Central Bank Watch: Disappoints now (?) but promises more (!)

- *In line with our expectations, the RBI cut the repo rate by 25 bps to 5.15% and reduced the reverse repo to 4.9%*
- *Five MPC members voted for a 25 bps cut and 1 voted for a 40 bps cut*
- *The MPC recognised the slowdown in growth and revised its GDP growth forecast from 6.9% to 6.1% for FY20.*
- *Inflation estimate for H2 FY20 were kept unchanged (3.5-3.7%) while that for Q2 FY20 was raised to 3.4% from 3.1%.*
- *Given the tepid growth outlook and with inflation in all likelihood remaining low (our forecast of 3.5% for FY20), we see more room for rate cuts this year (25-40bps).*

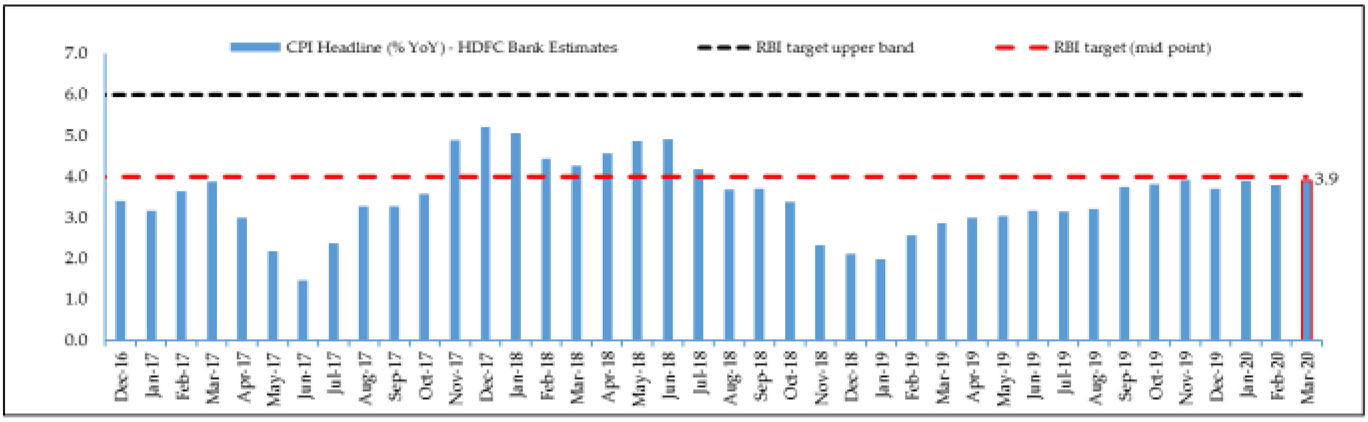
In today's policy announcement, the RBI cut the repo rate by 25bps, in line with our expectations. While markets were somewhat disappointed, as they were expecting a larger cut, the recent move needs to be seen cumulatively with the 110bps cut that the RBI has already delivered in this rate cut cycle. The RBI recognised the weak growth outlook and lowered its GDP estimate sharply to 6.1% in FY20 from 6.9% previously.

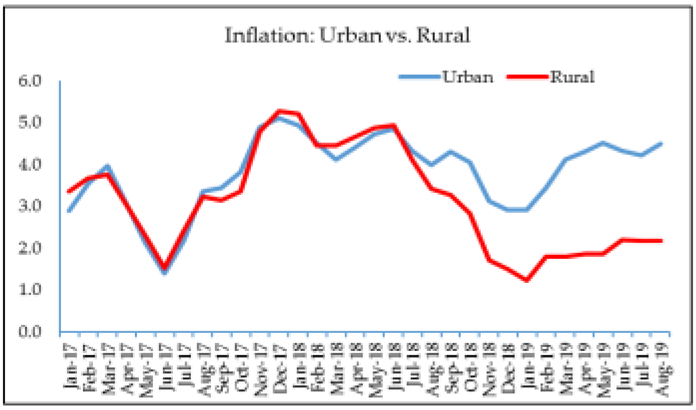
It clearly signalled its continued focus on reviving growth, implying that more rate cuts are in the offing. *The policy stated, "…MPC decided to continue with an accommodative stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target."* ***We expect 25-40bps more cuts in this fiscal.*** *The Taylor rule, which gives weightage to both growth and inflation targets (potential/desired), suggests that there is room for another 50bps cut to push growth higher without fuelling inflationary pressures.*

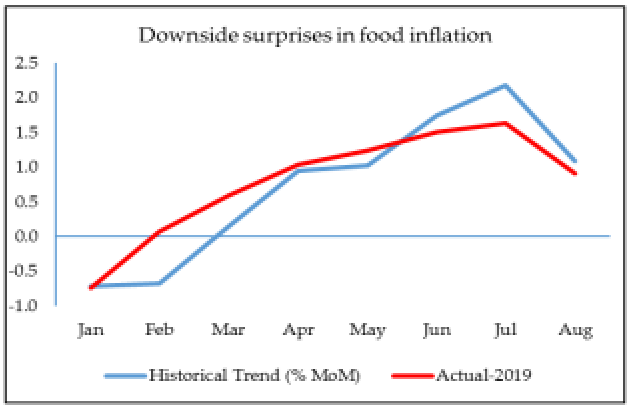
On liquidity, we expect the RBI to keep conditions in surplus in the remaining part of the year. *While the new liquidity framework suggests that liquidity would be kept in a slight deficit mode (of 0.25% -0.5% of NDTL) in stable conditions, the fact that the recommendations have also created headroom for keeping liquidity in surplus whenever "financial conditions warrant" gives the RBI an opportunity to keep liquidity in surplus. The RBI is likely to stress on transmission on the delivered policy rate cuts to ensure that growth improves visibly. This implies that we could see the current surplus liquidity regime continuing. We are not convinced that the RBI will prefer other infusion options to the OMOs (as some sections of the market expect).* ***In this "whatever works" mode of policy making, we expect the central bank to align itself with the markets preference for liquidity infusion instruments.***

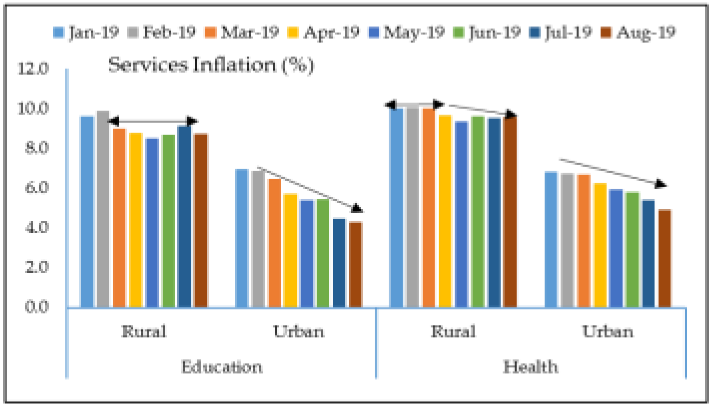
The bond market reaction was rather muted post the policy, with the current 10-year yield rising by 4bps. Going forward, fiscal borrowing pressures (chance of additional borrowing announcement in Q4 FY20) could put pressure on yields. On the upside, further RBI rate cuts, surplus liquidity in the system along with a chances of OMOs could keep yields supported. ***We expect the 10-year yield to trade in a band of +/- 10bps of the rate at which the new 10-year paper is issued at today.***

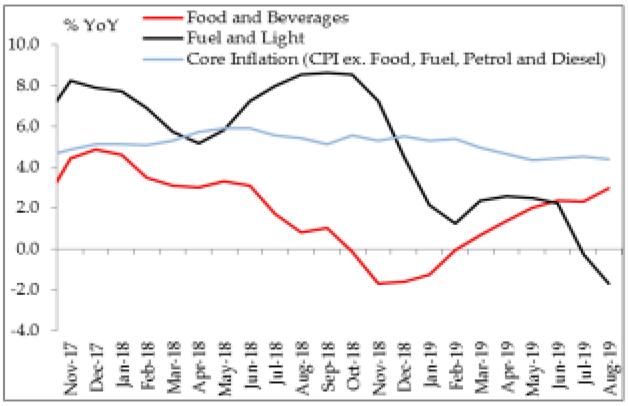
Inflation Dynamics

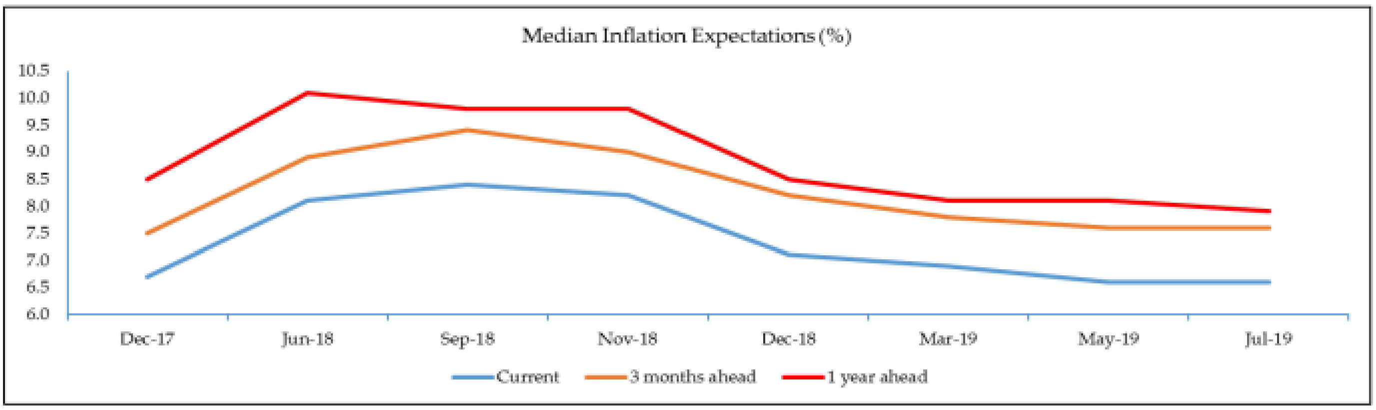






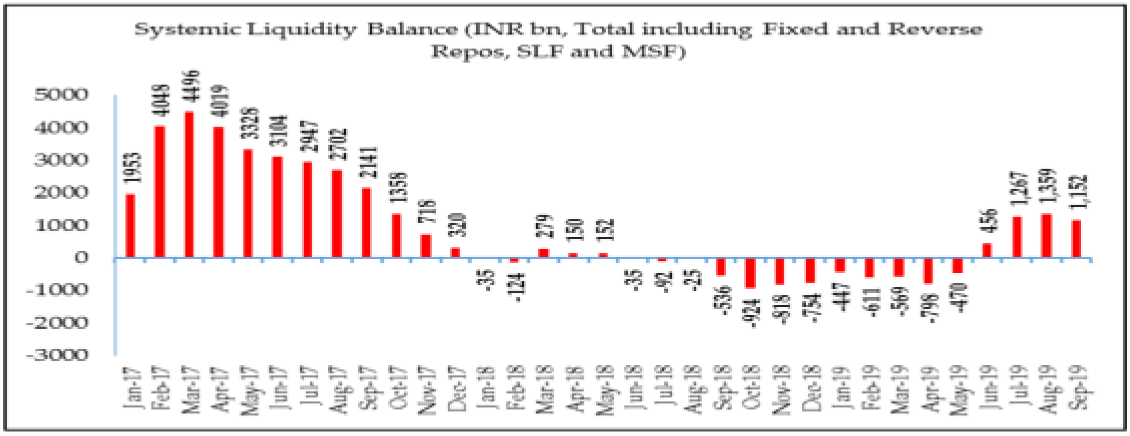






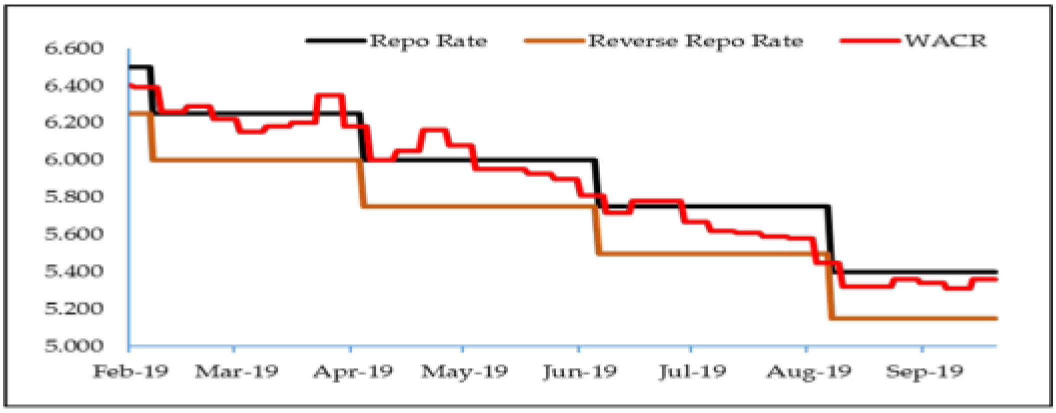
Source: RBI, CEIC, Reuters, and HDFC Bank

Rate Dynamics



Transmission of Rate cuts

%	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Transmission (Jan-Sep) (bps)
Repo rate	6.5	6.3	6.3	6.0	6.0	5.8	5.8	5.4	5.4	-110
CPs (average of low, high)	9.2	9.5	8.9	9.1	9.9	9.1	9.8	9.4	7.6	-162
CBs (AAA, average yield)	8.5	8.7	8.6	8.6	8.6	8.3	8.3	8.1	8.2	-39
10 yr G-sec (avg)	7.3	7.4	7.4	7.4	7.3	6.9	6.5	6.5	6.7	-63
MCLR (SBI)	8.6	8.6	8.6	8.5	8.5	8.5	8.4	8.3	8.1	-45
Term deposit (>1 yr)	6.9	6.9	6.9	6.9	6.9	6.8	6.8	6.7	6.6	-25
3-Month Tbill	6.6	6.4	6.3	6.3	6.3	6.0	5.8	5.5	5.3	-126
6 Month T-Bill	6.7	6.5	6.4	6.3	6.4	6.1	5.9	5.6	5.5	-126



Source: RBI, CEIC, Reuters, and HDFC Bank

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