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RBI cuts policy rates by a further 40bps; eases liquidity and financial stress

In another off-cycle policy meet today, the Monetary Policy Committee (MPC) reduced rates by another 40bps, citing the need to address growth concerns sooner than later in the wake of a much adverse macroeconomic impact of COVID-19 than envisaged earlier. This takes the repo and the reverse repo (the *de facto* policy rate in the current surplus liquidity environment) rates to 4% and 3.35%, translating into a total cut this year of 115bps and 155bps respectively. While refraining from giving estimates, the RBI expects Indian economy to contract in FY21 and inflation to remain elevated in H1FY21 amid persisting supply dislocations.

A host of other measures were also announced, extensions to some already announced in the past, to improve availability of liquidity further, support foreign trade and ease financial stress of corporates as well as state governments. The moratorium on term loans and working capital facilities was extended by three months on expected lines. Additionally, the exclusion of moratorium/deferment period from asset reclassification and resolution timeline would serve to alleviate stress on the banking sector.

The Central Bank has remained proactive in taking swift policy actions to mitigate the liquidity shock caused by COVID-19, with liquidity easing measures announced since Feb'20 adding up to Rs9.4trn or 4.6% of GDP. While rates at the short-end have accordingly dropped meaningfully (3M/1Y G-sec yield down 235/175bps YTD), spreads at the long-end remain elevated, probably reflecting the supply overhang. In this context, we expect more open market purchases at the long-end (or Operation Twist), including potential partial monetisation of the fisc in a weak demand environment and a benign inflation trajectory ahead. On policy rates, space remains available for another 25-50bps cut in this fiscal, *ceteris paribus*, but effectiveness is contingent on transmission.

- **Policy rates slashed by 40bps:** In an off-cycle policy meet today, the MPC decided to cut policy rates by 40bps with a 5:1 vote, citing the need to address growth concerns sooner than later in the wake of a much adverse macroeconomic impact of COVID-19 than envisaged earlier. This takes the repo and the reverse repo (the *de facto* policy rate in the current surplus liquidity environment) rates to 4% and 3.35%, translating into a total cut this year of 115bps and 155bps respectively. The Marginal Standing Facility (MSF) and Bank rate stand reduced to 4.25%. The MPC expects GDP to contract in FY21, even as it refrained from giving forecasts given heightened uncertainty, and inflation trajectory to remain benign barring near-term pressure owing to persisting supply dislocations. Further, the MPC has voted to maintain an accommodative stance for as long as necessary to revive growth, thereby keeping the room open for further rate cuts.

RBI cuts policy rates by 40bps, translating into cumulative cuts in repo/reverse repo rate this year by 110bps/135bps

- **RBI announces measures to ease financial stress:** The RBI also announced several measures to make debt servicing easier and improve access to working capital. These include a) Extension of moratorium on instalments on term loans outstanding as on March 1, 2020 by another three months until August 31st, 2020, without resulting in asset classification downgrade, b) Easier working capital financing and servicing: Deferment period on interest payment on working capital facilities has been extended by another three months until August 31st, 2020, without resulting in asset classification downgrade or an adverse impact on the borrower's credit history. The accumulated interest over this period would be permitted to be converted into a funded interest term loan to be repaid by the end of the current financial year. Lending institutions may also recalculate drawing power of borrowers by reducing margins and/or reassessing working capital cycle till the extended period, c) Extension of resolution timeline: Lending institutions are permitted to exclude the moratorium/deferment period from the calculation of review and resolution periods, and d) Group exposure limit under the Large Exposures Framework increased from 25% to 30% of the bank's eligible capital base, applicable until June 30, 2021.

Our reports on earlier measures announced by the RBI:

1. COVID-19 policy response: Rs1.7trn fiscal push, Rs3.74trn liquidity boost (March 27th, 2020)

2. RBI stems up policy response, over to the Government now (April 17th, 2020)

- **Measures to improve functioning of markets and support foreign trade:** To facilitate SIDBI to meet long-term funding requirements of small industries, the RBI decided to rollover the special refinancing facility of Rs150bn announced on April 17th by another three months. The RBI has extended the deadline for FPIs to utilise at least 75% of the allotted limit under the Voluntary Retention Route (VRR) from three months to six months. A slew of measures were announced to support foreign trade in the wake of a sharp drop in domestic/external demand and global supply chain disruptions including a) an extension in the permissible period of export credit from 12 months to 15 months for disbursements made up to July 31st, 2020, b) a credit facility of Rs150bn to the EXIM Bank for 90 days with rollover up to one year to meet its foreign exchange requirements, and c) extension of time of payment for imports from six months to 12 months from the shipment date for imports made on or before July 31st, 2020.
- **Liquidity support of Rs133bn for states:** To ease the stress on State Government finances, the RBI has relaxed the withdrawal rules from the Consolidated Sinking Fund—a fund maintained by State Governments with the RBI as a buffer for repayment of their liabilities, thereby enabling States to deal with the redemption pressures. This would provide an additional funding of Rs133bn to States.
- **Expect more OMOs/deficit monetisation; transmission critical:** The RBI, on several occasion, has highlighted the need to do 'whatever it takes' to contain the economic and liquidity shock caused by COVID-19 pandemic. This is reflected in the proactive policy response by the RBI thus far. The liquidity easing measures announced since Feb'20 adds up to Rs9.4trn or 4.6% of GDP. Consequently, while rates at the short-end have come off meaningfully (3M/1Y G-sec yield down 235/175bps YTD), spreads at the long-end remain elevated, probably reflecting the supply overhang. In this context, we expect the RBI to do more open market purchases at the long-end (or Operation Twist), and/or partly monetise fiscal deficit particularly given a collapsed demand environment and a benign inflation trajectory ahead (The RBI expects inflation to fall to sub-4% by Q3FY21). On policy rates, there's space available for another 25-50bps cut in this fiscal, *ceteris paribus*, but its effectiveness is contingent on speedy transmission.

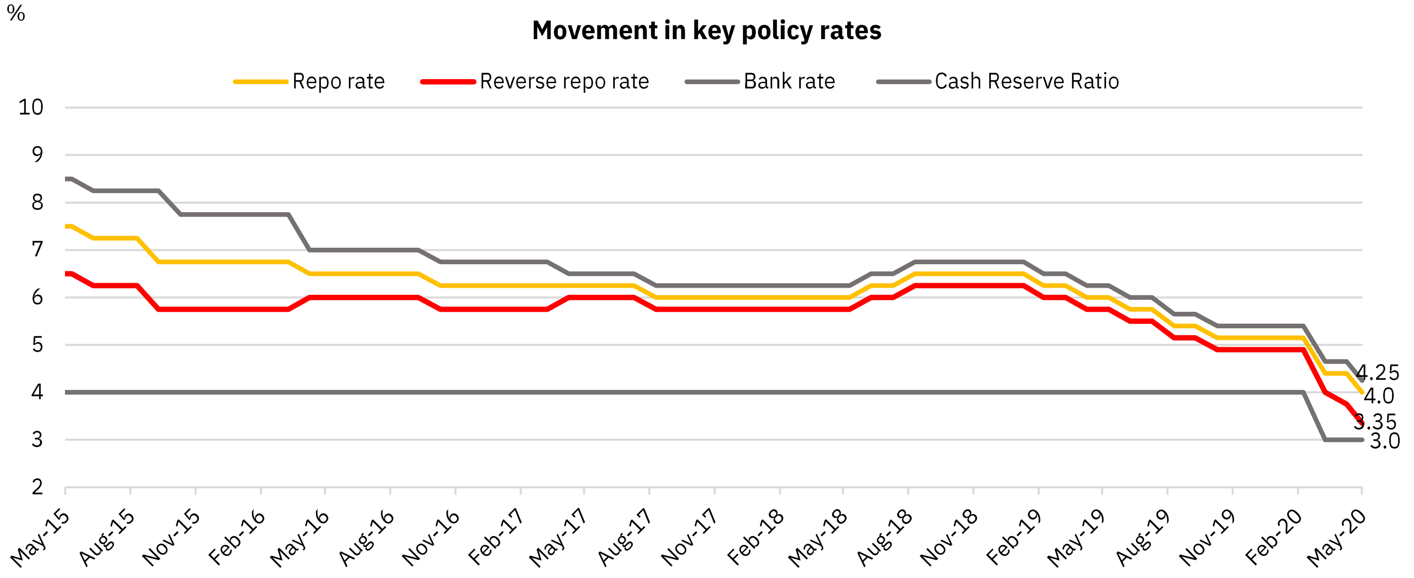
Figure 1: Changes in key policy rates

Key rates	Previous value	Current value
Repo Rate	4.4%	4.0%
Reverse Repo Rate	3.75%	3.35%
Marginal Standing Facility (MSF) Rate	4.65%	4.25%
Bank Rate	4.65%	4.25%
Cash Reserve Ratio (CRR)	3%	3%
Statutory Liquidity Ratio (SLR)	18.5%	18.5%

Source: RBI

Figure 2: Policy rates slashed by 40bps: repo/reverse repo rates now at 4%/3.35%

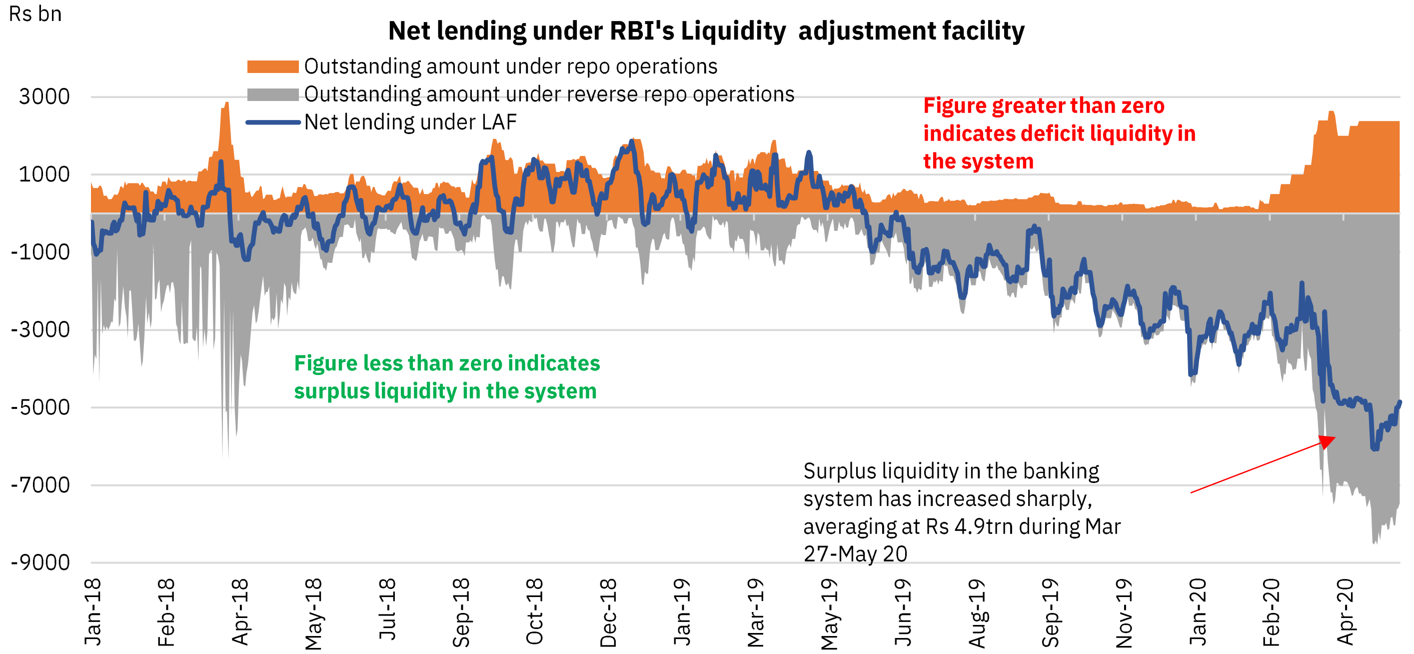
Cumulative cuts in repo and reverse repo rates in 2020 thus far stand at 110bps/155bps.



Source: RBI, CMIE Economic Outlook, NSE.

Figure 3: Net lending under RBI's Liquidity Adjustment Facility

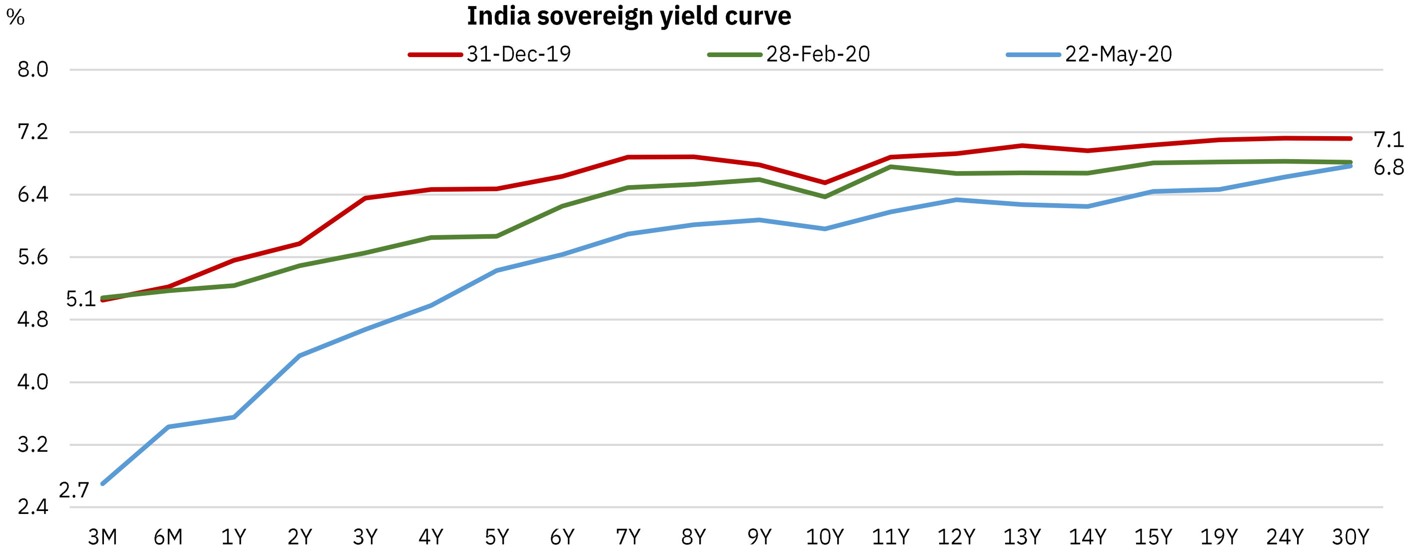
Systemic liquidity has remained in surplus since June and has increased sharply over the last couple of months, thanks to continued liquidity injection by the RBI through various conventional as well as unconventional measures. Net liquidity absorption under the RBI's Liquidity Adjustment Facility has averaged at Rs4.9trn during the period March 27-May 20th. The amount of outstanding money parked by banks with the RBI surged to as high as Rs 8.5trn on May 5th, averaging at Rs 7.3trn during the same period.



Source: CMIE Economic Outlook, NSE

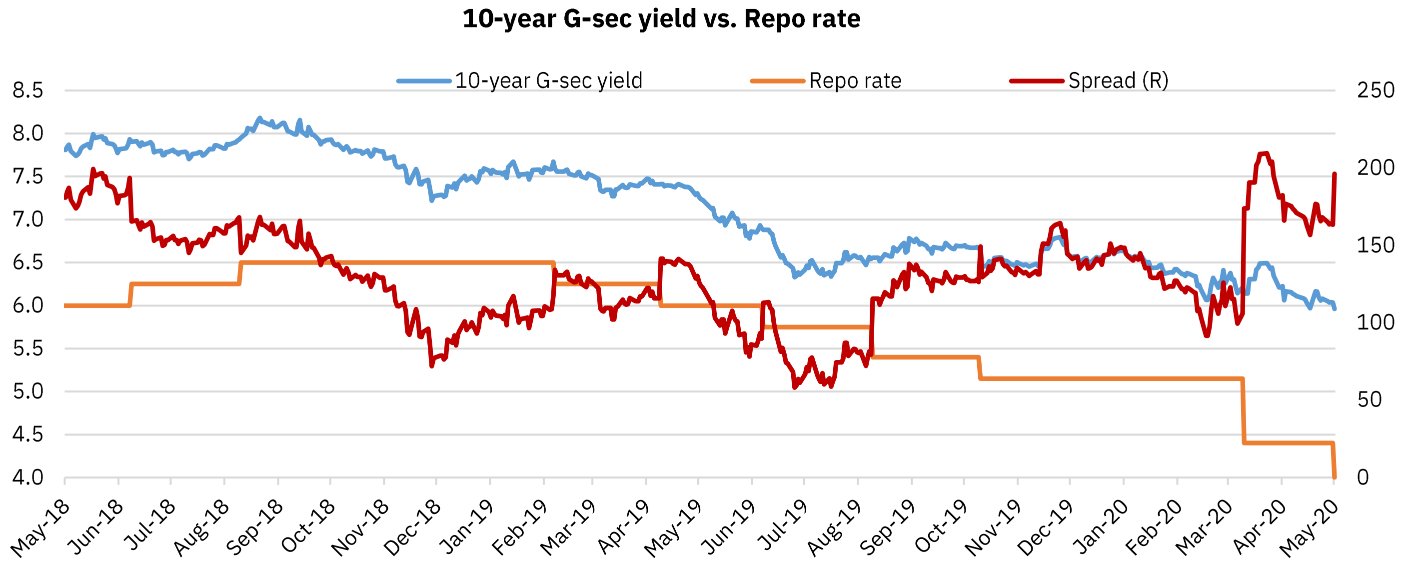
Figure 4: India sovereign yield curve

The India sovereign yield curve has steepened over the last couple of months, with the drop in yields seen only up to three-year maturity papers, thanks to a steep 155bps cut in reverse repo rate which has effectively become the policy rate in surplus liquidity conditions. A slew of liquidity easing measures taken by the RBI, including the LTROs and TLTROs (Targeted Long-term Repo Operations) and a huge surplus systemic liquidity, have brought the shorter-end of the yield curve lower. The longer-end, however, has remained steady—a reflection of strengthened growth concerns, massive FPI outflows and a huge demand-supply mismatch amid heavy supply of G-secs. With the combined fiscal deficit expected to significantly overshoot budget estimates in FY21, supply of central as well as state papers is expected to be huge this year, thereby putting continued pressure on the long-end of the curve.



Source: Refinitiv Datastream, NSE.

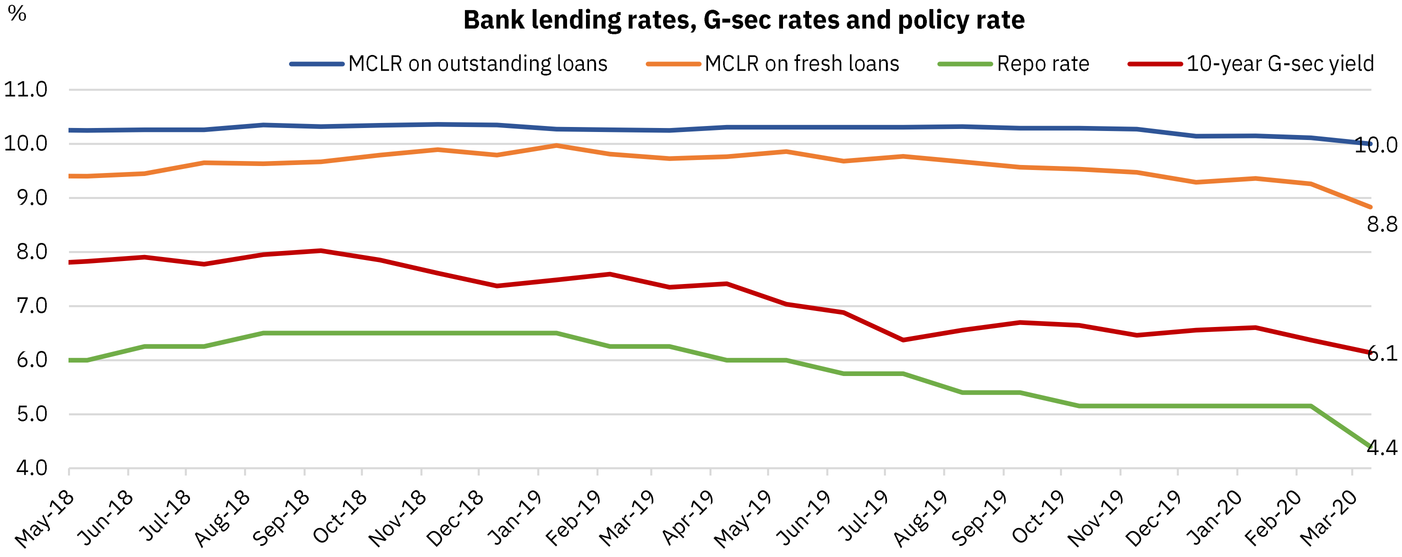
Figure 5: Spreads between 10-year G-sec and repo rate



Source: RBI, Refinitiv Datastream, NSE.

Figure 6: Bank lending rates vs. policy rate

The weighted average lending rate for fresh loans fell by a steep 43bps in March alone (-46bps in 1Q 2020) even as lending rate on outstanding loans fell by a meagre 11bps (-14bps in 1Q 2020). A pick-up in monetary transmission in the credit markets is crucial for the cut in policy rates to be effective in reducing the cost of borrowing for the real economy.



Source: RBI, Refinitiv Datastream, NSE.

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Tirthankar Patnaik, PhD	tpatnaik@nse.co.in	+91-22-26598149
Prerna Singhvi, CFA	psinghvi@nse.co.in	+91-22-26598316
Ashiana Salian	asalian@nse.co.in	+91-22-26598163
Runu Bhakta, PhD	rbhakta@nse.co.in	+91-22-26598163