

Insights – Monetary Policy Review

Status quo on policy rates while maintaining accommodative policy stance

August 6, 2020

At a time when economic growth is significantly battered by the pandemic, the Monetary Policy Committee (MPC) faced a tough decision given the surge in inflation which hovered near the upper end of the MPC's inflation mandate of 4% (within a band of +/- 2%). Keeping inflation anchored remained top priority for now and accordingly, MPC chose to hold the policy rates steady. Even as the MPC acknowledged the fragile macroeconomic conditions, it opted to remain vigilant of inflation trajectory and use the available policy space for further rate actions judiciously and opportunistically to maximize the beneficial effects for underlying economic activity. All the MPC members unanimously voted for keeping the policy rates unchanged while maintaining the accommodative stance. The repo rate and reverse repo rate has been retained at 4% and 3.35% respectively. The marginal standing facility (MSF) rate and the Bank Rate remains unchanged at 4.25%.

There were mixed views over the possibility of rate cut in today's policy review with around half of market participants expecting status quo on policy rates. We were of view that MPC remains focused on supporting growth and has room for further rate reductions. However, the policy decision does not come as a surprise as Indian economy is facing unusual situation of high inflation relative to weak growth conditions. Thus, we opined that even if there is a pause in rate reduction cycle, MPC will initiate/continue with the measures to ensure adequate liquidity and financial stability.

Following are the key measures announced to manage liquidity and mitigate the economic fallout of Covid-19:

- Additional standing liquidity facility of Rs. 5,000 crores for a period of one year at the RBI's policy repo rate to be provided to National Housing Bank, over and above Rs. 10,000 crores already provided. The move is aimed to support housing finance companies (HFCs) and shield the housing sector from liquidity disruptions.
- Additional special liquidity facility of Rs. 5,000 crores to be provided to NABARD for a period of one year at the RBI's policy repo rate for refinancing Non-Banking Financial Company (NBFC)- Micro finance Institutions (MFIs) and other smaller NBFCs of

asset size of Rs. 500 crores and less to support agriculture and allied activities and the rural non-farm sector.

- RBI will introduce an optional facility to provide banks more flexibility/discretion to manage their day end cash reserve ratio (CRR) balances.
- RBI will allow banks to restructure the loans of borrowers who are in financial difficulty and are unable to repay them. Accordingly, RBI will provide lenders a window to recast stressed assets without classifying them as non-performing subject to specified conditions.
- The central bank will also allow a debt recast facility for personal loans and small businesses.
- Stressed Micro, Small and Medium Enterprises (MSMEs) will remain eligible for debt restructuring.
- Loan-to-value on gold loans raised from 75% to 90%. This relaxation shall be available till March 31, 2021.

The various policy measures announced reinforced our belief of the need to have conducive conditions for benign interest rates and supportive financial markets given the gravity of ongoing economic challenges amid varying degree of continuing lockdowns.

In addition, the accommodative policy stance is retained as liquidity injection/absorption and easing of finance conditions has enhanced monetary transmission. The systemic liquidity remains in surplus. The average daily net absorptions under the liquidity adjustment facility (LAF) moderated from Rs. 5.3 lakh crores in May'20 to Rs. 4.1 lakh crores in June'20 as government spending slowed. In July'20, average daily net absorptions under the LAF moderated further to Rs. 4 lakh crores, as government spending remained subdued. Further, during 2020-21 (up to July 31, 2020), Rs. 1.24 lakh crores were injected through open market operation (OMO) purchases. The RBI also conducted 'operation twist' auctions involving the simultaneous sale and purchase of government securities for Rs. 10,000 crores on July 2, 2020 in order to distribute liquidity more evenly across the term structure and improve transmission.

The policy document also noted that borrowing costs in financial markets have dropped to their lowest in a decade on the back of abundant liquidity. Interest rates on instruments like the 3-month Treasury bill, commercial paper (CP) and certificates of deposit (CD) have fully priced in the reduction in the policy rate whereas spread between corporate bonds and G-sec have come down significantly in last four months.

Even as RBI has been taking steps proactively to frontload the rate cuts, maintain adequate liquidity and stabilize financial conditions, evolving growth-inflation dynamics continued to be a key determinant for policy makers.

The policy document cited cautious outlook to inflation and noted that headline inflation may remain elevated in Q2 2020-21 as supply chain disruptions on account of COVID-19 persist, with implications for both food and non-food prices. The upside risks to food prices remain, while inflation outlook of non-food categories is also fraught with uncertainty. However, it said that inflation may moderate in H2 2020-21 aided by large favorable base effects. It added that positive food inflation outlook may also emerge as the bumper rabi harvest eases prices of cereals.

With regard to growth estimates, MPC noted that for the year 2020-21, as a whole, real GDP growth is expected to be negative. An early containment of the COVID-19 pandemic may impart an upside to the growth outlook. However, it attributed a more protracted spread of the pandemic, deviations from the forecast of a normal monsoon and global financial market volatility as key downside risks to the economic growth outlook.

Our Views

The negative growth outlook and accommodative monetary policy stance gives room for further rate reduction, but we think that further policy actions will be guided by priority to achieve the medium-term target for CPI inflation of 4% within a band of +/- 2%. At the same time, we also see the reasons for benign interest rate environment to prevail and RBI to remain focussed on strong liquidity management. Thus, the OMO (Open Market Operations) and long-term repo operation (LTRO) may continue.

Accordingly, taking cues from policy review we will continue to tactically manage the duration, while remaining conservative on credit as demand destruction is going to impact credit profiles. We feel credit conditions are going to worsen, even though there are no substantial downgrades. We expect credit risk averseness may still continue with the overhang on economic slowdown. Thus, we believe 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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