MPC members voted for 25bps change. RBI has indicated room to further cut rates as it looks at closing the negative output gap. While RBI expects growth at 6.9% in FY20 (6.8% in FY19), recent indicators suggest growth will be lower. Thus RBI will be in a position to cut repo rate further by 40bps in the financial year to support growth as inflation outlook remains favourable.

Sameer Narang
Dipanwita Mazumdar | Aditi Gupta
chief.economist@bankofbaroda.com

Unconventional rate cut of 35bps: With a 4-2 vote, RBI reduced policy rate by 35bps instead of its convention of changing the same in multiples of 25bps. Two members voted to reduce rate by 25bps. Stance continues to remain accommodative in-line with surplus liquidity conditions with the banks.

FY20 growth forecast at 6.9% from 7%: RBI reduced its GDP forecast for FY20 to 6.9% (5.8-6.6% in H1FY20, 7.3-7.5% in H2FY20) with risks tilted to the downside as global economic activity is expected to weaken further. Hence, exports are likely to be muted. Even domestic consumption and investment activity has decelerated. Rural spending is muted as sowing is behind normal levels. Credit availability has impacted consumption and investment demand which in turn has led to lower production. Surplus liquidity conditions are favourable for credit availability with a lag.

Inflation to remain below 4%: While food inflation is likely to increase led by vegetables and pulses, higher food grain stocks give comfort. Crude oil prices are unlikely to move up as global growth is decelerating. Core inflation is expected to remain muted as firms will have limited pricing power when demand is low. Hence, RBI expects CPI inflation at 3.1% and 3.5-3.7% in Q2FY20 and H2FY20 respectively. In Q1FY21 inflation is expected at 3.6%. Our CPI forecast remains at 3.5% and 3.7% for FY20 and FY21.

Rate cuts to continue: Given the domestic and global growth dynamics, we believe GDP growth will be lower at 6.5%. This implies a widening output gap. In RBI's view, the benign inflation outlook provides headroom for policy action to close the negative output gap. Hence, we continue to expect repo rate to move to 5% in the financial year which is in-line with global narrative of central banks taking over the mantle to support growth.

KEY HIGHLIGHTS

- RBI cuts repo rate by 35bps, stance remains accommodative.
- Inflation projection retained at 3.3% for FY20.
- GDP forecast revised lower at 6.9% for FY20 from 7.0% earlier.

Regulatory announcements

- For ensuring better flow of credit to the NBFC sector, RBI has decided to raise banks' exposure limit to a single NBFC to 20% of Tier-I capital of the bank from 15% earlier.
- Further, bank lending to registered NBFCs (other than MFIs) for on-lending to agriculture (investment credit) up to Rs 1mn; MSME up to Rs 2mn and housing up to Rs 2mn per borrower (up from Rs 1mn at present) will be classified as priority sector lending.
- To further spur credit growth in the economy, RBI has decided to reduce the risk weight for consumer credit (excluding credit card receivables) to 100% from 125% currently.
- RBI has decided to make the National Electronic Funds Transfer (NEFT) payment system available on a 24*7 basis from Dec'19 onwards. This is expected to further strengthen digital payment network in the county.
- RBI has also expanded the biller categories for Bharat Bill Payment System (BBPS) to include all categories of billers (except prepaid recharges) who provide for recurring bill payments. These can now participate in BBPS on a voluntary basis.
- RBI has also decided to setup a Central Payment Fraud Registry to help collect data on frauds. Apart from helping payment system participants on real time fraud monitoring, the data will also help to educate customers on emerging risks to digital payments.

Disclaimer

Visit us at **www.bankofbaroda.com**

For further details about this publication, please contact:

Economics Research Department

Bank of Baroda

chief.economist@bankofbaroda.com