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FURTHER RATE CUTS LIKELY EVEN THOUGH EFFICACY OF SUCH IS QUESTIONABLE

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The growth considerations seriously weighed on MPC which decided to cut the repo rate fifth time in a row by 25 bps to 5.15%. MPC continues to maintain the accommodative stance of monetary policy. For FY20, RBI again cut its GDP growth forecast by 80 bps to 6.1% [5.3% in Q2 and H2: 6.6-7.2% (earlier7.3-7.5%)] owing to weakening of both domestic and external demand conditions. In the last four policies (including this) RBI cumulatively cut its growth forecast by 130 bps. GDP growth for Q1 FY21 is also revised downwards to 7.2% from 7.4% earlier. RBI has projected CPI inflation for Q2 FY20 at 3.4% (earlier: 3.1%) & 3.5-3.7% in H2 FY20. However, there are risks related to volatile crude oil prices, elevated vegetable prices and volatility in financial markets.

Even though RBI has clearly emphasized more rate cuts, the efficacy of such is questionable against an elevated household leverage, deteriorating company fundamentals (upgrade to downgrade ratio has now halved) and significantly weak demand. For example, total resource flow to commercial sector during Apr-Sep is now barely at Rs 90,000 crores (Rs 7.36 lakh crore last year), even as we are in the midst of an aggressive rate cutting cycle, indicating it is not helping. We also must ensure a fair and level playing field for our bank depositors vis-à-vis borrowers in terms of adequate real rate of returns in a country that has 41 million deposit accounts for senior citizens.

While the policy announcement was along expected lines, the development and regulatory policy measure covered a wide canvas. RBI decision to increase the household income limit for borrowers of NBFC-MFIs is a welcome move and will enhance the credit delivery to a larger customer base who are at the bottom of the pyramid. There is attempt to boost the domestic FX derivative market in light of the pickup in NDF activity in Indian rupee. RBI has decided to allow the domestic banks to offer foreign exchange prices to non-residents on 24 hour basis and this heralds a paradigm shift. More clarity is needed, going forward, to crystalize the KYC requirements for off-shore entities as also their tax implications. Furthermore, in consultation with the Government, RBI has enhanced the scope of non-interest bearing Non-resident Rupee Account (SNRR). Henceforth, persons resident outside India will be permitted to open SNRR accounts to facilitate Rupee denominated ECB, trade credit as well as trade invoicing.

Expanding and deepening of payment systems has received considerable thought. The RBI will now extend the collateralised liquidity support, which is currently available till 7.45 pm on NEFT working days, round the clock. It has decided to institutionalise an internal ombudsman scheme at the large non-bank PPI issuers (entities who have more than 10 million pre-paid payment instruments outstanding). RBI has decided to create an 'Acceptance Development Fund' (ADF) in consultation with the stakeholders to ensure growth of acceptance digital payment infrastructure across the country, especially in Tier III to Tier VI centres.

While we remain concerned more about state finances now, we are convinced that rate cuts are just palliative. Echoing Lorenzo Bini Smaghi, former member of Executive Board of ECB, we believe that hard choices are delayed until external conditions make them inevitable. At that point, however, the situation becomes so dire that the cure must be even more drastic. The resulting austerity depresses economic activity and threatens political and social cohesion. With the debt levels in India under control, Government can still go for a counter cyclical fiscal push rather than hoping for rate cuts to revive the economy.

RBI REDUCES REPO RATE BY 25 BPS TO 5.15%

- The growth considerations weighed on MPC which decided to cut the Repo rate fifth time in a row by 25 bps to 5.15% and decided to maintain the accommodative stance of monetary policy. All the members voted for a rate cut.
- For FY20, RBI again cut its GDP growth forecast by whopping 80 bps to 6.1% [5.3% in Q2 and H2: 6.6-7.2% (earlier7.3-7.5%)] owing to weakening of both domestic and external demand conditions. In the last four policies (including this) RBI cut its growth forecast by 130 bps. GDP growth for Q1 FY21 is also revised downwards to 7.2% from 7.4% earlier.
- RBI has projected CPI inflation for Q2 FY20 at 3.4% (earlier: 3.1%) & 3.5-3.7% in H2 FY20. However there are risks related to volatile crude oil prices, elevated vegetable prices and volatility in financial markets.

COMMUNICATION IS IN POLICY ITSELF

- The unconventional rate cut of 35 bps in the last monetary policy did create confusion regarding this policy's magnitude of rate cut. Now this a welcome sign that RBI returns to its conventional rate cut of 25 bps. RBI has used communication as a policy in itself rather than the policy statement being the vehicle for communication. With the use of sentences like "*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*", RBI has clearly indicated rates are likely to be lower than what the market is expecting in the future with a benign inflation and adequate liquidity provisions. This is more akin to first-generation signals as done by the US Fed and the European Central Bank (ECB). We thus expect yields to decline even though it has temporarily jumped post policy announcement.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21
Oct'19 (4th Bi-monthly)	3.4	3.5	3.7	3.6
Aug'19 (3rd Bi-monthly)	3.1	3.5	3.7	3.6
Jun'19 (2nd Bi-monthly)	3.2	3.4	3.7	-
Apr'19 (1st Bi-monthly)	3.0	3.4	3.8	-
Real GDP Growth (%)	**Q2 FY20**	**Q3 FY20**	**Q4 FY20**	**Q1 FY21**
Oct'19 (4th Bi-monthly)	5.3	6.8	7.3	7.2
Aug'19 (3rd Bi-monthly)	6.6	7.4	7.6	7.4
Jun'19 (2nd Bi-monthly)	6.8	7.3	7.4	-
Apr'19 (1st Bi-monthly)	7.2	7.3	7.5	-

Source: RBI, SBI Research

Monetary Policy Committees and Voting Pattern

Month	Rate Cut	Magnitude	Stance	Full Consensus	Partial Consensus	Dissent
Oct'19	Yes (All members)	25 bps (5 members) & 40 bps (1 member)	Accommodative (All members)		Yes	
Aug'19	Yes (All members)	35 bps (4 members) & 25 bps (2 members)	Accommodative (All members)		Yes	
Jun'19	Yes (All members)	25 bps (All members)	Accommodative (All members)	Yes		
Apr'19	Yes (4 members)	25 bps (4 members) & no change (2 members)	Neutral (5 members) & Accommodative (1 member)			Yes
Feb'19	Yes (4 members)	25 bps (4 members) & no change (2 members)	Neutral (All members)			Yes
Dec'18	No (All Members)	-	Calibrated tightening (5 members) & Neutral(1 member)		Yes	
Oct'18	No (5 members)	No change (5 members) and 25 bps hike(1 member)	Calibrated tightening (5 members) & Neutral(1 member)			Yes

Source: SBI Research

GROWTH CONSIDERATIONS TAKE THE CENTRESTAGE

RATING UPGRADE TO DOWNGRADES RATIO HALVED

- Rating upgrade to downgrade ratio has deteriorated to 0.41 in H1FY20 from 0.85 in H1FY19. Data taken for all rating agencies shows there are 3853 downgrades in H1FY20 against 1584 upgrades as compared to 2324 downgrades against 1977 upgrades in H1FY19. The number of downgrades in H1FY20 grew by 66% vis-à-vis 20% de-growth for number of upgrades. The pace of downgrades has been increasing and hence explains the sharp fall in U/D ratio in H1FY20 versus H1FY19. It may be possible that same company is being rated by more than one rating agencies. However, the trend is the same across rating agencies, as can be seen from table.

RATE CUTS UNLIKELY TO HELP

- Interestingly, the financial flows to the commercial sector in H1FY20 are significantly lower than H1FY19 due to a decline in funding from banks and non-bank sources.
- Interestingly, in H1FY19 despite rising interest scenario, credit had expanded by Rs 1652 billion but contracted by Rs 937 billion in H1FY20. This indicates that credit risk aversion continues to play center stage, particularly for the NBFC sector. We must do a proper introspection for further reviving the NBFC sector.
- Notably, a new framework for ECB was announced in Jan'19 to improve the ease of doing business; subsequently, end-use provisions were also rationalized in July 2019.

RISE IN CURRENCY IN CIRCULATION (CIC) IN SEPTEMBER MIGHT INDICATE UNCERTAINTY

- September which usually sees a monthly decline in *CIC* saw an increase of Rs 97.65 billion this year, despite demand slowdown and low inflation rates. The falling interest rates and increased uncertainty about the returns from other financial instruments could be one of the reasons for increased demand for currency. States like Haryana, Jharkhand and Maharashtra are going to witness elections soon. This could also be one of the reasons for rise in CIC.

WILL WE BE WORRIED ABOUT FISCAL?: YES, BUT STATES!

OPTIMAL LEVEL OF GOVERNMENT BORROWING: STILL UNSETTLED

- In 2005 the Government of Japan did an extensive survey of this idea. This report concluded that: *"Generally, the size of government is expressed either as the amount of spending and burden or as the strength of government involvement in terms of regulation. In either case, when government becomes large, the effective distribution of resources by the economy as a whole will not be achieved, and economic activity is likely to be less vigorous than it is under a smaller government*. Hence the optimal size of the government expenditure is determined by its ability to undertake its various mandates such as redistribution, relief etc. subjected to fairness, intergenerational equity and overall impact on savings rate.

STATE BORROWINGS IS THE CULPRIT FOR ELEVATED YIELDS

- As per the State Finance report FY20 of the total fiscal deficit of states (Rs 5.52 lakh crore) 87.9% (Rs 4.86 lakh crore) will be financed through market borrowings. With Rs 6.24 lakh crore total gross borrowings for FY20 and Rs 2.25 lakh crore in H1 FY20 already done and Rs 1.7 lakh crore gross borrowing for Q3 as per the borrowing calendar, States are expected to borrow Rs 2.2 lakh crore in Q4.
- Such elevated level of state borrowings could indicate that markets are wary about the supply of g-secs in Q4FY20, even as Centre borrowings are to be as per market expectations.

Rating upgrades and downgrades in H1FY20 vis-à-vis H1FY19

Rating Agency	H1FY20			H1FY19		
	Upgrades	Downgrades	U/D Ratio	Upgrades	Downgrades	U/D Ratio
CRISIL	626	1275	0.49	756	641	1.18
CARE	290	1280	0.23	336	808	0.42
ICRA	196	472	0.42	345	252	1.37
Brickwork	239	738	0.32	280	420	0.67
All	1584	3853	0.41	1977	2324	0.85

Soure: CRISIL quantix; SBI Research; U/D - upgrade to downgrade

Flow of Funds to the Commercial Sector (Rs billion)

	H1FY19	H1FY20	Growth (%)
A. Flow from banks	1,851	-1,288	-170
1. Non-food credit	**1,652**	**-937**	**-157**
*of which credit to NBFCs**	-62	392	-
*credit to Industry**	-372	-1,206	-
2. Non-SLR investment by scbS	199	-351	-276
B. Flow from non-banks (B1+B2)	**5,510**	**2,198**	**-60**
B1. Domestic source	4,447	136	-97
1. Public issues by non-financial entities *	63	583	833
2. Gross private placement by non-financial entitie	474	625	32
3. Net issuance of CPs subscribed by non-banks	2,537	191	-92
4. Net credit by housing finance companies $	522	-60	-112
5. Total accommodation by 4 RBI regulated AIFIs	400	-48	-112
6. NBFCs-ND-SI and NBFCs-D (net of bank credit)	412	-1,256	-405
7. LIC's net investment ^	40	100	151
B2. Foreign sources	1,063	2,062	94
1. ECB /FCCB	-6.5	541	-
2. FDI to India^	1,070	1,521	42
C. Total flow from banks and non-banks (A+B)	**7,361**	**910**	**-88**
Memo			
Change in Repo Rate	+50 bps	-60 bps	-
Change in 1-Yr MCLR	+30 bps	-30 bps	-

Source: SBI Research, RBI $: Up to Jun ^: Up to Jul *: Up to Aug

M-o-M Incremental Currency in Circulation in September (Rs billion)

Year	Change in CIC
2010	38.2
2011	-75.8
2012	-79.4
2013	-10.9
2014	-44.4
2015	137.4
2016	-46.2
2017	232.6
2018	-23.9
2019	97.7

Source: SBI Research

DEVELOPMENTAL AND REGULATORY POLICY MEASURES

- ***Non-Banking Financial Company – Micro Finance Institution*** :Increase in the household income limit for borrowers of NBFC-MFIs from the current level of Rs 1.00 lakh for rural areas and Rs 1.60 lakh for urban/semi urban areas to Rs 1.25 lakh and Rs 2.00 lakh, respectively, is a welcome move and will enhance the credit delivery to a larger customer base who are at the bottom of the pyramid. Further, raising the lending limit from Rs 1.00 lakh to Rs 1.25 lakh per eligible borrower can boost the asset portfolio of the NBFC-MFI by Rs 100 billion, which is presently around Rs 400 billion.
- Based upon the recommendations of the **Task Force on Offshore Rupee Markets,** RBI has decided to allow the domestic banks to offer foreign exchange prices to non-residents on 24 hour basis, out of their own Indian books, either by a domestic sales team or through their overseas branches. This heralds a paradigm shift for the Indian Fx market. But till such time Indian banks are permitted to participate in the NDF market, it is very much doubtful how far they will be able to offer competitive rates post Indian market hours.

- Further, Rupee Derivatives have now been allowed to be traded in IFSCs (International Financial Service Centres). Here again, more clarity will be needed, going forward, to crystalize the KYC requirements for off-shore entities as also their tax implications. It is hoped these ambiguities will be done away with once the full recommendations of the Task Force are acted upon.
- In consultation with the Government, RBI has enhanced the scope of non-interest bearing Non-resident Rupee Account (SNRR). Henceforth, persons resident outside India will be permitted to open SNRR accounts to facilitate Rupee denominated ECB, trade credit as well as trade invoicing. Besides this, RBI has also done away with the tenure restriction of SNRR accounts from the existing 7 years to Nil.
- ***Liquidity Support for the Proposed 24x7 National Electronic Funds Transfer (NEFT) System*:** As communicated in the previous policy announcement, the NEFT has been made 24/7. As per the data, 2.3 bn NEFT transactions worth ₹227.93 lakh crore were recorded in 2018-19. The NEFT transactions have been on a rise and have recorded a rise in Jul'19 (21.94 crore) over the Jun'19 levels (19.91 crore). The NEFT system is based on Deferred Net Settlement basis and if the payments are more against receipts for a Bank, the collateral would be used for the balance payments. The modalities, therefore, need to be work out in terms of the collaterals & accounting of transactions.
- ***Payment System Data Dissemination*** *:* Decision to disseminate more granular information on payment data covering the payment systems authorised by the Reserve Bank will not only help in monitoring digital progress but also analysing and evaluating customer choice and preference which leads to better product and services and boost faster adoption of the digital world.
- ***Acceptance Development Fund (ADF):*** India is poised to be a digital economy and with the rapid growth in the issuance of cards, there is also a need to ensure growth of acceptance infrastructure across the country, especially in Tier III to Tier VI centres. Presently in India, there are more than 4000 debit cards per ATM. In order to increase digitisation in these areas, the decision to create an 'Acceptance Development Fund' (ADF) in consultation with the stakeholders is a much-needed move and will boost the digital penetration. The framework will be operationalised by December 2019.
- ***Expanding and Deepening of Digital Payments Ecosystem****:* In order to promote cashless payments, the Government kick-started the digital push in 2016, post demonetisation and as a result many banks went ahead and adopted villages and create awareness about digital payments. In the 2019 interim budget, the Government has announced to make one lakh villages into 'Digital Villages' over the next five years towards achieving the objective of 'Digital India'. With over 97 crore mobile connections, the digital push looks quite doable. By identifying one district each in the states/UTs, the RBI is supporting the objective of Government and going forward, we may even see a greater number of districts getting covered under this. The guidelines once issued will give more clarity on this.

MONETARY POLICY ALONE IS NOT SUFFICIENT TO SPUR DEMAND

- It is widely believed that higher Government borrowing takes up all household savings, thereby leaving less for the private sector investment. However, this is incorrect. The incremental claims of government borrowings on households have increased by only Rs 60,000 crores for the 2-year period ended FY17. During the same period, the move to incentivize household savings through increasing the ceiling of Section 80C resulted in an incremental Rs 1.8 lakh crore of household savings flowing into tax saving instruments.
- In fact household savings in India have been on a declining trend since 2010. Since FY12, the total gross savings (as % of GDP) had declined from by 4.1 percentage points to 30.5% in FY18. This decline was entirely contributed by decline in household sector savings (by 6.4 percentage points), which was mostly visible in physical savings of the households and only marginal decline in financial savings. During the same period the private corporate savings increased by 2.1 percentage points.
- Clearly in the current context only monetary policy rate cut would not work in isolation. It has to be complemented with fiscal expansion. Government can use counter-cyclical fiscal tool to boost saving as well as consumption. Abolition of capital gain tax, increase in section 80C or PPF limit to incentivise household savings, front-loading of Government expenditure say through PM-KISAN and MGNREGA are some of the measures will help in boosting demand. As an example, PM Kisan is now a significant laggard and it semms that the amount disbursed in current fiscal could be not even half of Rs 87,600 budgeted amount!
- **Echoing Lorenzo Bini Smaghi, former member of Executive Board of ECB,who had stated that hard choices are delayed until external conditions make them inevitable.** The emergency becomes the main driving force behind political action. At that point, however, the situation becomes so dire that the cure must be even more drastic. **The resulting austerity depresses economic activity and threatens political and social cohesion.**
- **With the debt levels in India under control, Government can still go for a counter cyclical fiscal push rather than hoping for rate cuts to revive the economy before the situation turns uncomfortable due to over-leveraging on the back of low interest rates.**

Card Infrastructure (July'19)	
Desccription	Number in Lakh
ATMs	2.1
PoS Terminals	42.5
Credit Cards	502.6
Debit Cards	8406.2
Source: RBI; SBI Research	

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