

Insights – Monetary Policy Review

MPC promptly addresses the deteriorating economic conditions with significant rate reductions; expands regulatory measures to complement and strengthen the monetary measures

May 22, 2020

In the backdrop of severity of economic challenges triggered by Covid-19 pandemic, the Monetary Policy Committee (MPC) in its off-cycle meeting, responded with the set of conventional and unconventional measures. Akin to the previous policy action in March, today's rate action follows up the recent economic stimulus of Rs. 20 lakh crores unveiled by the government in five tranches.

Since the outbreak of the Covid-19, time and again, RBI has intervened on the monetary side by reducing the repo rates & reverse repo rates and infusing tons of surplus liquidity into the banks. In less than two months, RBI has reduced repo rate by 115 bps (in two tranches of 75 bps and 40 bps in each policy review) taking repo rate to 4%, whereas reverse repo rate has been reduced by 155 bps to 3.35%. The quantum and series of rate cuts in such a short span of time underscores our belief of the need to have lower interest rates. We have been highlighting through our communications that, 'level of interest rate needed to get an economy out of a lockdown situation is going to be much lower than it ordinarily would have been'. The measures undertaken by MPC are positive and supports our view of benign interest rate environment for a considerably long period given that world over economies are heading into recession.

The six-member MPC unanimously voted for reducing the repo rate and maintaining the policy stance to accommodative as long as it is necessary to revive growth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target. However, one member voted to reduce the repo rate by 25bps.

Not only that, MPC has acknowledged that pandemic has turned out to be severe than initially anticipated and macroeconomic & financial conditions remain grim. Consequently, it has re-iterated its commitment to remain vigilant and to further use all the available conventional as well as un-conventional tools to address the dynamics of unknown future. This opens up the possibility of further rate reductions if required. We also expect other measures to enable transmission of lower rates.

Key policy actions undertaken in today's monetary policy review are:

- The policy repo rate under the liquidity adjustment facility (LAF) has been reduced by 40 basis points to 4.00% from 4.40%. **This is the lowest repo rate in last 20 years**
- The **reverse repo rate under the LAF has been reduced by 40 basis points from 3.75% to 3.35%.**
- The **marginal standing facility (MSF) rate and the Bank Rate has been reduced to 4.25% from 4.65%.**

Even as monetary policy actions remained supportive, MPC's assessment of growth outlook made markets jittery. **The RBI governor in his statement cited concerns with regard to the economic growth in the near term and estimated it to remain in negative territory in 2020-21, with some pick-up in growth impulses from H2 2020-21 onwards.**

With regard to the headline inflation, MPC said that outlook remains highly uncertain. The headline inflation may remain firm in the first half of 2020-21, but should ease in the second half, aided also by favorable base effect. By Q3 and Q4 of FY 20-21, it expected inflation to fall below the target. However, the policy statement highlighted that the MPC's forward guidance on inflation is directional rather than in terms of levels.

In this scenario, when demand has collapsed and financial stress is imminent, RBI has continued to infuse liquidity into the banks, in order to alleviate the distress within the economy due to the lockdowns. Consequently, the systemic liquidity remained in abundance, with average daily net absorptions under the LAF increasing to Rs. 5.66 lakh crores in May 2020 (up to May 20) from Rs. 4.75 lakh crores in April. During 2020-21 (up to May 20), Rs. 1.20 lakh crores were injected through open market operation (OMO) purchases and Rs. 87,891 crores through three targeted long-term repo operation (TLTRO) auctions and one TLTRO 2.0 auction. Led by easy liquidity, monetary policy transmission to banks' leading rates improved and was also reflected in the bond yields.

Besides, the RBI announced a slew of regulatory measures to complement and strengthen the monetary measures. The measures were bucketed in four categories- 1. To improve the functioning of markets and market participants 2. To support exports and imports 3. To ease financial stress by providing relief on debt servicing and improving access to working capital 4. To ease financial constraints faced by state governments.

These steps taken by RBI will ease some of the stress on the financial system and will help to keep credit flowing to the economy, especially in the times when economic growth faces numerous headwinds. As an immediate reaction to the announcements the fixed income market reacted positively with yields broadly moving lower during the day.

Our views

- We think that RBI has been swift in reducing the rates with strong focus on liquidity management.
- Generally, the inflation targeting has been the mainstay of the policy decision, this time revival in growth took the precedence. The RBI governor highlighted that risks to growth are acute, while risks to inflation are short-lived.
- Along with that, RBI remains committed to ease financial conditions and take further steps to address the risks to growth. This opens up the space for further policy actions.
- We expect further rate reductions and much bigger quantum of liquidity infusion. The OMO (Open Market Operations) and long-term repo operation (LTRO) of much larger quantum may continue.
- As interest rates are expected to move lower, we feel investor can consider investing in long duration funds before the yields start to reflect the rate reductions of RBI.
- While all these measures will help the systemic liquidity, credit risk averseness may still continue with the overhang on economic slowdown and more so now with the moratorium announced that can lead to accumulated asset quality concerns later on.
- Accordingly, we think credit dispersion will continue with very high-quality credits benefitting from this but the lower quality credits continuing to be avoided for the time being.
- From a credit quality perspective, we have and will continue to stick to high quality credits – primarily Public Sector Undertaking (PSUs) and blue chip AAA credits¹.

¹The above strategy is based on current views and is subject to change from time to time.

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