To cut or not to cut: What to expect from the RBI on 29th September?

The market is expecting a reduction in the repo rate this time, and the discussion appears to be more on whether it would be 25 bps or a more aggressive 50 bps as inflation is low and there is urgency to revive growth with this view being reiterated by the government too.

However, if we go back to what was said in the last policy when rates were unchanged, a different line of thinking would emerge. The RBI was aware that CPI inflation had come down and that it would remain low in July and August. Further, there was uncertainty on the global environment with the Fed expected to increase rates. Also the RBI spoke of expectations in inflation being more important and that the monsoon, which began well, had to be monitored. Against this background, there is a strong case for status quo on interest rates in this policy.

1. While CPI inflation is less than 4%, there would be a tendency to increase from September onwards. The CPI index has shown an increase on a month on month basis. The table provides information on the CPI value for all the months starting March 2015. For September, it is assumed that the index moves up by 1 point, on a month on month basis. Such an increase would lead to an inflation of 4.7%.

Table1: Trend in CPI Inflation

Month	CPI	Change
March	120.2	5.3
April	120.7	4.9
May	121.6	5.0
June	123	5.4
July	123.7	3.8
August	124.7	3.7
Sept	125.7*	4.7*

*Source: MOSPI, * CARE forecast*

2. The Ministry of Agriculture has indicated in its First advance estimate that kharif output will be lower for most of the crops compared with the final numbers for 2014-15 even though these numbers are higher than the first advance estimates for 2014-15. Therefore, inflationary expectations on the food side remain a concern even though crude oil and other commodity prices remain benign.
3. The recent turbulence in the forex market due to the Yuan depreciation has made most currencies decline. Lowering rates at this point of time would be a deterrent for FPI which has been negative in the last 2 months.
4. Uncertainty regarding the Fed decision still persists and the market expects action to be taken in December. Interestingly, the Fed in its statement last week had mentioned global factors being a consideration for its action or inaction, unlike the past where focus was on inflation and unemployment.
5. The RBI has been talking of a slow transmission mechanism of rate cuts to base rates. Between the last policy and the present, the range of base rate for banks as presented in the WSS of RBI has moved very marginally from 9.75-10% to 9.7-10%. At March-end they were 10-10.25% (which was also the same in January before the first rate cut), which means that the rate cuts announced this year of 75 bps has lowered rates by only 25 bps so far.

Based on these factors there would be a case for the RBI not to touch interest rates this time. The markets have however thought otherwise and the GSec yields on 10 years have already come down by 10 bps in the last 2 weeks.

Liquidity Scenario

Liquidity appears to be fairly easy as reflected by the repo market where banks have been drawing less than the 0.25% of NDTL from this window. The positive outflows from the reverse repo window also reinforce this view.

Flow of funds to the corporate sector

There have been three sources of funding to the productive sectors.

a. **Bank credit**

Increase in bank non-food credit during the financial year so far until September 4, 2015 was Rs 1,575 bn as against Rs 1,124 bn during the same period of last year. While this does indicate an increase, the number is skewed on account of the sharp increase in the credit in the first fortnight of the new financial year, which is between March 20 (the reporting fortnight for considering bank credit for the year) and April 3rd. During this fortnight increase in credit was Rs 2,915 bn as against Rs 794 bn, with a large part attributable to the loans taken in the context of the spectrum sale. Since then, incremental credit has been in the negative zone.

On an average basis, the base rate reduction was from 10.125% to 9.85% - a decrease of 27.5 bps.

For the period April-July, the latest period for which sectoral credit information is available, change in credit to manufacturing and services was negative with only personal loans and agriculture being positive.

b. **Commercial paper market**

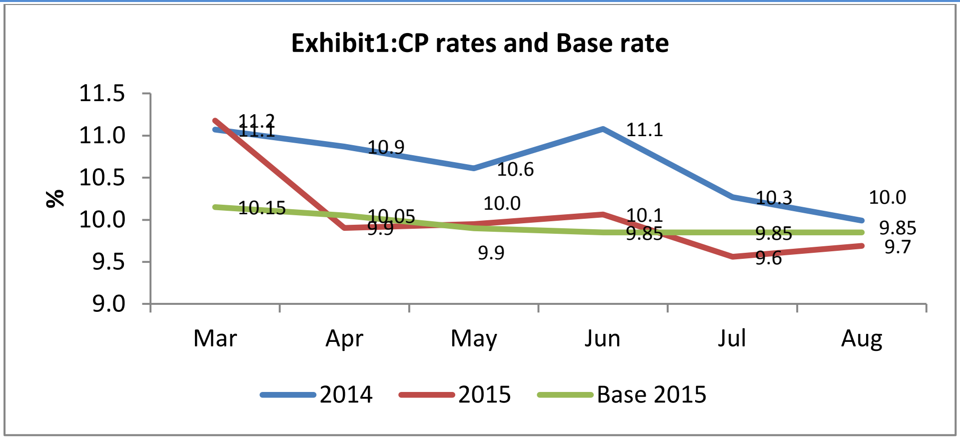
The commercial paper market has witnessed a more impressive growth during these 5 months. Between March end and August end of 2015, growth in CPs outstanding has been 60.1% from Rs 1,933 bn to Rs 3,095 bn. Therefore, there has been substitution between bank loans and CPs during this period, which is a feature that was observed last year too.

The CP market has also been quick to react to the RBI policy rates and the table and graph below provides information on the CP market during the last 2 years for the period, April-August.

Table 2: Issuance of Commercial Paper

	Amount issued (Rs bn)
April-Aug 2014	4,320.8
April- Aug 2015	6,361.0

Source: RBI



Note: Base rate in 2014 was at 10.15% through the period.

The graph above shows that the average CP rate displayed different directions in movement this year relative to the average base rate. In July and August the CP was lower than the base rate with the differential being between 15-25 bps. However, this should be interpreted with caution as the rates are fine for companies and the tenure and credit rating does matter.

c. Corporate debt market

During the first 5 months of the year, overall debt raised in the market increased from Rs 1.07 lkh crore in 2014 to Rs 1.63 lkh crore in 2015. While this is an impressive increase, the amount is tilted still towards the financial sector which accounts for nearly 78% of total issuances.

	Non-financial	*Manufacturing*	*Electricity*	*Services*	*Construction*	*Mining*	**Financial**
2014	23.5	*3.2*	*3.0*	*9.4*	*7.8*	*0*	76.5
2015	21.8	*6.0*	*5.2*	*4.6*	*4.7*	*1.3*	78.2

Source: CMIE

What to expect then?

- With liquidity being adequate with no pressure on funds, there would not be a case for a cut in CRR or SLR.
- On repo rate cut, on balance it would be a tough call. Based on the rationale used in the last policy for not cutting rates, there is a case for status quo.
- The growth conditions have been at best stable, and given that the busy season is to begin, there is a case for lowering rates which should get reflected in the capital market if not the bank lending rates.
- A call on GDP growth estimate revision may be expected. CARE's forecast still stands at 7.8% with a lower bias given the adverse kharif crop expected this year.

- While there are expectations of RBI also changing the inflation target from 4% (plus minus) 2%, we do not expect the same as we believe that the inflation rate will not remain below 4% for long and will move towards the 5% mark in the next two months.

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