Insights – Monetary Policy Review

A substantial rate cut accompanied by big measures to address economic and financial markets woes

March 27, 2020

The unprecedented times call for extraordinary measures. A day after the government announced a slew of measures to battle challenges faced by economy amid COVID-19 outbreak, the Monetary Policy Committee (MPC) responded with swift and timely measures covering major aspects of the economy, financial markets and relaxed regulatory norms. These measures undertaken by MPC exceeded the expectations and are positive.

The six-member MPC unanimously voted for a reduction in the policy repo rate but differed in the quantum of reductions. The MPC decided by 4-2 majority to reduce repo rate by 75 basis points (bps) to 4.4%. In doing so, the MPC also retained its ‘accommodative’ stance acknowledging the need to revive growth, mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target. Not only that, MPC has maintained an overall dovish tone and re-iterated its commitment to further use all the available conventional as well as un-conventional tools to preserve the financial stability and support economic growth given the major disruption in economic activity amid coronavirus pandemic. This opens up the possibility of further rate reductions if required.

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 75 basis points to 4.40% from 5.15%. **This is the lowest repo rate ever**; earlier it had fallen to a lowest of 4.75% in April-May 2009.
- The **reverse repo rate under the LAF has been reduced by 90 basis points** from 4.9% to 4%.
- The fixed rate reverse repo rate, which sets the floor of the LAF corridor, has been reduced by 90 bps to 4%, thus creating an asymmetrical corridor. The MPC stated that purpose of this measure is to **make reverse repo rate relatively unattractive for banks to passively deposit funds with the RBI** and instead, to use these funds for on-lending to productive sectors of the economy.
- The **marginal standing facility (MSF) rate and the Bank Rate has been reduced to 4.65% from 5.40%.**

Given the gravity of ongoing economic challenges, the rate cut was also accompanied by a flurry of liquidity and regulatory measures. Following are the key measures announced:

Liquidity Measures

- In addition to the previous Long-Term Repo Operations (LTRO) of ~Rs 1.25 lakh crores, **RBI announced another Rs. 1 lakh crores of Targeted LTRO (TLTRO) for upto 3 years at a floating rate linked with the policy rate**. This utilization has to be necessary used for buying the Commercial Papers / Corporate Bonds & Debentures both in primary as well as secondary market within 15 days of TLTRO. First tranche of Rs. 25,000 crores has been announced today. This will address the illiquidity premium of Corporate bonds / CPs which had gone up by as high as 225 – 250 bps. Short term rates have reacted positively post policy announcement by almost 100 – 125 bps.
- **Cash reserve Ratio (CRR) has been reduced by 100 bps** to 3% for 1 year till March 2021. This is expected to release a primary liquidity of ~Rs 1.37 lakh crores. Minimum CRR on daily basis has also been reduced from 90% to 80% upto June 26, 2020.
- In view of the exceptionally high volatility in domestic financial markets and to provide comfort to the banking system, **it has increased limit available to banks to dip into the Statutory Liquidity Ratio (SLR) limit** from 2% to 3% to borrow under Marginal Standing Facility. This measure will be applicable up to June 30, 2020. This is also expected to introduce a liquidity of ~Rs 1.37 lakh crores.

All the 3 measures are expected to release Rs 3.74 lakh crores of primary liquidity amounting to around 1.8% - 1.9% of Gross Domestic Product (GDP).

Regulatory Measures

- The RBI has given **3 months moratorium on debt servicing of term loans** of all banks, Financial institutions and Non-Banking Financial Companies (NBFCs) / Housing Finance Companies (HFCs).
- **3 months moratorium on interest servicing of Working Capital Loans** for all banks, financial institutions & NBFCs / HFCs.
- **The above two measures will take care of the cashflow disruption of the underlying borrowers due to lockdown.**
- Leeway of re-calculating the drawing power for Working Capital Loan. Consequently, **working capital loans will be easily available for borrowers.**

- Applicability of last tranche of 0.625% of Capital Conservation Buffer for banks postponed by 6 months from 1st April 2020 to 1st Oct 2020. **It is expected to provide additional room for credit growth while absorbing credit losses.**
- Indian Banks operating International Financial Services Centre (IFSC) / Banking Units (IBUs) can participate in offshore Non-Deliverable Rupee derivative market. **The move will possibly help in better price discovery.**

The 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. Given that economic outlook remains uncertain and negative, it refrained from giving any growth and inflation forecasts. However, it noted that headline Consumer Price Index (CPI) based inflation which was projected at 6.5% for Q4 2019-20, its prints for January and February 2020 indicate that actual outcomes for the quarter are running 30 bps above projections, reflecting the onion price shock. It further stated that downside risks to growth arise from the spread of COVID-19 and prolonged lockdowns, whereas upside growth impulses are expected to emanate from monetary, fiscal and other policy measures and the early containment of COVID-19.

As an immediate reaction to the announcements the fixed income market reacted positively with yields broadly moving lower. The benchmark 10-year G-sec yields declined by 15-20 bps, whereas AAA bond yields inched lower by 100-150 bps.

Our views

- We think this is a strong response from a hitherto conservative RBI, exceeding the market expectations especially on the quantum of policy rate cuts and moratorium.
- Along with that, RBI has reiterated its commitment to further use all the available conventional as well as un-conventional tools to mitigate the impact of Covid-19 and preserve financial stability.
- For the first time, RBI has commented on the liquidity premium being very high for CPs / NCDs / Bonds and have taken targeted liquidity measures to address that. If the liquidity premium was to go up again, RBI may be willing to take further such measures.
- The liquidity measures announced along with requiring banks to buy corporate bonds will help improve corporate bond liquidity in the market. Mutual Funds will likely benefit from this given the illiquidity over last few days.

- 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.
- Also, with the moratorium announced only on the term loans and Working Capital loans and not on Capital market instruments like CPs / Bonds, it will expose the corporates having high dependence on capital market instruments. Having said that, strong companies would still be easily able to replace Non-convertible debentures (NCDs) / CPs with bank term loans.
- 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.
- We feel there might be a need for additional fiscal measure over the Rs. 1.7 trillion fiscal measures aimed primarily at the less privileged sections of the population. The economic damage from shut down could be far more painful. RBI did not announce any additional sovereign OMO along with the policy announcement, perhaps keeping it available once fiscal package gets announced.
- 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 credits[1].

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