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PERCEPTIBLE GROWTH SLOWDOWN: DECISIVE WINDOW FOR MONETARY EASING IN EXCESS OF 25 BPS

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We expect GDP growth for Q4FY19 at 6.1%. GVA growth could be at 6% or slip marginally below 6% at 5.9%. FY19 GDP growth will be at 6.9%. The good thing is that we expect that the current slowdown could be transitory, if proper policies are adopted in interregnum. For example, the current high real interest rates are severely acting as an impediment to investment.

We are thus penciling a larger rate cut (35-50 bps) by RBI in the forthcoming policy. Interestingly, RBI for the first time could use the rate change in non multiples of 25 bps as a first step towards providing second generation signals to market of future policy stance. However even such larger rate cuts will not help fully, but its transmission will. To this end, the RBI should now ensure following things.

First, ensure that asset and liability side of the Banks move in tandem and ensure repo rate is directly benchmarked to external benchmark/non volatile bank liabilities /CASA that are mostly used for transaction purposes! Otherwise, we would continue to be constrained by lack of transmission, even as RBI will continue to cut rates. For example, since, 7 Feb'19 RBI has reduced the policy repo rate by 50 bps, while the median rate of all banks 1-year MCLR indicate a transmission of only 6 bps.

Second, ensure that liquidity is plentiful. With Government spending muted and significant currency leakage prior to elections has not helped either. We believe , post elections, capital flows will pick up materially and thus RBI will be able to recoup dollars and add to foreign exchange reserves and thus attendant domestic liquidity. In fact, since the exit polls and subsequent results, there has been inflow into the market of around Rs 4000 crores.

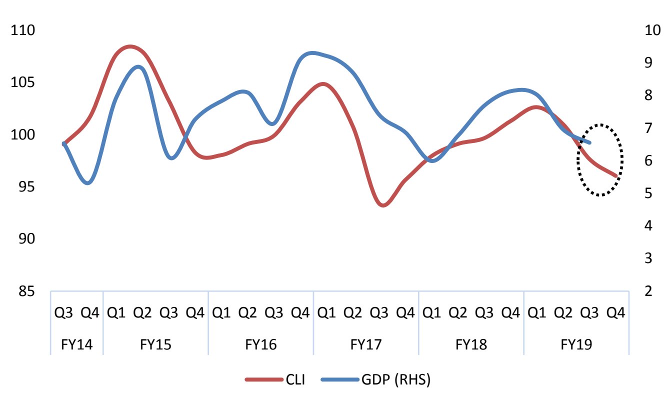
Third, a less likely but an potent weapon is to cut CRR/ merge CRR in LCR estimation, that could be more than a handful to the banks in immediate monetary transmission. A 1% CRR cut for example, could release Rs 1.28 lakh crores, reduce lending rate by 15 bps and improve profitability of banks Rs 12,000 crores annually!

Q4FY19 GDP IS EXPECTED TO SLOWDOWN

- Both the investment demand and consumption demand is showing signs of moderation as revealed by various leading indicators. The automobile sector is witnessing a decline in domestic sales, production and export growth. For passenger vehicles (PVs), domestic sales growth has declined to a mere 2.7% in FY19 compared to 7.9% in FY18. Meanwhile, their production growth eased to 0.1% from 5.8% in FY18. In case of CVs, production growth has increased to 24.2% in FY19 from 10.2% in FY18, however, sales growth has declined to 17.6% from 20% in FY18. Export growth of automobiles has also witnessed declining growth momentum from the past two years.
- FMCG sector is also showing lacklustre performance in recent quarters with deceleration in demand for consumer staples, such as biscuits, soaps, oil.
- The leading indicators, when grouped into rural and urban consumption, reveal a serious slowdown in both areas. Percentage of indicators of rural and urban consumption showing acceleration has fallen in recent months (50 in Jan'19 to 30 in Feb'19 in case of rural and 38 to 25 in case of urban consumption demand).
- Moreover, our Composite Leading Indicator (CLI) which has a one-quarter lead over non-agricultural GDP growth, is signaling a contraction in economic activity for Q4 FY19. The CLI Index (a basket of 32 leading indicators) is based on monthly data which shows the early signals of turning-points in economic activity. Based on the leading indicators yoy performance, we are expecting the GDP growth to be around 6.1%-6.2% in Q4 FY19. Among the Leading Indicators, the growth of PVs, Railway Traffic, Cargo traffic, Electricity Generation and Manufacture of Capital Goods are showing declining trend during the Q4 FY19.

Automobile Production growth (% yoy)					
Category	FY15	FY16	FY17	FY18	FY19
Passenger Vehicles	4.3	7.6	9.7	5.8	0.1
Commercial Vehicles	-0.1	12.7	3.0	10.5	24.2
Three Wheelers	14.3	-1.6	-16.1	30.4	24.1
Two Wheelers	9.5	1.8	5.9	16.2	5.8
Automobile Export growth (% yoy)					
Category	FY15	FY16	FY17	FY18	FY19
Passenger Vehicles	4.2	5.1	16.2	-1.4	-9.6
Commercial Vehicles	12.8	18.6	5.0	-10.5	3.2
Three Wheelers	15.3	-0.8	-32.8	40.1	49.0
Two Wheelers	17.9	1.0	-5.7	20.3	16.5
Source: SIAM, SBI Research					

Graph 1: CLI vis a-vis GDP



Source: SBI Research

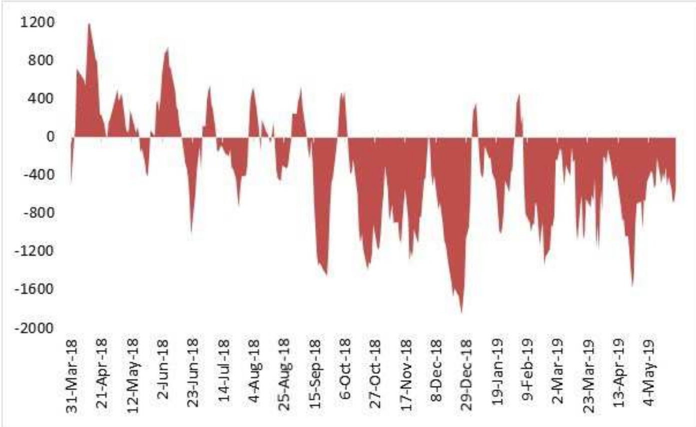
EXPECT RBI TO CUT RATES BY 35-50 BPS IN FORTHCOMING POLICY

- Against this backdrop of expected slowdown we expect the RBI to cut rates in forthcoming policy. However. RBI could use the rate change in non multiples of 25 bps in June policy as a first step towards providing second generation signals to market of future policy stance.
- This apart, the RBI should also ensure that adequate transmission is effected by banks. For example, since, 7 Feb'19 RBI has reduced the policy repo rate by 50 bps, while the median rate of all banks 1-year MCLR indicate a transmission of only 6 bps. Among the bank group wise, PSBs have reduced the maximum rate, while private banks have increased the median MCLR rate by 7 bps. So, RBI should now ensure that asset and liability side of the banks move in tandem and ensure repo rate is directly benchmarked to non volatile bank liabilities /CASA that are mostly used for transaction purposes! Otherwise, we would continue to be constrained by lack of transmission. Between Jul'18 and Apr'19 when RBI has reduced Repo rate by 50 bps almost all the banks increased their 1-year MCLR.
- The other option is to cut CRR / merge CRR in LCR estimation for an immediate impact on bank lending rate. In India, the CRR has remained unchanged at 4%, since Feb'13, though SLR has been reduced to 19%, from 23% in Feb'13. Banks are currently holding more than the required reserve requirements as part of their contingency mitigation plan. A CRR cut by 1% to 3%, which will effectively release durable liquidity of Rs 1,28,000 crore into the banking system without losing sight of monetary control.
- At the same time, CRR cut will also help in reducing lending rates and improve banks' profitability. In our estimate, if RBI reduces CRR by 1% then lending rates of the banks will change 12/15 bps. In addition, banks will be able to earn additional net interest income of Rs 12,000 crore annually on the released CRR funds, which will improve profitability and capital position of banks.

Bank Group Wise Median MCLR (1 Year)

in %	Jan-19	Apr-19	Change (in bps)
Public Sector Banks	8.75	8.65	-10
Private Sector Banks	9.30	9.38	7
Foreign Banks	8.65	8.62	-4
Scheduled Commercial Banks	**8.80**	**8.74**	**-6**
Memo:			
Repo Rate	6.50	6.00	-50
10-Year G-sec Yield (Avg)	7.37	7.39	2
Source: RBI; SBI Reseach			

Graph 2: System Liquidity Position (Rs Billion)



Source: SBI Research

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