

## Central Bank Watch: 'Growth' is back in the RBI's vocabulary

- In line with our expectations, the RBI decided to cut the repo rate by 25 bps to 6.25% in a 4-2 vote.
- The MPC voted unanimously to change the policy stance from "calibrated tightening" to "neutral" on account of benign inflationary pressures.
- The RBI expects FY20 GDP growth at 7.4%. Inflation estimates for H1:2019-20 have been revised down by 65 bps to 3.2%-3.4%.

### How do we read the policy?

- **The decision to cut the policy rate today ticks all the proverbial boxes.** It recognizes that recent inflation has printed way below the RBI's forecast range. It has signalled that it will go by the headline inflation, as mandated under the inflation targeting rule and that it does not fret 'excessively' about the so-called core inflation. Finally, today's decision is likely to dispel the notion that the RBI is only in the business of hiking rates and chooses to look askance when prices soften. This 'symmetry' in rate action was important to establish the credibility of this relatively new policy model.
- **How does it differ from the previous policies?** For one thing, "growth" re-enters the central bank's vocabulary as something to be cherished and not to be viewed exclusively as something that raised the risk of inflation. Two, the assumption that monetary policy had to necessarily move in the opposite direction as fiscal policy (that underpinned many of the earlier policies) seems to have been relaxed. Three, today's decision jettisons the needless choreography of the monetary policy ritual with a change in 'stance' first, followed by a possible cut in the actual rate. The RBI seems to be operating ahead of the curve now and this should be comforting for the markets.
- **Another rate cut could be in the offing.** Going forward, the neutral stance certainly provides flexibility to act in line with the data flow. This suggests that, unless food prices reverse sharply (or inflation suddenly surges), there could be space for another rate cut in the current easing cycle. For one, inflation is likely to average at 4% in FY20 and remain in the so called comfortable zone of the targeted inflation band. Two, we believe that there is room to bring down the policy rate in order to support a broader recovery in credit growth and in turn push up the growth momentum in the economy.

## **RBI's growth-inflation assumptions**

### **Inflation: RBI expects inflation to remain below 4% this calendar year**

In the December monetary policy resolution, CPI inflation for H2:2018-19 was projected in the range of 2.7%-3.2% and 3.8%-4.2% for H1:2019-20, with risks tilted to the upside. On the back of downside surprises in food inflation, excess supply conditions in several food groups, moderation in fuel prices, moderation in electricity prices, and fading out of the HRA impact (increase for the government employees that came in after the pay commission awards), the RBI decided to revise down its inflation forecasts.

- **The RBI now expects inflation for Q4:2018-19 at 2.8%, 3.2%-3.4% for H1:2019-20, and 3.9% for Q3:2019-20. The recent unusual pick-up in health and education inflation, which came in December, is perceived as a one-off phenomenon by the RBI.**

### **Growth: RBI expects growth to pick up slightly to 7.4% in 2019-20 from 7.2% this fiscal**

In the December policy, GDP growth was projected at 7.4% for H2:2018-19 and at 7.5% for H1:2019-20. The RBI is now working with an implicit assumption of 7.2% for 2018-19, as estimated by the CSO.

- **For 2019-20, the RBI is now projecting a growth rate of 7.4%, with a range of 7.2%-7.4% for H1, and 7.5% for Q3.** In terms of headwinds to growth, the RBI highlighted slowing global demand on account of trade tensions and the fact that bank credit to commercial sectors is yet not broad-based.

## **Bond Market implications**

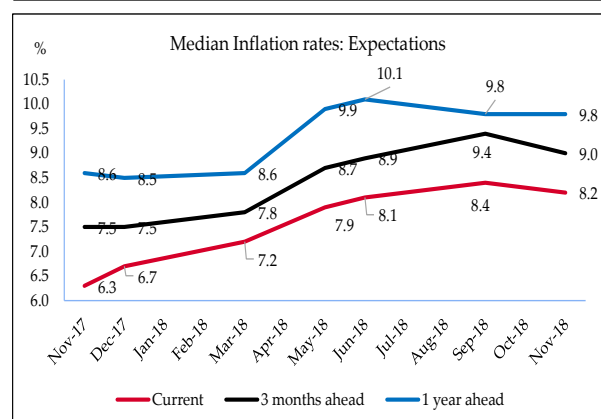
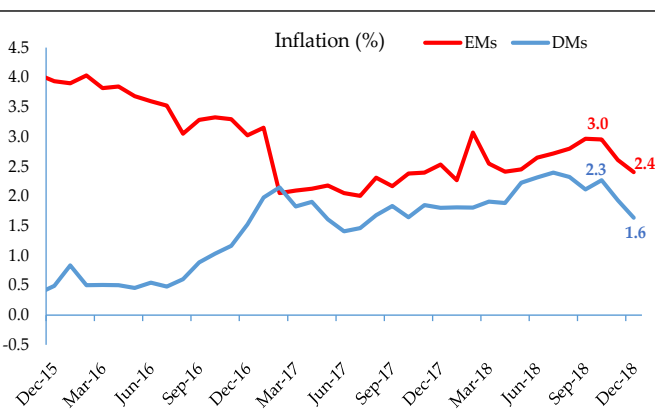
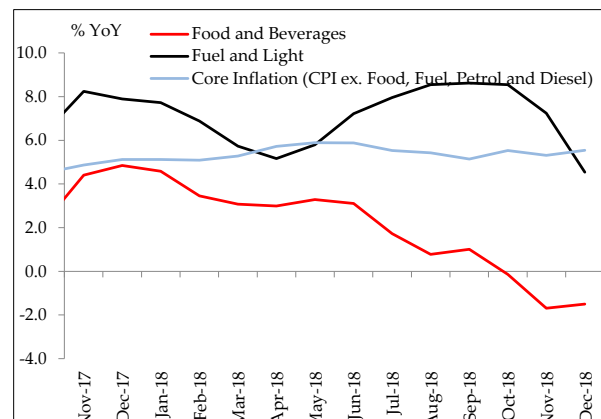
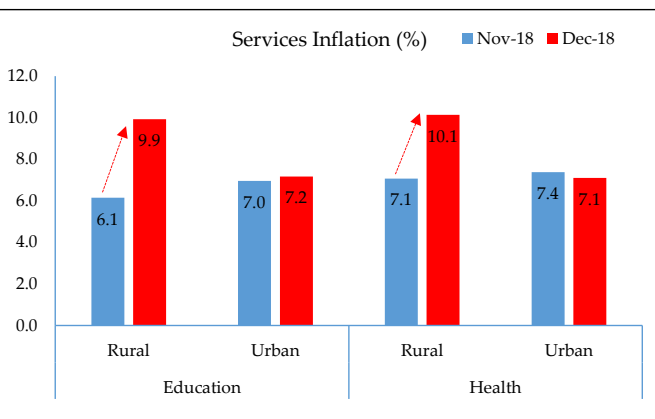
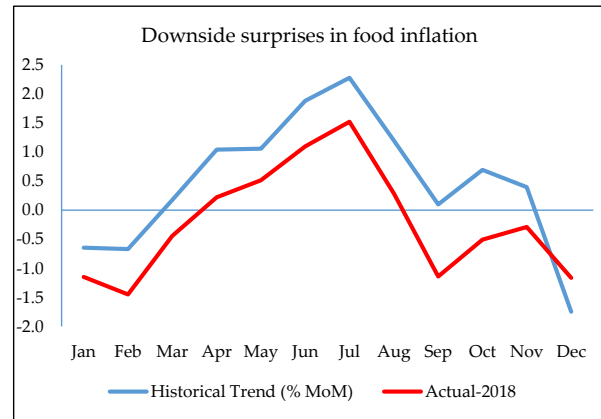
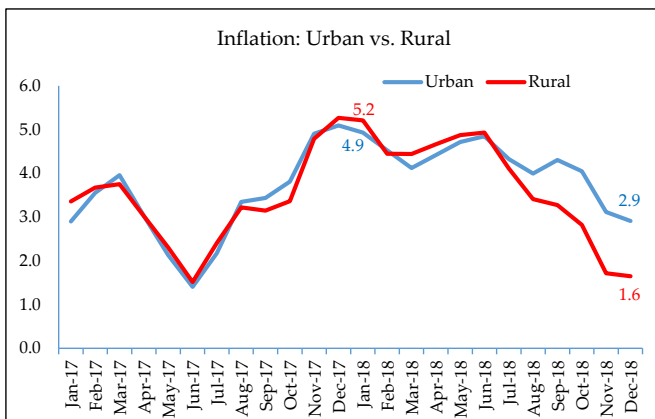
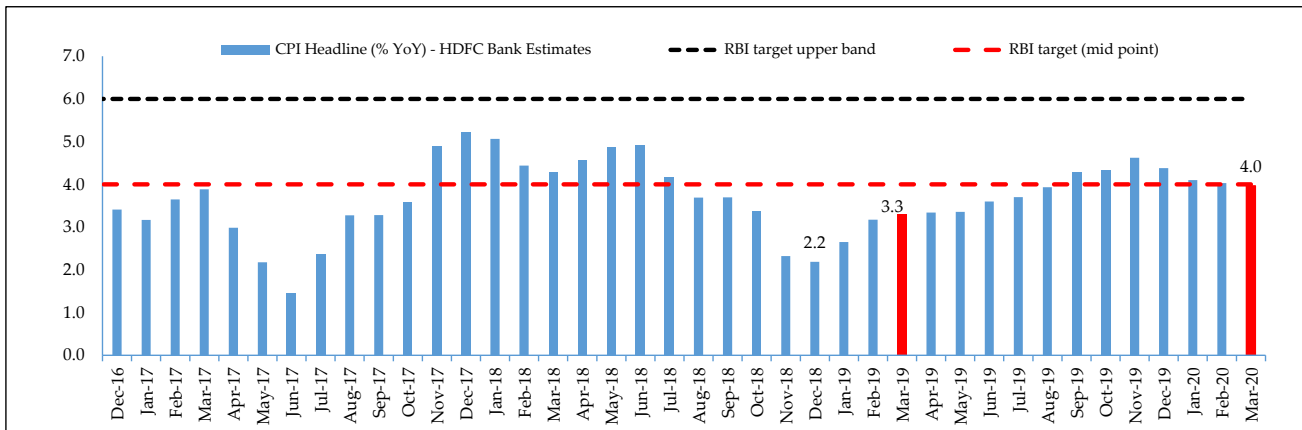
- **Markets were somewhat divided about the policy rate expectations.** Hence, today's rate cut could come as a surprise to at least some of the market participants and lead to marginal downward movement in the bond yields. As we write, the benchmark 10-year bond yield has already dropped by around 7 bps from the day's high of 7.37%.
- **Going forward, we expect the benchmark 10-year yield to drop to 7.2% levels as expectations of another rate cut get priced in. However, this rally in the bond market is likely to be shallow and short-lived.** For one, volatility and uncertainty before general elections could provide a floor on the downside. Two, once the new government comes in and a full-fledged budget is announced, the focus of the market is likely to shift to the borrowing plan of the government.

- Hence, **after the positive impact of the easing monetary policy cycle fades away, the jitteriness could come back in the market in 2H-2019**. Fresh supply of government paper, to the tune of Rs. 7.1 trn could bring back the pressure. After bottoming out at around 7.2% levels in March-2019, we expect the benchmark yield to inch up to 7.5% levels by September-2019.
- **In the short-term, possible announcement on interim dividend (from the RBI) and likely revision of the fiscal deficit numbers could also come as positive surprise** for the markets and support the movement towards 7.2% for the benchmark bond yield, apart from hopes of another rate cut by the RBI.
- Just to recall, the government had recently revised the GDP growth rates by 110 bps from 7.1% to 8.2% for 2016-17 and by 50 basis points from 6.7% to 7.2% for fiscal 2017-18. However, in the budget math, **the government derived the fiscal deficit ratios based on the old GDP estimates and had not used the revised estimates**. After the revised GDP numbers are incorporated, the fiscal deficit ratios for 2018-19 as well as 2019-20 could come down to 3.2%-3.3%. This could support the sentiment to some degree.

### **Regulatory changes** ([click here to access the RBI's Statement](#))

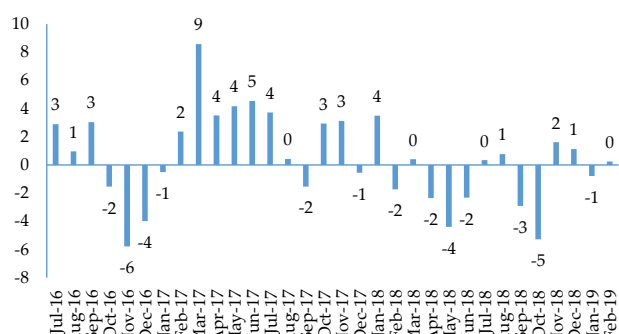
- Important announcements on the Developmental and Regulatory Policies' side also seem to be in sync with the RBI's renewed emphasis on the growth front. For instance, exempting FPIs from the current limit of not having an exposure of more than 20% of their corporate bond portfolio to a single corporate is a step that will infuse greater liquidity in the NBFCs (given 20-30% of corporate debt is issued by them) - a critical lender to MSMEs and the infrastructure sector. Similarly the step to allow banks to risk weight their lending to the NBFC sector as per the ratings assigned to them is expected to facilitate greater flow of credit to the sector. In a bid to deal with stressed assets/bad loans in the system, the RBI has now allowed resolution applicants under the Insolvency and Bankruptcy process to tap ECBs (external commercial borrowings) and repay the existing lenders.

## Inflation Dynamics

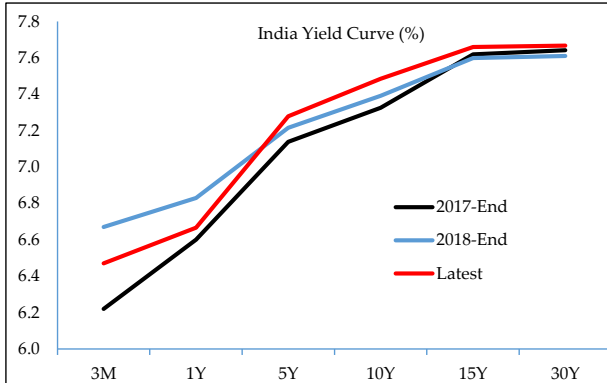


## FX and Bonds Update

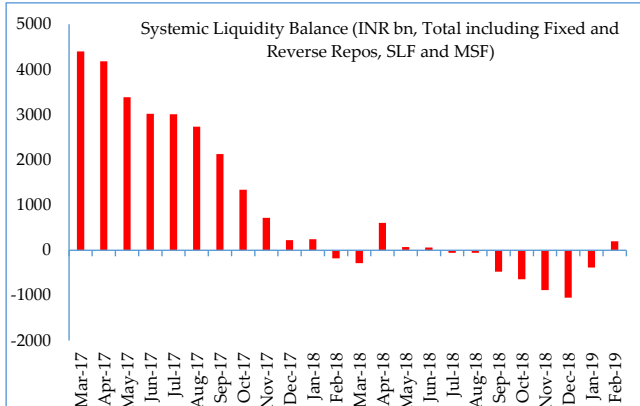
FII Net Investment (USD bn, Debt and Equity)



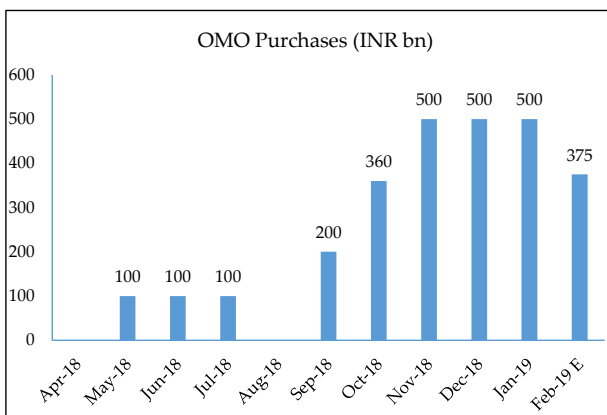
India Yield Curve (%)



Systemic Liquidity Balance (INR bn, Total including Fixed and Reverse Repos, SLF and MSF)



OMO Purchases (INR bn)



Bond Yields (Benchmark 10-Year)

	Latest Level (%)	WTD (bps)	CYTD (bps)
US	2.69	5.6	-5
Germany	0.16	0.6	-8
Japan	-0.01	-0.8	-1
UK	1.21	-0.9	-6
Canada	1.92	4.5	-3
Australia	2.15	-9.0	-21
China	3.15	2.0	-12
India	7.31	5	5

NB: For Bond yields, 2029 (7.26%) 10 year bond is used for latest levels.

FX Market (All vs. USD)

	Latest	WTD (%)	CYTD (%)
Dollar Index	96.54	1.0	0.1
EUR	1.13	-0.9	-0.8
JPY	110	-0.5	0.3
GBP	1.29	-1.3	1.6
CAD	1.32	1.1	-2.9
INR	71.44	0.0	-2.2
CNY	6.74	.	1.9

NB: positive change reflects appreciation against the dollar

FII Flows (USD mn)

	Equity	Debt	Total
06-Feb-19	100	-120	-21
FY19-till date	-6654	-7306	-13959
FY18	4019	18505	22524

Net Government market borrowings (INR trn)

	Centre	State
Yearly		
FY17	4.08	3.43
FY18	4.48	3.41
FY19 TD	3.41	2.68

Source: RBI, CEIC, Reuters, and HDFC Bank

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