Central Bank Watch: Looking beyond the policy rate, RBI supports growth

- *In line with our expectations, the RBI kept the policy rate unchanged at 5.15% given the recent high inflation prints.*
- *The MPC revised its GDP growth forecast down (by 35bps to 5.5-6% for H1 FY21) …*
- *… while revising up its inflation projections to 6.5% for Q4 FY20 and 5.0-5.4% for H1 FY21*
- ***RBI kept its stance accommodative and signalled that there is space for future action.***
- *RBI announced a number of measures to support growth and boost credit growth (for sectors such as auto, housing and MSMEs)*
- *The RBI also announced LTROs of Rs 1,00,000 crore to provide durable liquidity and push credit growth*

In today's policy announcement, while the RBI kept the policy rate unchanged – given the high inflation prints - it announced a number of measures to support growth. The announcement of the LTROs to provide durable liquidity and the CRR relief for on-lending to the auto, the housing and the MSME sector is likely to push credit growth. In an effort to improve transmission, the RBI also announced external benchmarking for medium enterprises.

In terms of the policy rate, the RBI kept its stance as accommodative and signalled that there is space for further rate cuts. Going forward, our sense is that the central bank could take the first opportunity it gets to cut rates - as soon as the inflation optics start looking better (with vegetable price spikes cooling-off) and headline inflation comes in closer to the RBI's target band. They are likely to rely on the fact that inflation is expected to drop sharply over the next 12 months (estimate at 3.2% in Q2 FY21). We now see a high probability of a rate cut (25bps) as early as Q1 FY21 (Apr-June 2020). (For our latest analysis on inflation and monetary policy see our report: Inflation Vs. Growth, which way is the RBI likely to sway?, 5 February, 2020).

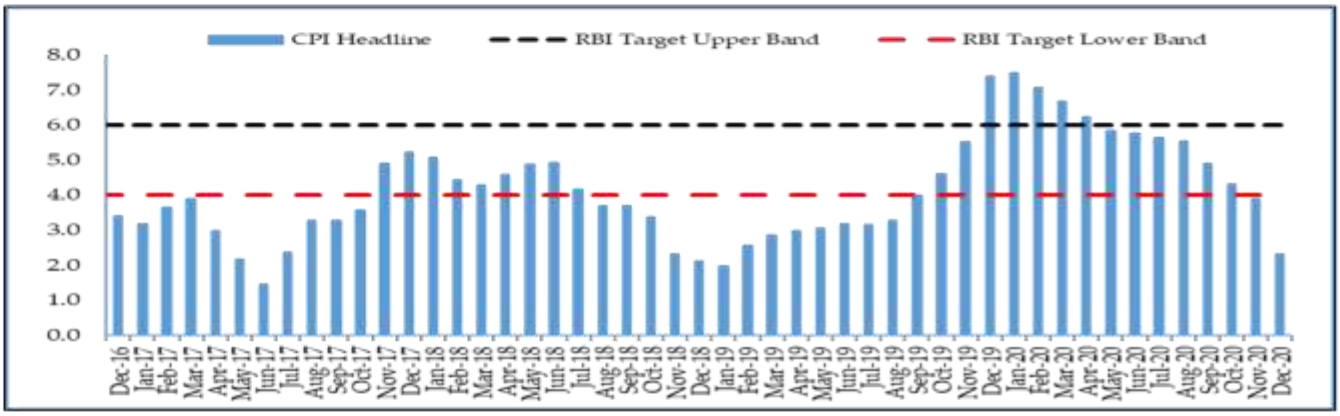
On liquidity, we expect the RBI to keep liquidity in surplus over the coming months. In our opinion, the excess liquidity in the system, along with the announcement of the LTROs, could make it difficult to justify any plain vanilla OMOs (unsterilized) and reduce the possibility of the same.

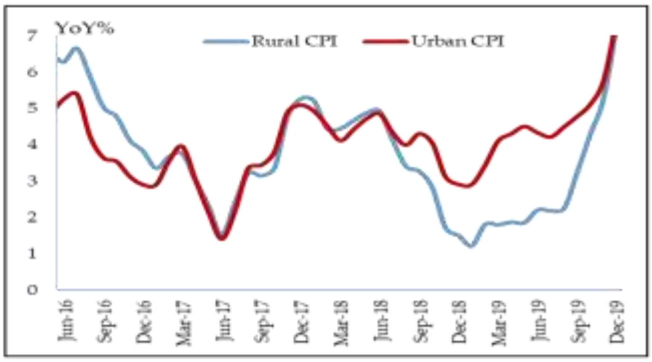
The bond market reacted positively to today's announcement and the 10 year gained by 5 bps, trading at 6.458% at the time of writing (from yesterday's close of 6.505%). The short-end of the curve recorded a bigger rally with bonds maturing upto 5 years seeing a 15 bps fall in their yields with the announcement of the LTROs. In the short-run, as higher inflation prints in Q4 FY20 are more or less baked in, oil prices are likely to remain contained, and the government borrowing program has been in line with market expectations, the case for a range bound movement in yields – tilted downward – seems likely.

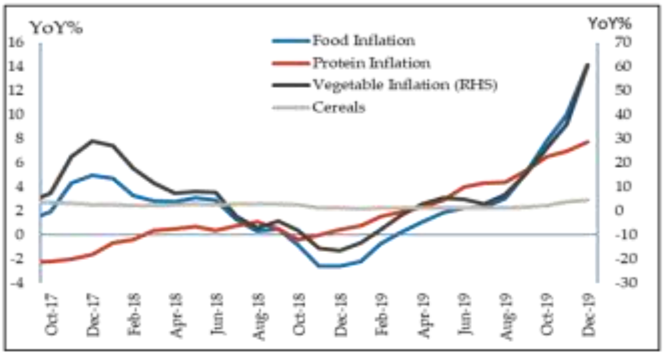
The Specifics:

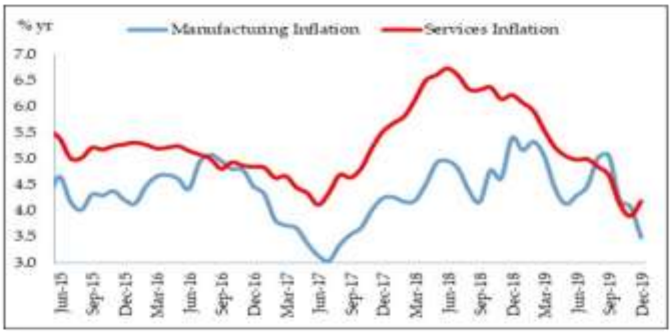
- **Growth and Inflation View:** The RBI revised down its growth projections for H1 FY21 (by 35bps) to 5.5%-6.0% while revising up its inflation projections for Q4 (to 6.5%) and H1 FY21 (to 5.0-5.4%). We expect growth to come in at 5.8% in H1 FY21 and inflation to come in at 5.5% by the end of H1 FY21. In the second half of the year, we expect inflation readings to fall sharply to 2.3% by December 2020.
- **Tweaks to the Liquidity Management Framework:** The RBI removed the daily fixed repo and four 14-day repos conducted every fortnight. Instead, the variable 14-day repo/reverse repo would be the main liquidity management tool.
- **Introducing LTROs (Long Term Repo Operations) to improve transmission and supplying durable liquidity:** The RBI shall conduct term repos of one-year and three-year tenors of appropriate sizes for up to a total amount of Rs 1,00,000 crore at the policy repo rate.
- **Other Measures to support growth:**
  - **CRR relief to boost credit flow:** Commercial banks will be allowed to deduct the equivalent of incremental credit disbursed by them as retail loans for auto, residential housing and loans to micro, small and medium enterprises from their NDTL for maintenance of cash reserve ratio (CRR).
  - **External benchmarking for Medium enterprises to improve transmission:** RBI decided to link pricing of loans, by scheduled commercial banks, for the medium enterprises to an external benchmark effective April 1, 2020.
  - **Relief for real estate sector:** RBI permitted the extension of date of commencement of project loans for commercial real estate, delayed for reasons beyond the control of promoters, by another year without downgrading the asset classification. This could help improve last mile funding for real estate projects.

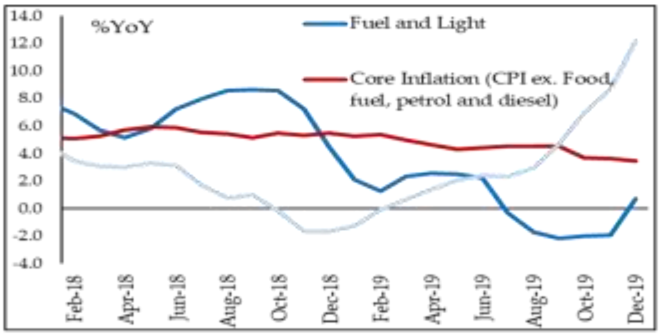
	What changed between two meetings?	
	Dec-19 meeting	Feb-20 meeting
GDP Growth	FY20: 5.0%, 2 H FY20: 4.9-5.5% H1 FY21: 5.9-6.3%	H1 FY21: 5.5-6.0% Q3 FY21: 6.2%
CPI Inflation	H2 FY20: 4.7-5.1% H1 FY21: 3.8-4.0%	Q4 FY20: 6.5 H1 FY21: 5.0-5.4%, Q3 FY21: 3.2%
Risks	Broadly Balanced	Broadly Balanced

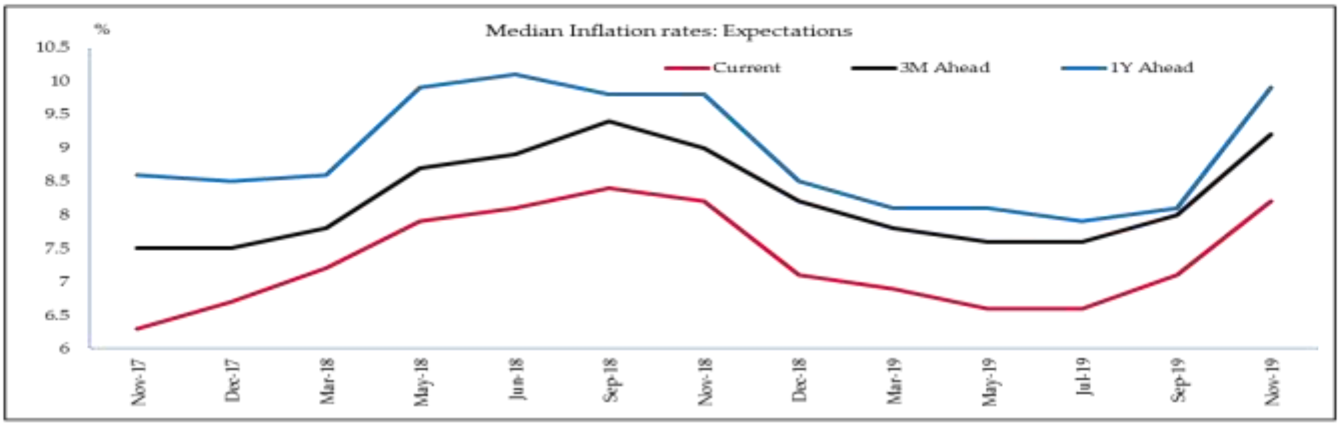


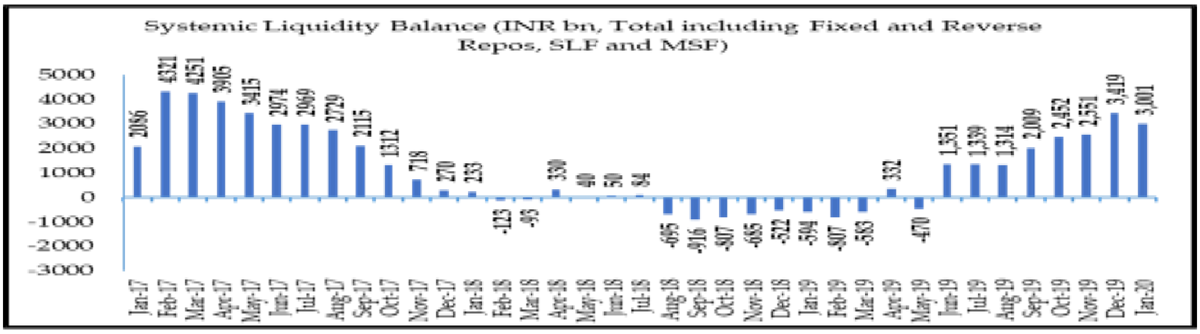






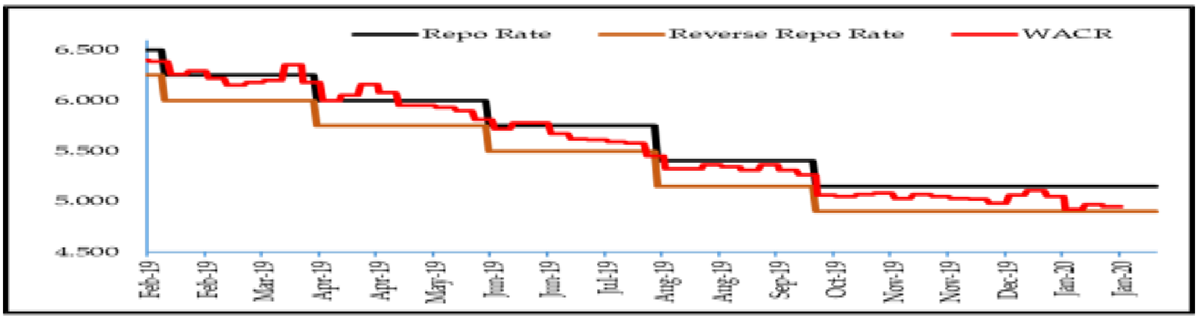


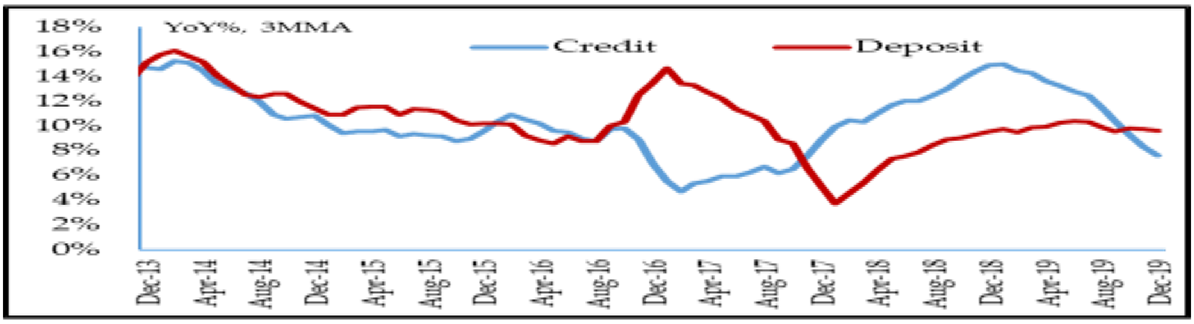


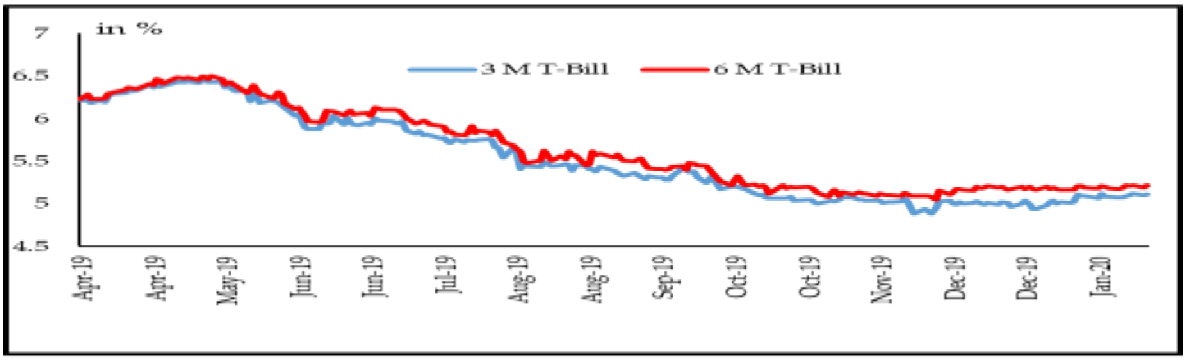


	Transmission (Feb19-Jan 20) (bps)
Repo rate	-135
CPs (average of low, high)	-190
5 yr G-sec (avg)	-73
10 yr G-sec (avg)	-76
MCLR (1 year)	-55
WALR (Fresh loans)	-69
WALR (Outstanding loans)	-13

WALRs of domestic banks on fresh rupee loans	Transmission (Oct-Dec 2019) (bps)
Housing loans	-18
Vehicle loans	-87
MSME loans	-23







Source: RBI, CEIC, Reuters, and HDFC Bank

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