# ECOWRAP

भारतीय स्टेट बैंक
STATE BANK OF INDIA

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## JUDICIOUS RBI POLICY COMMUNICATION BUT GROWTH CONSIDERATIONS NOW WEIGH

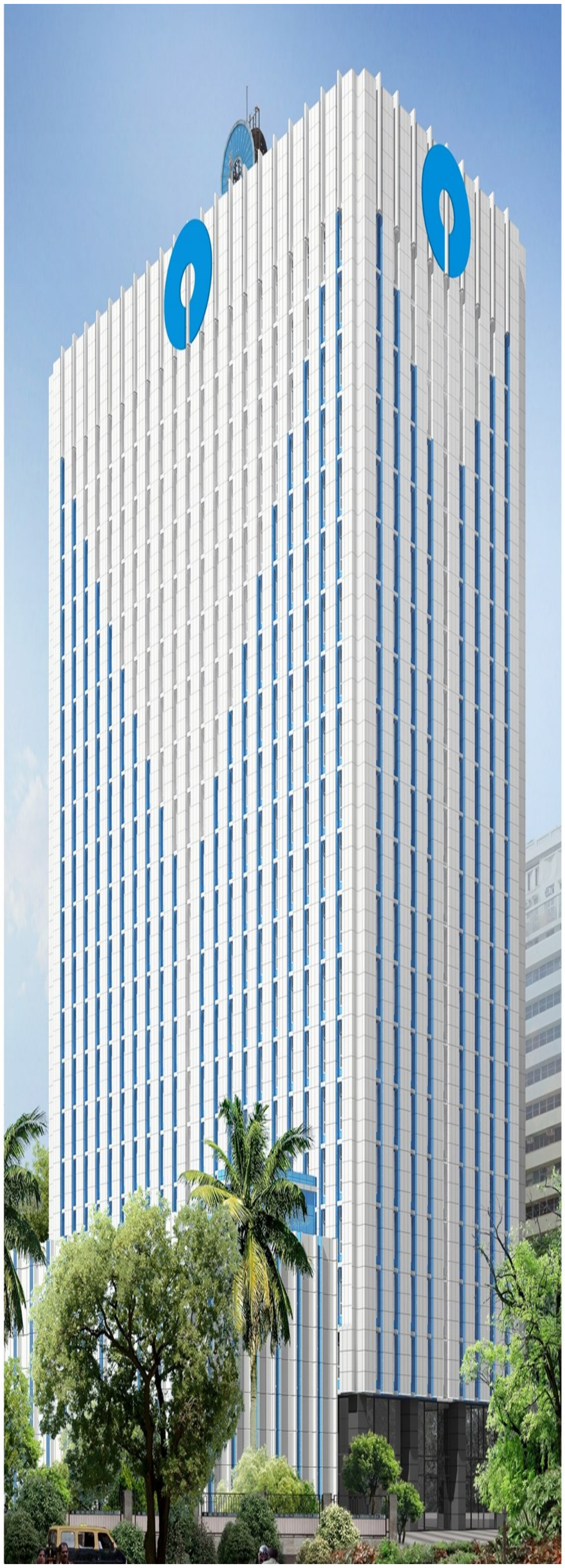
One of the most defining moments of the RBI policy announcement today was the clear and effervescent communication in guiding the market in the post policy interaction. In post policy media interaction the RBI statement of continuing to provide market of durable liquidity was grossly reassuring. The decision to provide information on CRR balance on a real time basis will clearly address the problem of signal extraction for the market participants.

We however believe that with global growth becoming uncertain and domestic growth considerations slowly taking center stage, a depiction of uncertainty should form part of the policy statement. For example, in the UK monetary policy report fan charts of GDP and CPI are accompanied by quarterly probability density charts. We believe RBI should provide the quarterly probability density charts for better understanding of CPI and GDP projections and revisions.

RBI has now mandated banks to benchmark all new floating rate personal/retail loans from April 1, 2019 to an external benchmark. Such a move could imply a regime change in interest rate structure in India with a switchover to a real time flexible system. However, such a move may also imply a floating interest rate structure of deposits, otherwise there would be significant ALM mismatch for the banks. In a developing country like India that has limited social security system in place, this could be self-defeating.

The steps on the developmental front by RBI are largely positive. The reduction in SLR effectively could have been only 1.5% (LCR of 100% on January 19 requires 18% of NDTL). Nevertheless, this will send a positive signal for the markets and bond yields as it will release around Rs 1.5 lakh crore of incremental liquidity. This also means that LCR and SLR cannot coexist, as hypothetically SLR cannot be reduced ever to lower than 18% (a *sine qua non* of Public Debt Management Agency coming into existence). We believe 10 year yields could drift down to 7.3%, if not lower.

On the global front, the sudden inversion of US yield curve in 3-5 year segment has sparked concerns on recession in 2019-2020. The Fed estimates of the probability of recession in next 12 months based on spread between the 3-month and 10-year treasury is close to 9% now and is expected to rise to 14% by end-2019. Clearly, we are in for an extended pause in repo rates. A change in stance is most likely in Feb 2019 policy and if headline inflation remains stuck at this sub 4% levels till Q2FY20, growth numbers could be the next casualty. RBI survey released today indicates that the one year ahead perception of current economic situation is at a 6 month low, whereas inflation expectations is at a 23 month low! And if this trajectory holds true, a rate action is not ruled out!



## RBI KEEP REPO RATE UNCHANGED AT 6.50%

| RBI Growth & Inflation Outlook for India | | | | |
|---|---|---|---|---|
| CPI Inflation (%) | Q3 FY19 | Q4 FY19 | Q1 FY20 | Q2 FY20 |
| Dec'18 (5th Bi-monthly) | 2.8 | 3.2 | 3.8 | 4.2 |
| Oct'18 (4th Bi-monthly) | 4.0 | 4.5 | 4.8 | - |
| Aug'18 (3rd Bi-monthly) | 4.7 | 4.8 | 5.0 | - |
| Jun'18 (2nd Bi-monthly) | 4.7 | 4.7 | - | - |
| Apr'18 (1st Bi-monthly) | 4.6 | 4.4 | - | - |
| Real GDP Growth (%) | Q3 FY19 | Q4 FY19 | Q1 FY20 | |
| Dec'18 (5th Bi-monthly) | 7.1 | 7.0 | 7.0 | 7.2 |
| Oct'18 (4th Bi-monthly) | 7.3 | 7.2 | 7.4 | - |
| Aug'18 (3rd Bi-monthly) | 7.6 | 7.3 | 7.5 | - |
| Jun'18 (2nd Bi-monthly) | 7.2 | 7.3 | - | - |
| Apr'18 (1st Bi-monthly) | 7.2 | 7.5 | - | - |
| Source: RBI, SBI Research | | | | |

- As widely expected, the Monetary Policy Committee (MPC) decided to keep Repo rate unchanged at 6.50% by 6-0 vote maintained the stance of calibrated tightening. While one of the MPC member voted to change the stance to neutral.
- RBI has significantly revised its CPI inflation projections for H2 FY19. CPI inflation is projected at 2.7-3.2% in H2 FY19 (earlier 3.8-4.5%) and 3.8-4.2% in H1 FY20, we believe that CPI projections of RBI (based on the fan chart) are grossly off the mark (at least by 100 bps). During FY18, actual CPI was on an average 112 bps lower than the RBI projections.
- Though GDP growth has plunged to 7.1% in Q2 FY19 compared to 8.2% growth in Q1, RBI has still retained the real GDP growth projection at 7.4% for FY19 with H2 GDP growth would be in the range of 7.2-7.3%. We believe RBI's projections are overstated and GDP growth in H2FY19 would be lower than 7%.
- If we look into the credit growth of the scheduled commercial banks, the total number this year has been around Rs 3.3 trillion expansion, out of which Rs 2 trillion happened in September. This number has declined to Rs 30,000 crore in October. That means the total incremental credit expansion in the month of October for all scheduled commercial banks is 15% of that what happened in September. Evidences suggest that possibly the growth slowdown has come a little earlier than anticipated, and our sense is that we could be in for some amount of moderation with the Q3 and Q4 numbers.
- Fan charts depict the estimate of the confidential interval, the width of which represents the size of the risk estimate in the forecast. The confidential interval is derived from the density function (probability distribution). In the UK monetary policy report fan charts of GDP and CPI inflation is accompanied by quarterly probability density charts but in our reports only fan charts are provided. We believe that RBI should provide the quarterly probability density charts for better understanding of CPI and GDP projections.
- However, the RBI communication in post policy media interaction of providing market of continuing to provide durable liquidity was grossly reassuring. The decision to provide information on CRR balance on a real time basis will address the problem of signal extraction. In principle, central banks across the world have superior information on all supply parameters of liquidity. However, the actions of the central bank both through market operations and media interactions, may in itself reveal part of its superior information set to market participants, which creates a *signal extraction problem.* For the central bank, a potential way out of this problem is to publish the liquidity data., and this is possibly the first step in the direction.

## DEVELOPMENTAL AND REGULATORY POLICIES

**External Benchmarking of New Floating Rate Loans by Banks**

- RBI has mandated that banks are needed to benchmark all new floating rate personal/retail loans (housing, auto, etc.) and floating rate loans to Micro and Small Enterprises from April 1, 2019 shall be benchmarked to one of the external benchmark: (i) RBI's policy Repo rate; (ii) 91/182-days T-bills yield; or (iii) any other benchmark market interest rate produced by the Financial Benchmarks India Private Ltd (FBIL). RBI will issue the final guidelines by the end of Dec'18. However, RBI left it to the individual bank to decide the spread over the benchmark rate, which would remain constant through the life of the loan.
- Such a move could imply a regime change in interest rate structure in India with a switchover to a real time flexible system. However, such a move may also imply a floating interest rate structure of deposits, otherwise there would be significant ALM mismatch for the banks. In a developing country like India that has limited social security system in place, this could be self-defeating. In India, the banks largely fund themselves through retail deposits and only around 1% of the bank borrowings at the policy rate of 6%. Further, the share of public deposits has a preponderance of CASA (41% approximately) that is mostly interest rate agnostic in India with an average interest rate of around 3.5%. The rest are time deposits with a fixed interest rate for the duration of the deposit tenure. Thus, when say repo rate changes by 25 basis points, even under full transmission there could be at most a 15 basis point impact on deposit rates (25 bp*59% interest sensitive time deposits) and thereby on lending rates.

**Mandatory Loan Component in Working Capital Finance**

To promote greater credit discipline among the working capital borrowers (mostly large corporate borrowers), RBI will issue the final guidelines on 01 Apr'19, to stipulate a minimum level of 'loan component' in fund based working capital finance. This will help the banks in planning their asset liability management. Further, it will help the corporates as the interest rate burden will be reduced.

**Aligning Statutory Liquidity Ratio with LCR**

The reduction in SLR in a staggered basis was anticipated. In fact, the reduction in SLR effectively could have been only 1.5% (LCR of 100% on January 19 requires 18% of NDTL). Nevertheless, this will send a positive signal for the markets and bond yields as it will release around Rs 1.5 lakh crore of incremental liquidity. This also means that LCR and SLR cannot coexist, as hypothetically SLR cannot be reduced ever to lower than 18% (a *sine qua non* of Public Debt Management Agency coming into existence coming into existence),

**Access for Non-Residents to the IR Derivatives Market**

RBI proposal to permit the non-residents to hedge their rupee interest rate risk flexibly using any available IRD instrument will provide the much needed fillip to this sleeping market. Similarly, allowing the non-residents to participate in the Overnight Indexed Swap (OIS) market for non-hedging purposes, will add depth to this market. Once stabilized, the Rupee Derivative market is more likely to match the Forex Derivative market as far as volumes are concerned.

**Rationalisation of Borrowing and Lending Regulations under FEMA, 1999**

The proposed regulations which would be out by Dec'18, would rationalise the extant framework for external commercial borrowings and Rupee denominated bonds.

**Ombudsman Scheme for Digital Transactions**

RBI has outlined that there is an emerging need for a dedicated, cost-free and expeditious grievance redressal mechanism for strengthening consumer confidence in this channel. The Scheme will be notified by the end of January 2019.

**Framework for Limiting Customer Liability in respect of Unauthorised Electronic Payment Transactions involving Prepaid Payment Instruments**

To prevent fraud due to unauthorised electronic payment transactions involving prepaid payment instruments, RBI has issued instructions to both Banks and NBFC on limiting customer liability and decided to bring all customers up to the same level with regard to electronic transactions. We believe, the continuous effort from RBI to strengthen the Electronic platform will improve cyber security and boost customer confidence.

## CYCLICAL BEHAVIOUR OF LEADING INDICATORS AND EFFECTIVENESS OF MONETARY POLICY

- The deceleration of GDP in Q2 FY19 to 7.1 % from the previous eight quarter high of 8.2% in Q1 is primarily attributed to the negative growth in Mining and moderate growth in Steel, Natural Gas, Crude oil, Sale of Passenger Vehicle, Exports and Telecommunication etc. Interestingly, if we look at the cyclical behavior of above indicators during Apr'12 to Aug'18 and compare with the business cycle of GVA, all the above mentioned indicators used to have a lead length of more than 5 months on GVA except mining and Export. In other word, the value of indicators at time t, is expected to impact GVA at (t+5) months.

| Indicators who dragged GVA in Q2 FY19 | | | |
|---|---|---|---|
| Leading Indicators | Lead Length (in months) | Q2 FY18 (%) | Q2 FY19 (%) |
| Sale of Passenger Vechicle | 6 | 4.2 | -2.7 |
| Cargo Traffic_Airports | 9 | 14.5 | 7.3 |
| Crude Steel Production | 5 | 5.5 | 4.1 |
| IIP Mining | 0 | 7.2 | 1.0 |
| Number of Cellular Subscribers | 12 | 21.8 | 6.8 |
| Crude Oil: Production | 8 | -0.1 | -4.4 |
| Natural Gas | 10 | 2.8 | -2.0 |
| Exports | 3 | 12.5 | 10.5 |
| Source: SBI Research | | | |

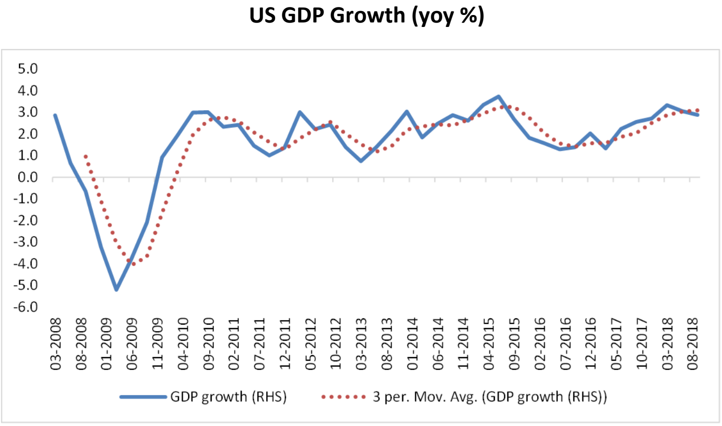
- But, the GVA figures in Q2 reveals a different story, which further explain that the lag between GVA and all these above indicators have shortened to less than 3 months from the previous lag of 5 months.
- Empirical studies highlighting that the Monetary policy transmission in India have a lag of 2 quarter or more on output and interest rate, so on policy front, with shortening of lead length in major leading indicators on GVA is suggesting that both monetary policy cycles are now shorter than earlier. This is an area of further debate.

## GLOBAL OUTLOOK

- The global economic outlook has been clouded by trade was for some time. The impact on this has now become visible fuelling concerns about a possible slowdown in the global growth. Among advanced economies (AEs), economic activity appears to be slowing in the US in Q4:2018, after a buoyant Q3. The Euro area growth lost pace in Q3. In China, growth slowed down on weak domestic demand. The ongoing trade tensions and the possible cooling of the housing market pose major risks to growth in China. It is possible that Euro zone along with UK may slow down due to less than perfect Brexit and other demand uncertainties. Thus 2019 and 2020 require caution on all counts.

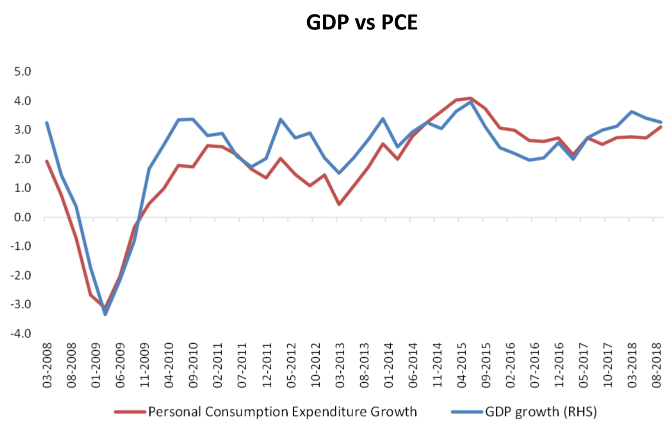
## US ECONOMY—IS IT HEADING TOWARDS RECESSION?

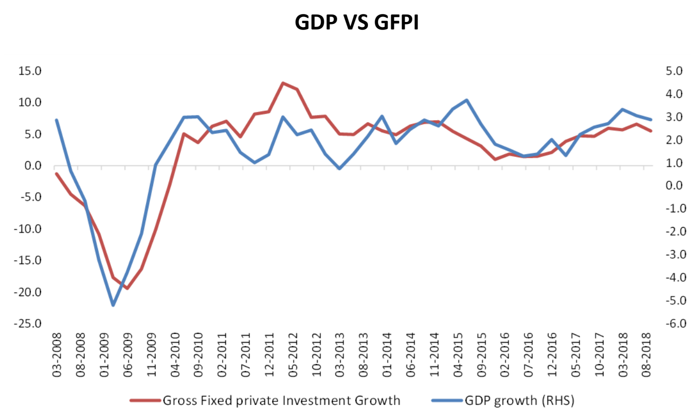
- The US economy has been experiencing a healthy growth with the latest quarter registering 3.5% QoQ, though lower than 4.2% in Q2. When the YoY growth is looked at, the economy has experienced two quarters of declining growth rate.
- Based on the past data from Mar'09, we tried to map the business cycle by looking at the period between two troughs. This shows that the length of the business cycle has increased. The latest cycle of increasing growth which started in Jun'16 peaked in Mar'18. However, with two quarters of declining growth the judgment is still divided whether the US has entered the slowdown mode. The 3-period moving average also indicates a flattish growth trend going ahead.




Source: SBI Research, CEIC

- Among other economic indicators, private consumption expenditure has been growing at more or less the same rate as GDP growth, meanwhile the gross fixed private investment is following GDP growth with a lag.
- With the Government debt as a percentage of nominal GDP already reaching 105.17% in 2017 vis-à-vis 72.72% of GDP in 2008, the Government does not have much room for fiscal stimulus should a recession like situation build up.
- The normalization of monetary policy by Federal Reserve and growing fiscal deficit in the US both have created a situation where doubts have been raised on the efficacy of fiscal deficit. The sudden inversion of US yield curve in 3-5 segment has sparked concerns on recession in 2019-2020. The Feds estimates of the probability of recession in next 12 months based on spread between the 3-month and 10-year treasury is close to 9% now and is expected to rise to 14% by end-2019.




Source: SBI Research, CEIC

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## ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

## DISCLAIMER



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