Central Bank Watch: Room for another cut, but not back-to-back!

- **In line with our expectations, the RBI cut the repo rate by 25 bps to 6.0%**
- **The Monetary Policy Committee (MPC) voted 4:2 in favour of the 25 bps rate cut**
- **The stance of the policy was kept unchanged as neutral**
- **The RBI revised down its projections for both growth and inflation**
- **In order to ease liquidity pressures, the RBI announced an increase in the FALLCR**

The MPC highlighted that "the output gap remains negative and the domestic economy is facing headwinds, especially on the global front. The need is to strengthen domestic growth impulses by spurring private investment which has remained sluggish". This suggests that there could be more rate cuts in the offing. Current RBI projections on growth and inflation also suggest that there is room for further easing.

However, the MPC is likely to wait for further clarity on monsoon and its impact on food prices, the fiscal math of the new government, and the evolving dynamics in the global crude market before making its next move. ***Therefore, we expect the RBI to stay on hold in its June meeting. A rate cut in August would hinge on how the above mentioned risks unfold. For the bond market, unless there is a liquidity surplus in the system, yields could continue to edge up (September estimate of 7.75% for the 10-year benchmark yield).***

Downward revisions for both growth and inflation estimates

On inflation, the MPC statement highlighted lower than expected trends for food and fuel, and moderation in inflation expectations of households.

CPI estimates for H1-FY20 were thus revised down to 2.9%-3.0% from the earlier range of 3.2%-3.4%. For H2-FY20, the MPC now expects a range of 3.5%-3.8% compared to earlier outlined number of 3.9% for 3Q-FY20.

Our inflation estimates on average are broadly in line with the RBI's forecasts.

On growth, the RBI in the February policy had projected a figure of 7.4% for FY20 with a range of 7.2%-7.4% for H1, and 7.5% for Q3.

Now the RBI expects GDP growth at 7.2% (20 bps downward revision) with a range of 6.8%-7.1% for H1-FY20 and 7.3%-7.4% for H2-FY20.

In its policy statement, the RBI mentioned that there are some signs of domestic investment activity weakening and that the moderation of growth in the global economy could also impact India.

We expect GDP growth to come in at 7.0-7.2% in FY20, supported by gradual improvement in private consumption and some traction in investment activity post elections. That said, risks from oil prices, global slowdown, monsoons could create a downside to our forecasts.

Bond Market implications

After the policy announcement, the benchmark 10-year bond yield has gone up from an intra-day low of 7.23% to 7.34%, despite the rate cut. Markets were perhaps anticipating a relatively high degree of dovishness from the policy statement (some participants were even anticipating a 50 bps rate cut) which hasn't materialised.

Going forward, a number of upside risks to inflation mentioned by the RBI, if they materialise, could mean further upward pressure on yields.

- One, with some probability of El Niño effects in 2019, there is the risk of an abrupt reversal in vegetable prices, especially during the summer months.
- Two, uncertainty around the sustainability of the current softening in fuel inflation. The outlook for oil prices continues to be hazy. Should there be a swift resolution of trade tensions, a pick-up in global demand is likely to push up oil prices.
- Three, inflation excluding food and fuel has remained elevated over the past twelve months with some pick up in prices in February.
- Four, financial markets remain volatile reflecting in part global growth and trade uncertainty, which may influence the inflation outlook.
- Lastly, the fiscal situation at the general government level requires careful monitoring.

In our base case, given these risks, we do not expect another back-to-back rate cut by the RBI. While there is still a reasonable chance of another 25 bps rate cut this year, the MPC is likely to adopt a data dependent approach and wait for clarity to emerge on monsoon and its impact on food prices especially during the summer months, full year budget after the new government comes into power, and global crude oil prices (if there is any reversal from the current levels or not).

Thus the next move could come in August (not in the June policy) assuming the government does not materially shift away from the fiscal deficit numbers outlined during the interim budget and that there is not a substantial shift in the food price trajectory because of sub-par monsoon. For bond yields, this means a marginal uptick as the new borrowing calendar kicks off. **Unless the liquidity moves to a surplus territory, 7.25% could be the bottom for the benchmark 10-year yield in the short term.**

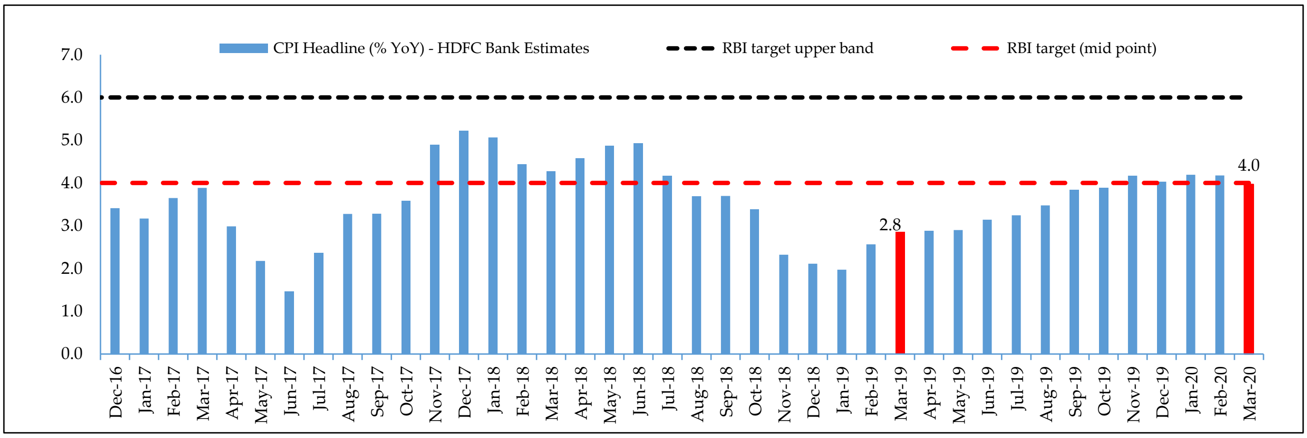
Meanwhile, the focus of the RBI is likely to be on the transmission of the past two rate cuts. That is liquidity management is likely to be the key area of attention. **In this regard, the RBI could resort to further Dollar/INR swaps along with OMOs to manage liquidity conditions. This would imply further lowering of forward premia. Although for now, forward premia have gone up, temporarily, due to excess dollar liquidity in the system.**

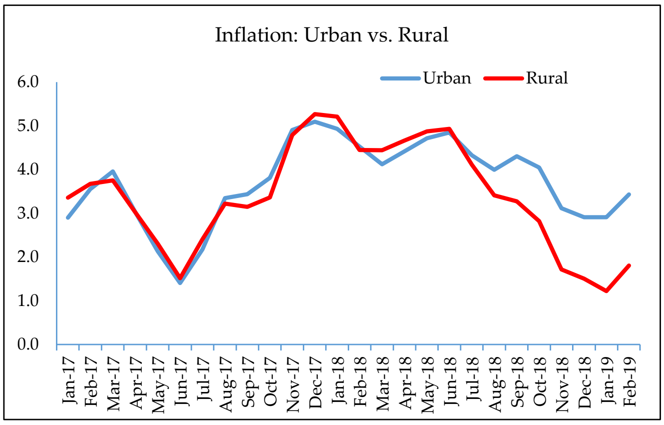
Regulatory changes

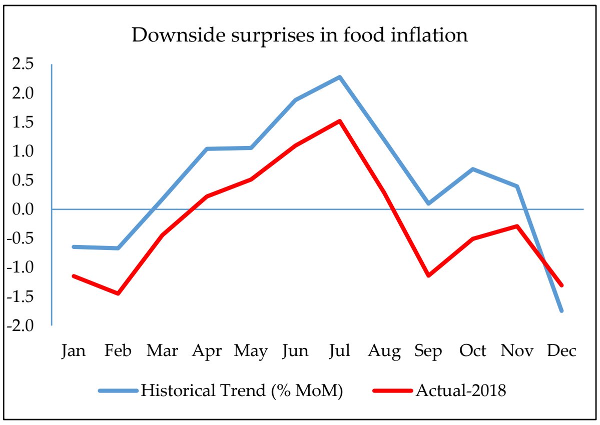
In line with its focus on liquidity, the RBI permitted banks to use an additional 2% of government securities as FALLCR in order to meet their LCR requirements. The Facility to Avail Liquidity for Liquidity Coverage Ratio (FALLCR) was increased from the existing 13% to 15% of banks' net demand and time liabilities (NDTL) and will be implemented in a phased manner between April 2019 to April 2020. This essentially implies that banks can now dip into government bonds held under SLR to the extent of 17% of NDTL (total HQLA carve out from SLR) for meeting LCR requirements. **This is likely to ease up liquidity pressure in the banking system and consequently provide some push to credit growth.**

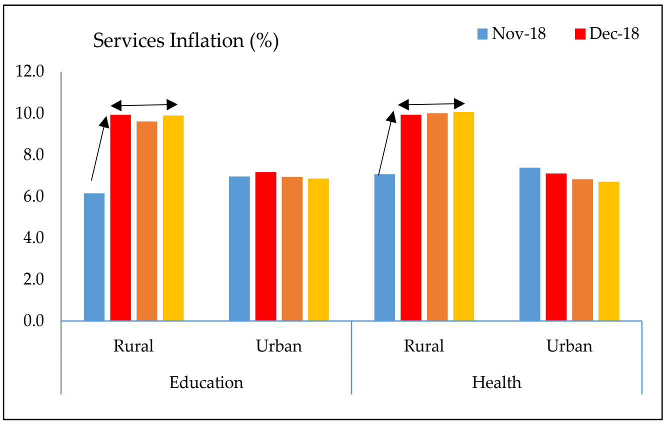
Currently, government securities under the MSF (2% of NDTL) and FALLCR at 13% of NDTL within the mandated SLR could be used for computing LCR.

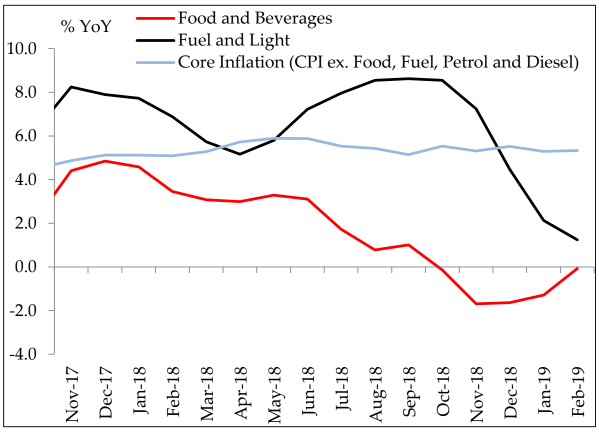
Inflation Dynamics

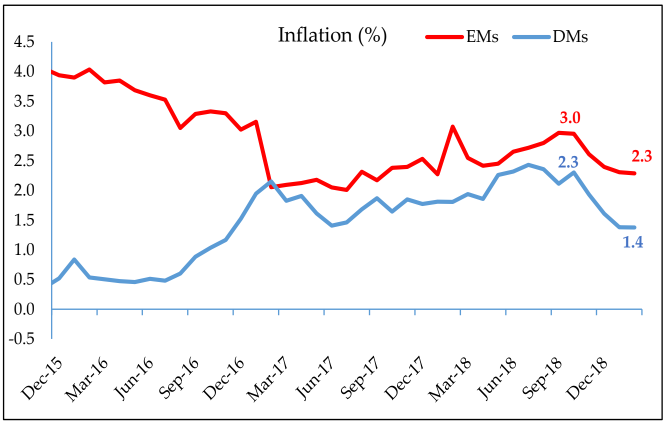


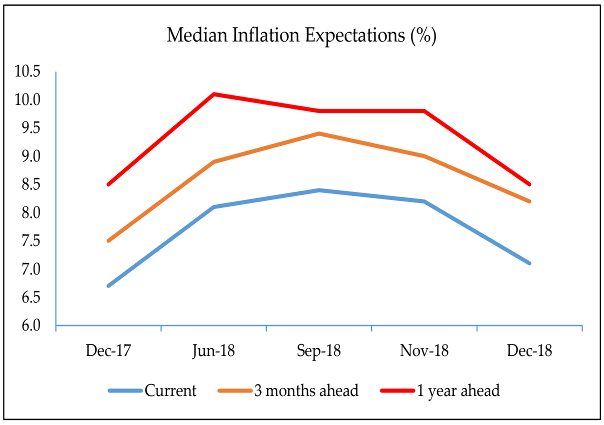




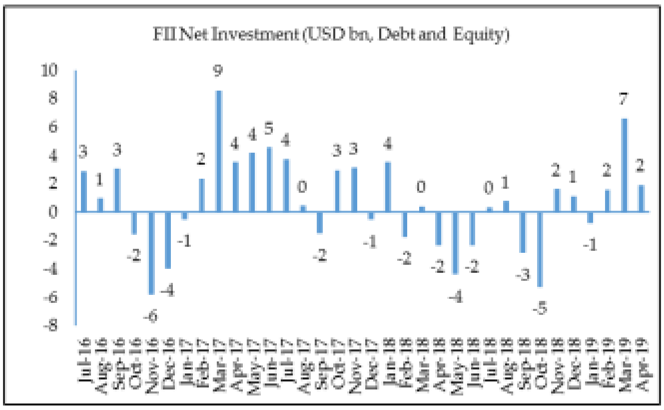


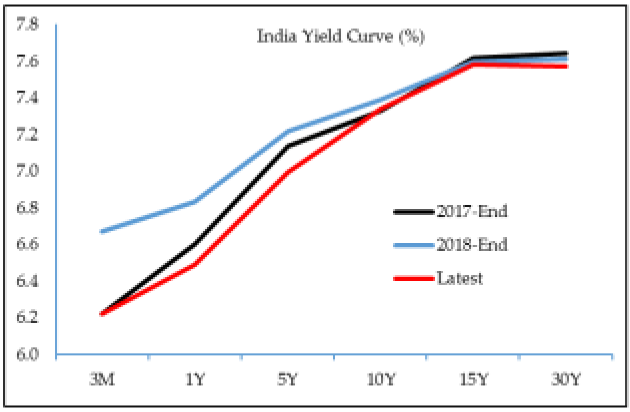


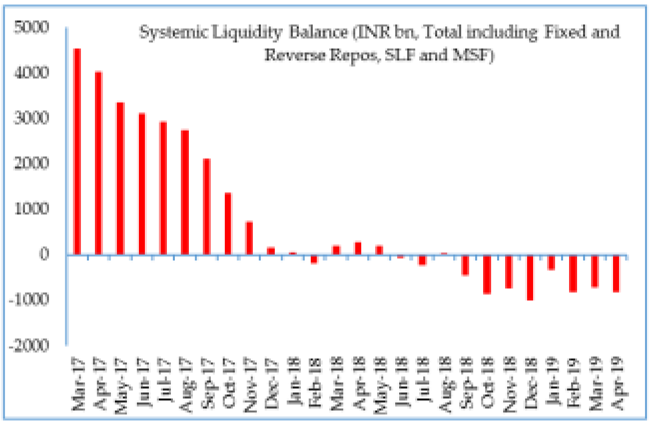


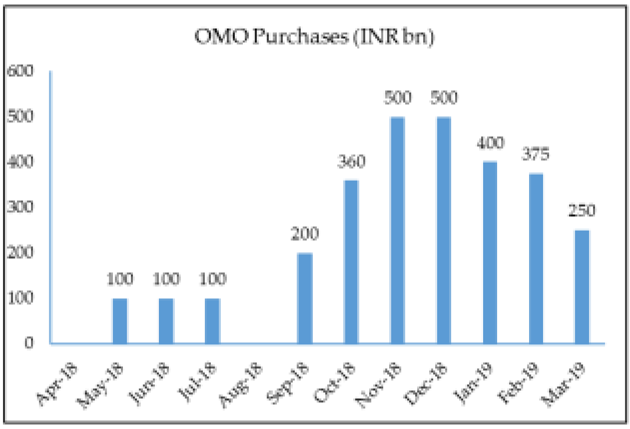


FX and Bonds Update









Bond Yields (Benchmark 10-Year)			
	Latest Level (%)	WTD (bps)	CYTD (bps)
US	2.50	12	-23
Germany	-0.001	7	-24
Japan	-0.04	6	-4
UK	1.08	8	-19
Canada	0.00	-156	-196
Australia	1.88	16	-48
China	3.27	19	0
India	7.34	1	8

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	97.08	-0.2	0.7
EUR	1.12	0.2	-1.7
JPY	111	-0.5	-1.0
GBP	1.32	1.1	3.7
CAD	1.34	0.1	-2.1
INR	69.07	0.2	1.2
CNY	6.72	-0.1	2.3

NB: positive change reflects appreciation against the dollar

FII Flows (USD mn)			
	Equity	Debt	Total
03-Apr-19	69	-252	-184
FY19	123	-6127	-6004
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	4.05	3.43

Source: RBI, CEIC, Reuters, and HDFC Bank

Treasury Economic Research team

Abheek Barua

Chief Economist
Phone number: +91(0) 124-4664305
Email ID: abheek.barua@hdfcbank.com

Tushar Arora

Senior Economist
Phone number: +91 (0) 124-4664338
Email ID: tushar.arora@hdfcbank.com

Tanvi Garg

Economist
Phone number: +91 (0) 124-4664372
Email ID: tanvi.garg@hdfcbank.com

Sakshi Gupta

Economist
Phone number: +91 (0) 124-4664372
Email ID: sakshi.gupta3@hdfcbank.com

Disclaimer: *This document has been prepared for your information only and does not constitute any offer/commitment to transact. Such an offer would be subject to contractual confirmations, satisfactory documentation and prevailing market conditions. Reasonable care has been taken to prepare this document. HDFC Bank and its employees do not accept any responsibility for action taken on the basis of this document*