

## Central Bank Watch: An out of the box cut but is it enough?

- In a surprise move, the RBI cut the repo rate by 35 bps to 5.40% and reduced the reverse repo to 5.15%
- Four MPC members voted for a 35 bps cut and 2 voted for a 25 bps cut
- The MPC recognised the slowdown in growth and revised its GDP growth forecast from 7.0% to 6.9% for FY20.
- Inflation estimates for H2 FY20 were kept broadly unchanged.
- It was disappointing to see no clarity on the new liquidity framework and few specifics on improving the transmission of rate cuts
- Given the downside risks to growth and with inflation in all likelihood remaining low, we see more room for rate cuts this year.

**BOND VIEW:** For the bond market, the policy decision was broadly neutral. While the consensus was for a 25 bps rate cut, some expectations of a 50 bps cut were partially baked in by bond markets. The “middle ground” (a 35bps cut) result has therefore had limited impact on the 10-year paper. The 10-year yield was trading at 6.36% at the time of writing (compared to yesterday’s close of 6.34%).

Further rate cuts by the RBI are likely to put some downward pressure on the yields. However, return of fiscal worries and heavy borrowing pressure in H2 could put a floor for 10-year yield at 6.25% by the year-end. The big market mover for yields would now be the sovereign bond issuance which if implemented could create further downside pressure to our yield forecast.

**FX View:** Technically a policy rate cut is INR negative, but the earnings effects (due to push to growth) of the cut usually tends to dominate. As a result, the INR appreciated marginally against the USD post the policy (trading at 70.68 vs. 70.90 – level at which it opened today). That said, barring this brief recovery in the USD/INR pair seen today, we think that the pressure on the currency is likely to continue on account of a rise in trade war tensions and a correction driven by its overvaluation (as argued in our recent note: FX View – No full stops here?, 5 August 2019). We see the pair at 71-72 levels by September-end.

### 25 bps too little, 50 bps too much – RBI settles at a 35 bps cut

The RBI cutting the policy rate by 35 bps is an interesting policy innovation, deviating from the convention of changing the policy rate in multiples of 25 bps. Although the governor had alluded to this at an international policy forum in February, few in the market had expected him to walk the proverbial talk so soon.

The RBI has painted a reasonably gloomy picture for the economy and the 35 bps cut seems to suggest that it concedes the fact that the extent of the slowdown is sharper than it had projected earlier although it does not see the need to push the panic button (that a 50 bps might have been interpreted as). However, we think that the revision of the GDP growth from 7.0% to 6.9% is paltry and somewhat dissonant with the characterization of the economic situation. **We think the RBI’s growth projections (H2 growth especially) are somewhat optimistic. We expect GDP growth to come in at 6.8% in FY20.**

The RBI expects growth to be at 5.8%-6.6% in H1 and 7.3%-7.5% in H2 FY20. The RBI kept its inflation forecasts broadly unchanged at 3.1% in Q2 and 3.5%-3.7% in H2.

## What was missing in the policy?

- There are **few specific actions to enhance the transmission of the policy rate cuts** to either the credit or the bond market, except for the governor's assurance that this will happen soon. While the pass through of the 75 bps cut since Feb 2019 to the G-sec yields has been almost 100%, the MCLR (on average) has gone down by only 15 bps.
- Moreover, there was not much clarity either on whether the current liquidity situation (characterized by large surplus liquidity) is likely to persist under the new liquidity framework that is due to be announced soon. **However, if we were to read the governor's lips closely in the press conference the risk of significant liquidity compression seems remote.**

**We expect the RBI to cut rates by more given that low inflation readings and a slowdown in growth gives room to keep monetary policy accommodative.**

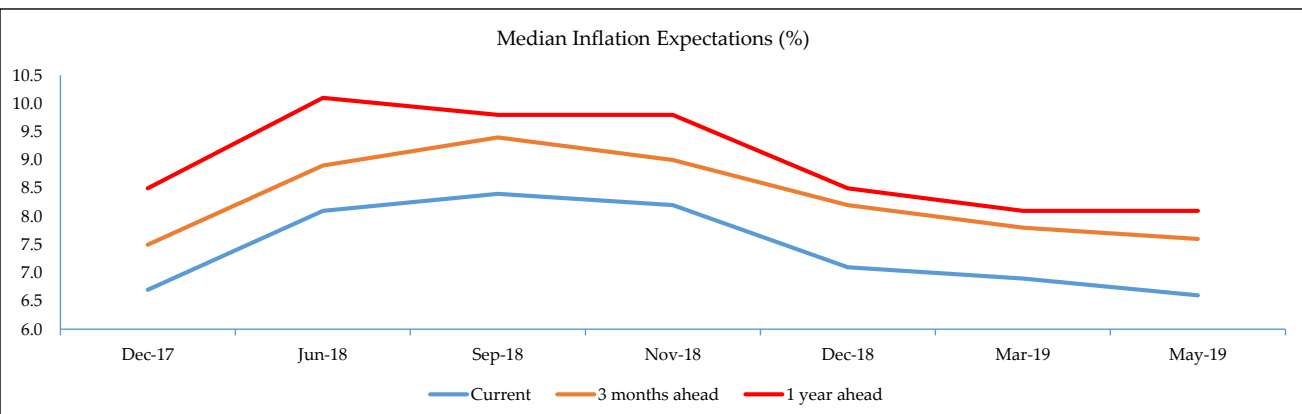
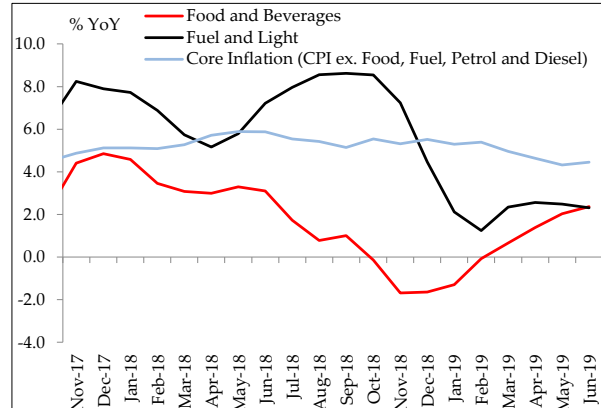
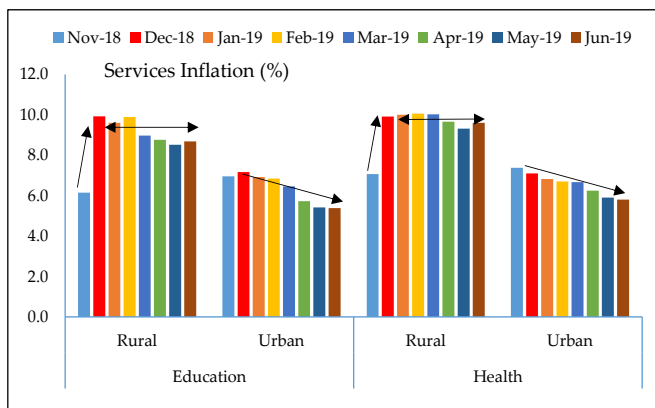
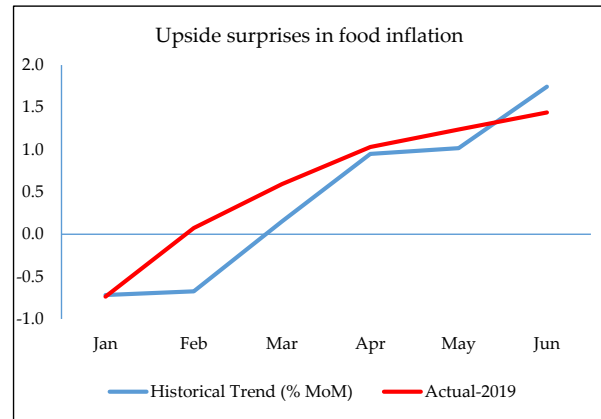
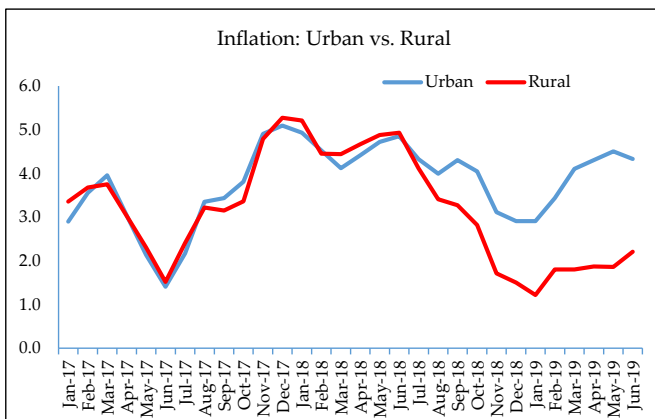
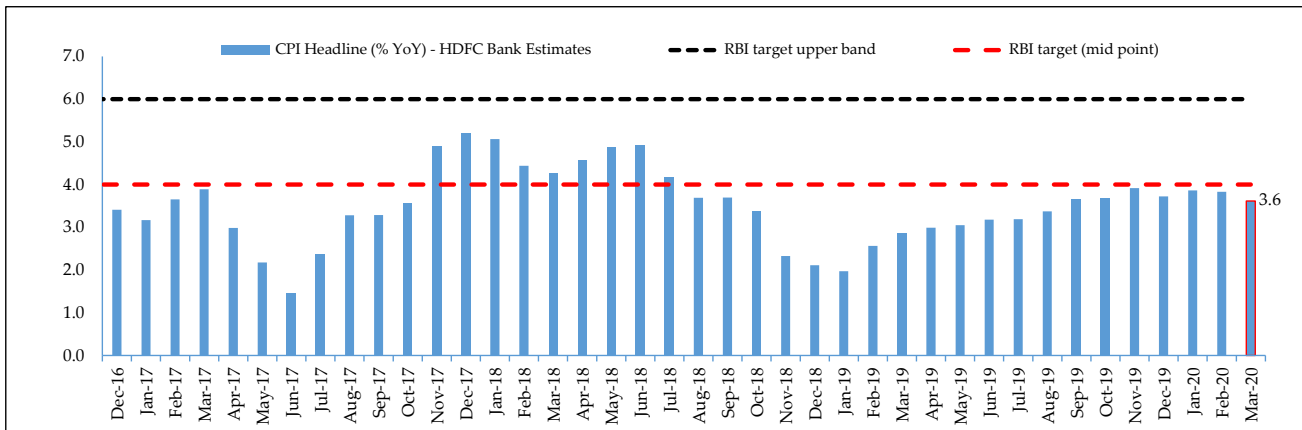
## Regulatory Changes

On the regulatory front, the RBI announced three key measures to boost credit growth in the economy. For consumer loan, the RBI reduced the risk weight for personal loans. Depending on the risk perception, a higher risk weights enforces a bank to keep aside a higher amount of money as reserve capital. For lending to NBFCs, bank's exposure limit to a single NBFC was raised to 20% of the Tier-I capital of the bank from 15%. Also banks will now be able to lend to NBFCs for on-lending to agriculture up to Rs. 10 lakh, subject to certain conditions.

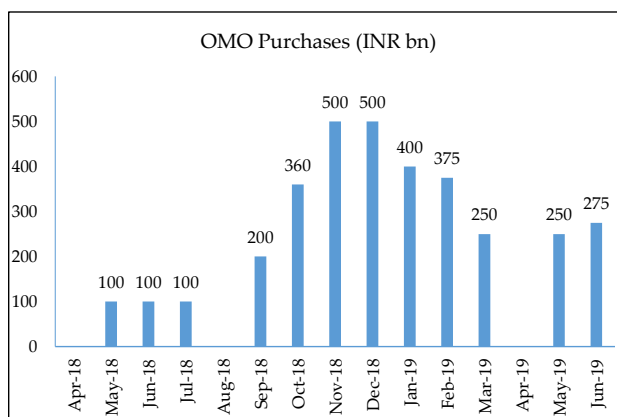
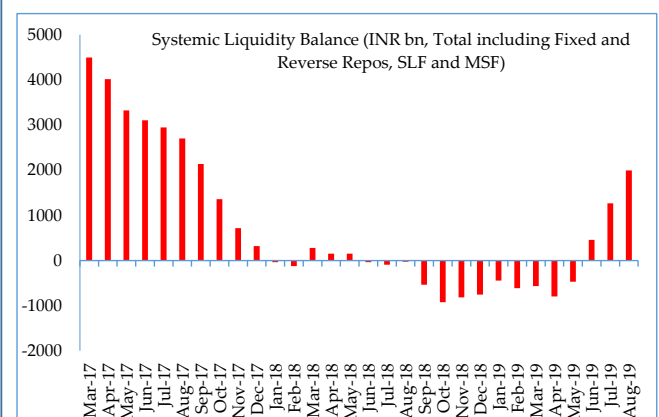
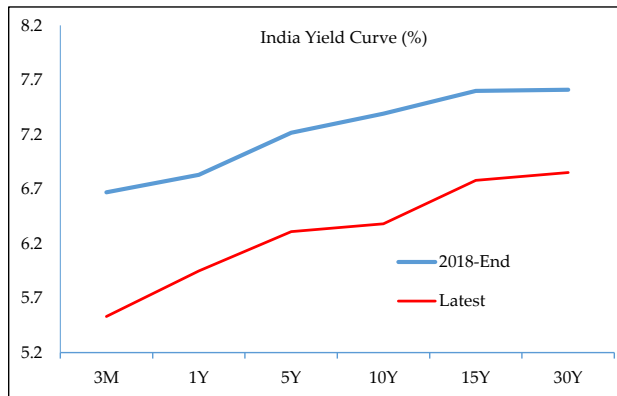
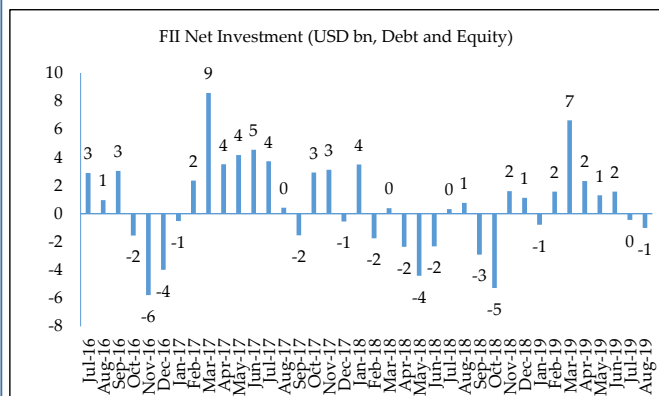
### **RBI: Statement on Developmental and Regulatory Policies**

- **Reduction in risk weight for consumer credit except credit card receivables:** Under the standardized approach for Credit Risk Management, consumer credit, including personal loans and credit card receivables attract a higher risk weight of 125 per cent or higher, if warranted by the external rating of the counterparty. On a review, it has been decided to reduce the risk weight for consumer credit, including personal loans, but excluding credit card receivables, to 100%.
- **Harmonization of single counterparty exposure limit for banks' exposure to single NBFCs with general single counterparty exposure limit:** Under the revised guidelines on large exposure framework (LEF) that came into effect from April 1, 2019, a bank's exposure to a single NBFC is restricted to 15 per cent of its Tier I capital, while for entities in the other sectors the exposure limit is, 20 percent of Tier I capital of the bank, which can be extended to 25 per cent by banks' Boards under exceptional circumstances. As a step towards harmonization of the counterparty exposure limit to single NBFC with that of the general limit, it has been decided to raise a bank's exposure limit to a single NBFC to 20% of Tier-I capital of the bank.
- **Credit to the Priority Sector – Permitting banks to on-lend through NBFCs:** With a view to further increasing the credit flow to certain priority sectors which contribute significantly to the economic growth in terms of export and employment, and recognizing the role played by NBFCs in providing credit to these sectors, it has been decided to allow, subject to certain conditions, bank lending to registered NBFCs (other than MFIs) for on-lending to Agriculture (investment credit) up to ₹10.0 lakhs; Micro and Small Enterprises up to ₹ 20.0 lakh and housing up to ₹ 20.0 lakh per borrower (up from ₹10.0 lakh at present) to be classified as priority sector lending.

## Inflation Dynamics



## FX and Bonds Update



Bond Yields (Benchmark 10-Year)			
	Latest Level (%)	WTD (bps)	CYTD (bps)
US	1.68	-17	-105
Germany	-0.56	-7	-80
Japan	-0.20	-3	-20
UK	0.49	-6	-78
Canada	0.00	-138	-196
Australia	0.96	-14	-140
China	3.07	-7	-20
India	6.38	3	-88

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	97.6	-0.4	1.3
EUR	1.12	0.8	-2.1
JPY	106	0.3	3.6
GBP	1.22	0.1	-4.3
CAD	1.33	0.6	-2.6
INR	70.73	-1.5	-1.2
CNY	7.04	-1.4	-2.3

NB: positive change reflects appreciation against the dollar

FII Flows (USD mn)			
	Equity	Debt	Total
06-Aug-19	-309	-15	-323.6
FY20 TD	1666	2091	3756
FY19	123	-6127	-6004

Net Government market borrowings (INR trn)		
	Centre	State
Yearly		
FY18	4.48	3.41
FY19	4.23	3.50
FY20 TD	1.77	0.85

Source: RBI, CEIC, Reuters, and HDFC Bank

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