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Rate cuts to resume in Q1FY21

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RBI kept repo rate on hold as it revised its inflation trajectory upwards to 4.9% in H2FY20 from 3.6% in Oct'19. Inflation is likely to be within target range in Q2FY21. While growth is expected to pick-up from 5% in FY20 to 6.1% in H1FY21, it is still well below potential. Hence, we believe rate cut cycle is likely to resume in Q1FY21. In the interim, surplus liquidity conditions and anticipation of more rate cuts will ensure faster transmission. A change in fiscal stance or geo-political events driving oil prices are key risks to our view.

KEY HIGHLIGHTS

- Inflation forecast revised upward by 130bps in H2FY20 ta 4.9%
- GDP growth forecast for FY20 revised downward to 5%
- Inflation concerns prompted status quo. Scope remains for 25bps rate cut in Q1FY21.

MPC holds rates on inflation concerns: Contrary to consensus and our forecast of a 25bps rate cut, MPC members kept repo rate unchanged at 5.15%. This was on the back of sharp jump in CPI inflation to 4.6% in Oct'19 and anticipated elevated trajectory in Q4FY20. For H2FY20, RBI has now revised its inflation forecast to 4.9% from 3.6% in Oct'19. Inflation expectations for 3-month and 1-year horizon have also risen by 120bps and 180bps respectively which seem to have restrained members from cutting rates now. As per RBI's revised guidance, CPI inflation is expected to fall below target only in Q2FY21.

FY20 growth revised to 5% from 6.1%: As expected RBI reduced its GDP forecast for FY20 by 110bps from Oct'19 to 5% now. Growth in H1FY21 is now expected at 6.1%. The up-tick in growth in FY21 is expected on the back of 1) transmission of earlier rate cuts, 2) economic measures announced by the government and 3) pick-up in rabi sowing with water reservoirs at 86% of capacity (61% last year). Credit and liquidity conditions in the real economy will also ease given the FDI/ FPI inflows this year and surplus liquidity in the banking system. Given the negative output gap, we expect RBI to cut rates again in Q1FY21 as growth remains well below potential in H1FY21 as well.

Rate cut guidance maintained: While all members unanimously voted for no change, the rate cut cycle will have to wait for inflation to be within the target range. At the same time, MPC members indicated that accommodative stance will continue as long as it is necessary to revive growth. Surplus liquidity and further rate cuts are important for transmission as 55% of deposits of SCBs are more than 1-year vintage. Hence, visible transmission is likely to happen from Feb'20, a year after beginning of rate cutting cycle. We see surplus liquidity conditions to drive faster transmission in H1FY21.

Regulatory announcements

- RBI has announced several measures to strengthen the Urban Co-operative Banks (UCBs). These include: 1) amendment in regulatory guidelines such as exposure norms for single and group/interconnected borrowers, promotion of financial inclusion, priority sector lending, 2) UCBs with assets above Rs 5bn would be brought under the Central Repository of Information on Large Credits (CRILC) reporting framework, 3) RBI also recommended a graded framework for cyber security for UCBs based on the type and scale of digital payment instruments offered by them.
- As a first step towards the development of secondary markets for corporate loans, RBI will facilitate setting up a self-regulatory body (SRB) which will standardise documents and practices related to secondary market transactions.
- RBI also released guidelines for 'On Tap' licensing for Small Finance Banks.
- With regard to hedging of foreign exchange risk, RBI has issued certain directions, such as: 1) For over the counter (OTC) currency derivative transaction upto US$ 10mn evidence for underlying exposure is not needed, 2) net gains on hedge transactions booked on anticipated exposures can be passed on by the banks in exceptional circumstances, 3) better safeguards so that complex derivatives are only to users which can manage the risk.
- RBI has also introduced a new bank account linked Prepaid Payment Instrument (PPI) with a spending limit of Rs 10,000 to be used only for digital payments.
- International Financial Service Centre Banking Units (IBUs) will be allowed to: 1) open foreign currency current accounts subject to restrictions under FEMA Act of 1999, 2) accept foreign currency deposits with a tenor of less than 1 year and has also removed the current restriction on premature withdrawal.
- The aggregate limits for an individual borrower across all P2P platforms has been raised from Rs 1mn to Rs 5mn. Further, RBI also proposed to do away with the requirement of escrow accounts to be operated by bank promoted trustee for transfer of funds to be necessarily opened with the concerned bank.

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