CIO Memo

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India: RBI pauses, cites inflation

Key take aways

- The RBI kept repo and reverse repo rates unchanged with qualitative measures announced that included debt restructuring for certain borrowers and an increase in loan to value for lending against gold.
- Market reaction was muted as the pause in the rate cut cycle did not come as a surprise and further no large liquidity measures were announced.
- As marginal utility of rate cuts diminish, flow of credit, rates transmission and fiscal measures assume greater importance to kick start growth in the economy.

1. What happened?

The Reserve Bank of India (RBI) kept repo and reverse repo rates unchanged in its monetary policy announcement today. It also retained the accommodative stance 'for as long as it is necessary'. This marks a pause after a 115 bps cut YTD to 4% and overall 250 bps in the current cycle.

Mentioning inflation several times in his speech, the RBI Governor did not give any guidance for inflation expectations for the year, merely stating that after remaining elevated until September, it is expected to ease in the second half of FY21. The CPI prints for April and May (undeclared) will be regarded as a break in the series. Though statistical data has been unavailable due to lockdowns, and current inflation levels seems to be more a function of supply side dislocations, a broad headline guidance would have served markets well.

Liquidity measures were conspicuous by their absence. Only a small incremental amount of INR 100 billion was allocated to NABARD and NHB for support to agriculture and housing sectors, through mortgage lenders and micro finance institutions. Loans against gold ornaments and jewellery have been granted increased margins up to 90%, against 75% earlier.

The most important announcement today came for restructuring of loans to small businesses, and sectors especially hit by Covid. With certain conditions (like accounts being standard at the beginning of 2020), this allows banks to reset loans without altering the asset classification of that account.

Details will be worked out under a new panel being constituted under KV Kamath, ex-Chairman of ICICI Bank. Personal loans will also be brought under this purview. This may kick the can on NPL's down the road a long way, but it provides borrowers a welcome window to recover lost business momentum without any rating downgrades.

2. How did markets react?

The 10 year G-Sec moved up by 4 bps, closing at 5.81%, while the shorter end of the curve barely moved as no large liquidity measures were announced. The Nifty Index was up 0.89% to close at 11200, while the sectoral Bank Nifty moved up less by 0.62%.

3. What does it mean for investors?

RBI's announcements today were underwhelming. With growth headed for negative territory in FY21 in their own guidance, more transmission and liquidity measures could have kept the momentum going. Though future cuts have not been ruled out ('space remains for further policy action but important to use it judiciously'), they may be enacted once inflation prints cool off. The market remains concerned at the increased Government (federal and state) borrowing program, and the means to fund it. Announcements from RBI for Open Market Operations and/or Operation Twist will be keenly watched for term premiums to contract.

As we had mentioned in the previous Memo ("India: Further monetary measures"), rate cuts now have diminishing marginal utility. Flow of credit, rates transmission and fiscal measures are more important to kick start growth in the economy. Our investment stance remains status quo, preferring high quality AAA and sovereign/quasi sovereign debt only.

Glossary

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Non-performing loans (NPLs) are loans for which the debtor has not made the scheduled payments.

A Non Banking Financial Company (NBFC) is a company engaged in the business of loans and advances, acquisition of shares, stock, bonds, hire-purchase insurance business, but does not include any institution whose principal business is that of agriculture, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of fixed property.

The NIFTY 50 is a benchmark Indian equity index representing the weighted average of 50 stocks over 12 sectors.

The Reserve Bank of India (RBI) is the central bank of India.

A Government Security (G-Sec) is a tradeable instrument issued by the Indian Central Government or the State Governments. It acknowledges the Government’s debt obligation.

The CPI (Consumer Price Index) measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation.

INR (Indian Rupee) is the official currency of India.

National Bank for Agriculture and Rural Development (NABARD) is a Government of India owned development finance institution with a mandate for providing and regulating credit for the promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas.

National Housing Bank (NHB) is a Government of India owned financial institution for housing and operate as the principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions.

AAA is the highest possible rating that may be assigned to an issuer's bonds by the domestic credit rating agencies. AAA-rated bonds have a high degree of creditworthiness because their issuers are easily able to meet financial commitments and have the lowest risk of default.

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