

## Status quo now doesn't preclude future cuts

In its last meeting, the outgoing Monetary Policy Committee (MPC) of the RBI unanimously decided to keep policy rates unchanged in the bi-monthly policy review, citing a broad-based spike in recent inflation prints and an uncertain trajectory ahead. Availability of further policy action, however, was reiterated, to be utilised judiciously for maximum beneficial impact. Inflation is expected to remain elevated in the second quarter of FY21 owing to continued supply chain disruptions and cost-push pressures emanating from higher fuel and metal/gold prices, but should ease thereafter, supported by a favourable base. Key measures announced today include a) an additional special liquidity facility of Rs100bn to National Housing Board (NHB) and NABARD, b) a one-time restructuring of eligible COVID-19-related stressed corporate and personal loans, including stressed MSME borrowers that were standard as on March 1st, 2020, c) increase in loan-to-value ratio for gold loans from 75% to 90%, d) reduction in capital charge for **market risk towards banks' investment in debt mutual funds and debt ETFs**, and e) amendment of priority sector lending (PSL) guidelines to remove regional disparities, include start-ups and increase the limit for renewable energy.

Injection of abundant liquidity into the system and additional measures including Operation Twist and TLTROs have resulted in enhanced monetary transmission in money, bond and credit markets, particularly swiftly at the shorter-end, and a sharp reduction in illiquidity premia/credit spreads. The longer end of the curve, however, has remained relatively elevated amid growth and fiscal concerns. Absence of an expected hike in the HTM (hold to maturity) limit for banks and more Operation Twist-like open market operations (OMOs) is likely to result in further steeping of the yield curve. On policy rates, space remains available for another 25-50bps cut in the current easing cycle, contingent on a durable reduction in inflation trajectory. However, the conclusion of four-year term of existing external MPC members in September this year imparts uncertainty to future policy actions.

- Policy rates kept unchanged: The MPC unanimously decided to maintain status quo on policy rates citing a broad-based spike in recent inflation prints and an uncertain trajectory ahead. As such, the repo, reverse repo and bank/Marginal Standing Facility (MSF) rates remain unchanged at 4.0%, 3.35% and 4.25% respectively. The Committee, however, decided to continue with the accommodative stance as long as it is necessary to revive growth, reiterating the availability of space for future policy action which needs to be utilised judiciously for maximum beneficial impact.
- Inflation expected to remain elevated in the near-term: The MPC expects inflation to remain elevated in the second quarter of FY21 on the back of a) a spike in food prices due to floods in Eastern India and sustained supply-side disruptions, and cost push pressures emanating from higher taxes on petroleum products, hike in telecom tariffs and increase in metal and gold prices. Headline inflation is expected to ease in the second half supported by a favourable base. Given high uncertainty surrounding the inflation outlook, the MPC finds it prudent to pause at this juncture.
- Additional measures announced to ease financial stress: Further key measures announced today include a) an additional special liquidity facility of Rs100bn to National Housing Board (NHB) and NABARD, b) one-time restructuring of eligible COVID-19-related stressed corporate and personal loans, including stressed MSME borrowers that were standard as on March 1st, 2020, c) increase in loan-to-value ratio for gold loans from 75% to 90%, d) reduction in capital charge for **market risk towards banks' investment in debt mutual funds and debt ETFs**, and e) amendment of priority sector lending (PSL) guidelines to remove regional disparities, include start-ups and increase the limit for renewable energy.

---

*RBI keeps policy rates unchanged citing inflationary concerns in the near-term.*

---

---

*Elevated food prices owing to supply-side bottlenecks and floods in Eastern India and cost push pressures are likely to keep inflation elevated in the near-term.*

---

- Surplus liquidity results in a sharp drop in funding costs and illiquidity premia: A steep cut in policy rates (250bps since Feb'19) and injection of abundant liquidity into the system using conventional as well as conventional tools have meaningfully strengthened the pace of monetary transmission in money, credit and bond markets, particularly at the shorter-end. The weighted average lending rate on fresh loans has fallen by a steep 100bps since Jan'20, and 162bps since Jan'19, even as WALR on outstanding loans has come off by a mere 41bps and 53bps during the same period respectively. Money market rates (3-month T-bill/CP/CD rates) have also fallen sharply since Mar'20, more than pricing the reduction in policy repo rate. Corporate bond spreads have also come off meaningfully, supported by the RBI's Operation Twist and TLTRO (Targeted Long-term Repo Operations) programme. The longer end of the curve (10-year and above), however, has remained relatively elevated amid growth and fiscal concerns. Absence of an expected hike in the HTM limit for banks and more Operation Twist-like OMOs is likely to result in further steeping of the yield curve.
- Monetary easing to resume following a temporary pause: Persistence of headline inflation above the upper bound of the MPC's target range of 4% +/- 2% over the last three months, coupled with easing financial conditions, prevented the MPC to cut policy rates in today's review meeting. The Committee, however, acknowledged the need to support the economic recovery which has got significantly disrupted and derailed by the COVID-19 pandemic and attendant containment measures. The MPC, therefore, decided to maintain the accommodative stance as long as it is necessary, reiterating the availability of space for future policy action which needs to be utilised judiciously for maximum beneficial effect on the economy. We expect the MPC to cut policy rates by another 25-50bps cut in the current easing cycle, contingent on a durable reduction in inflation trajectory.

---

*Expect another 25-50bps cut in policy rates in the current easing cycle, contingent on a durable reduction in inflation trajectory.*

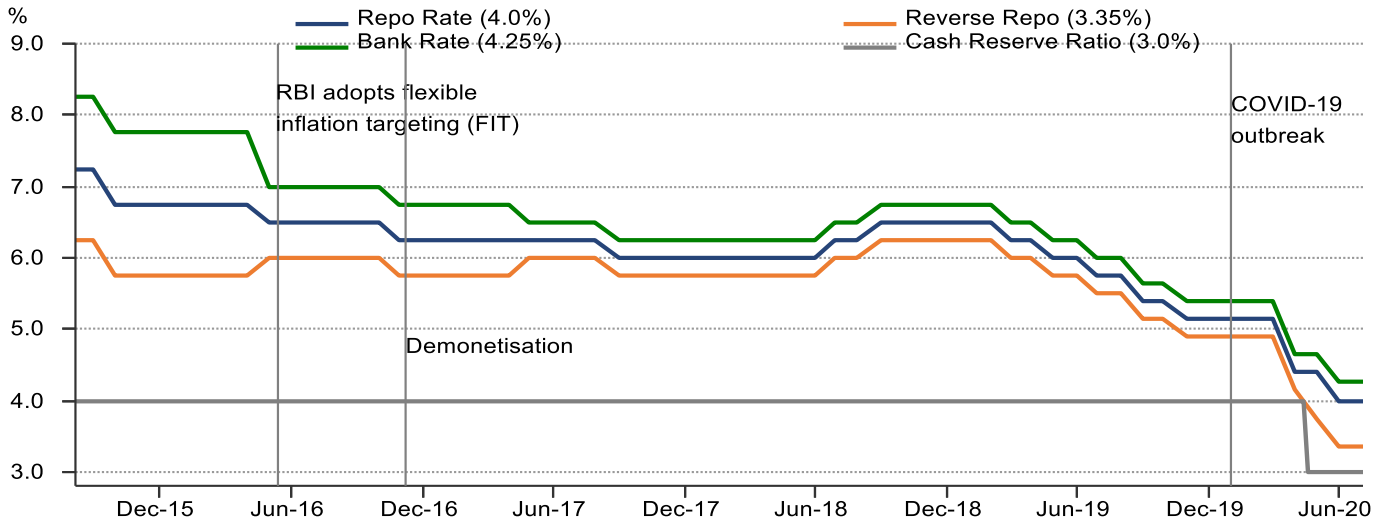
---

Figure 1: Current policy rates

Key rates	Current value
Repo Rate	4.0%
Reverse Repo Rate	3.35%
Marginal Standing Facility (MSF) Rate	4.25%
Bank Rate	4.25%
Cash Reserve Ratio (CRR)	3.0%
Statutory Liquidity Ratio (SLR)	18.5%

Source: RBI

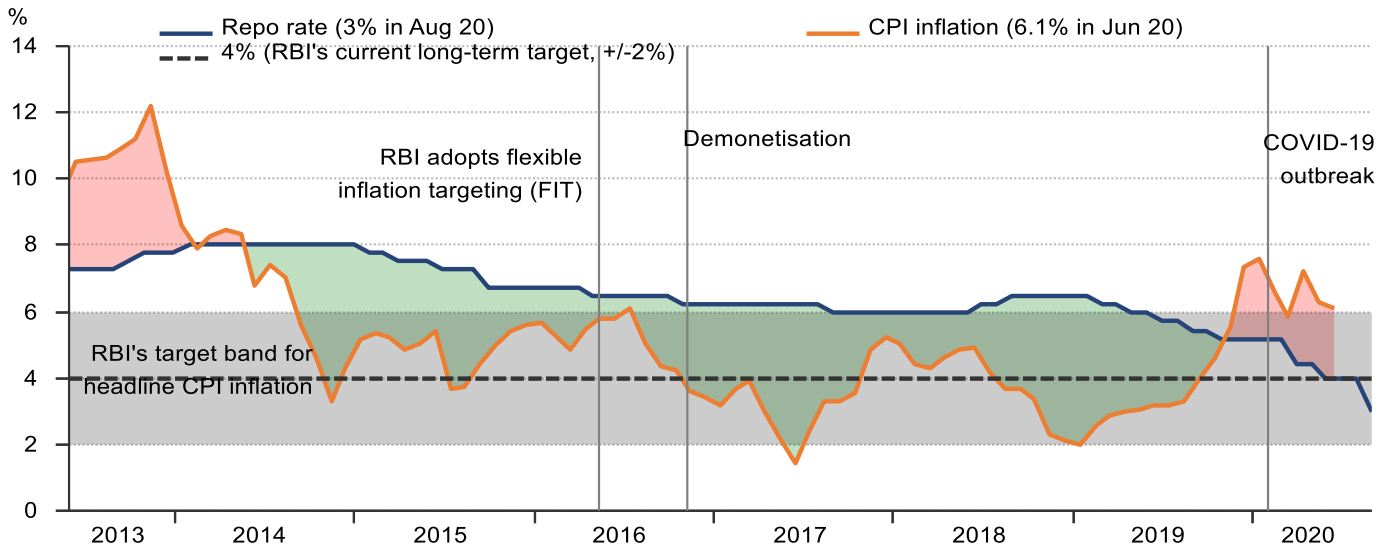
Figure 2: Policy rates kept unchanged



Source: Refinitiv Datastream.

Figure 3: India headline Consumer Price Inflation (CPI) and real interest rates

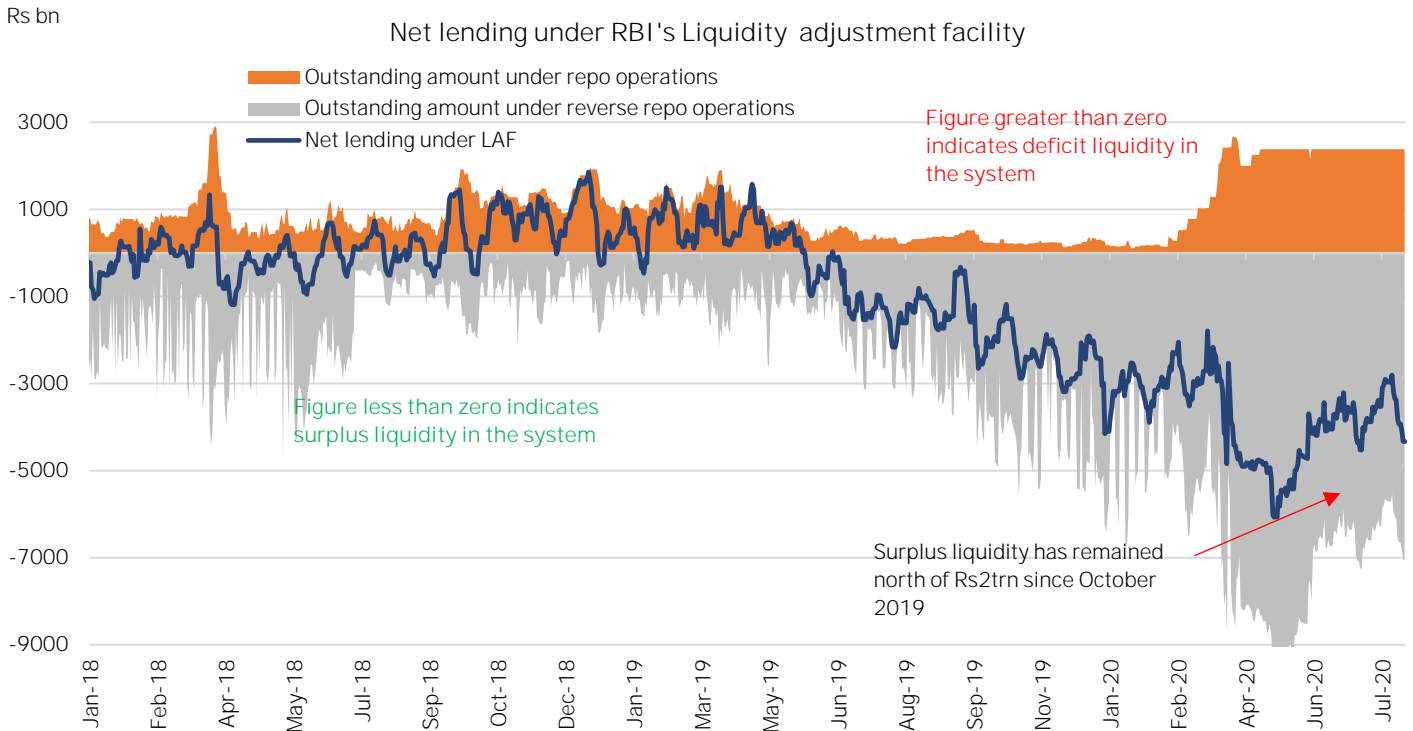
India headline CPI inflation has remained closer to or above the upper-bound of the RBI's target range of 4% +/- 2% since Dec'19. This has prevented the RBI to cut policy rates in today's review meeting.



Source: Refinitiv Datastream.

**Figure 4: Net lending under RBI's Liquidity Adjustment Facility**

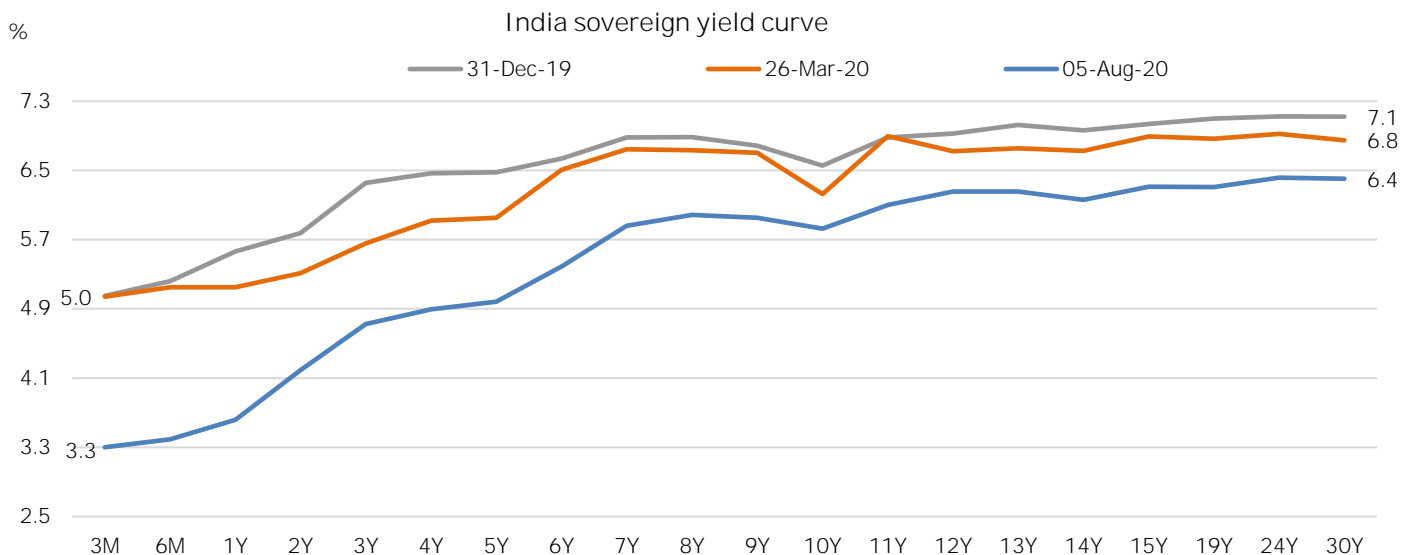
Surplus liquidity in the banking system has remained in a huge surplus even as it has come off over the last two months amid a decline in outstanding money parked with the RBI under reverse repo operations. This is largely owing to incrementally higher investments by banks in corporate securities under LTROs/TLTROs as well as SLR securities (government securities) over the last couple of months, even as credit offtake has remained weak.



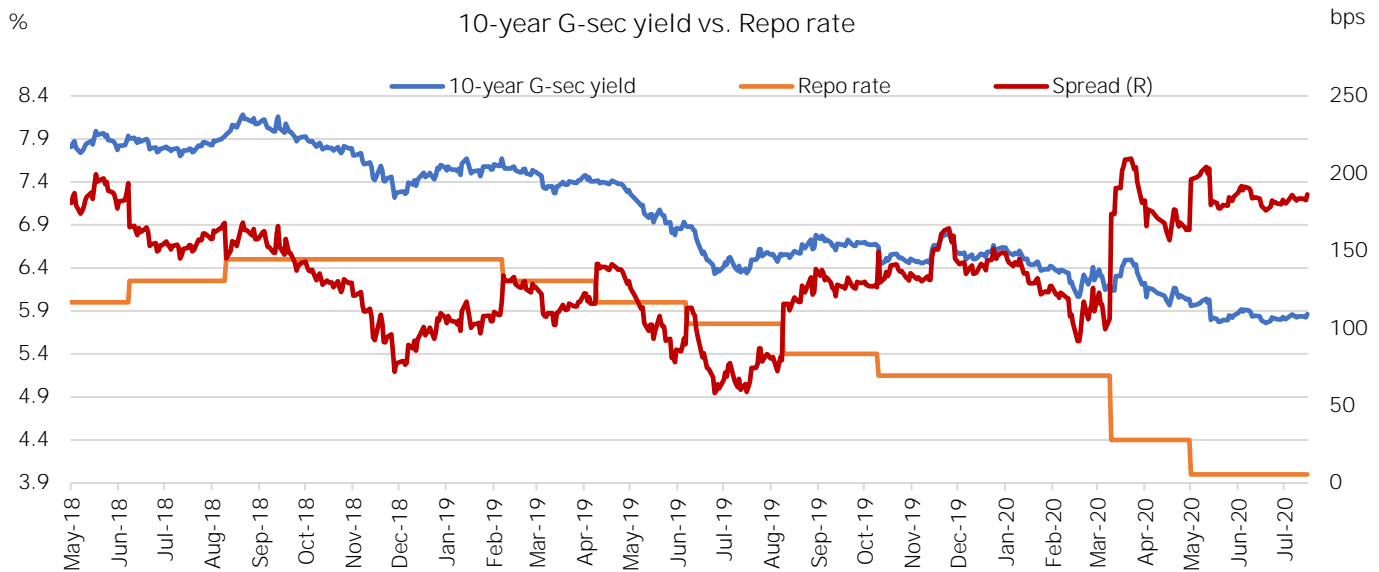
Source: CMIE Economic Outlook, NSE

**Figure 5: India sovereign yield curve**

The India sovereign yield curve has steepened significantly since the RBI's first policy response to the COVID-19 outbreak. The short end of the curve has fallen by as much as 175bps since March 26<sup>th</sup>. This has been primarily on the back of a steep 155bps cut in reverse repo rate which has effectively become the policy rate in surplus liquidity conditions and a slew of liquidity easing measures taken by the RBI. The longer-end of the curve (10-year and above), however, has come down by an average of ~50bps during the same period, reflecting strengthened concerns on India's economic growth and Government's fiscal balances.



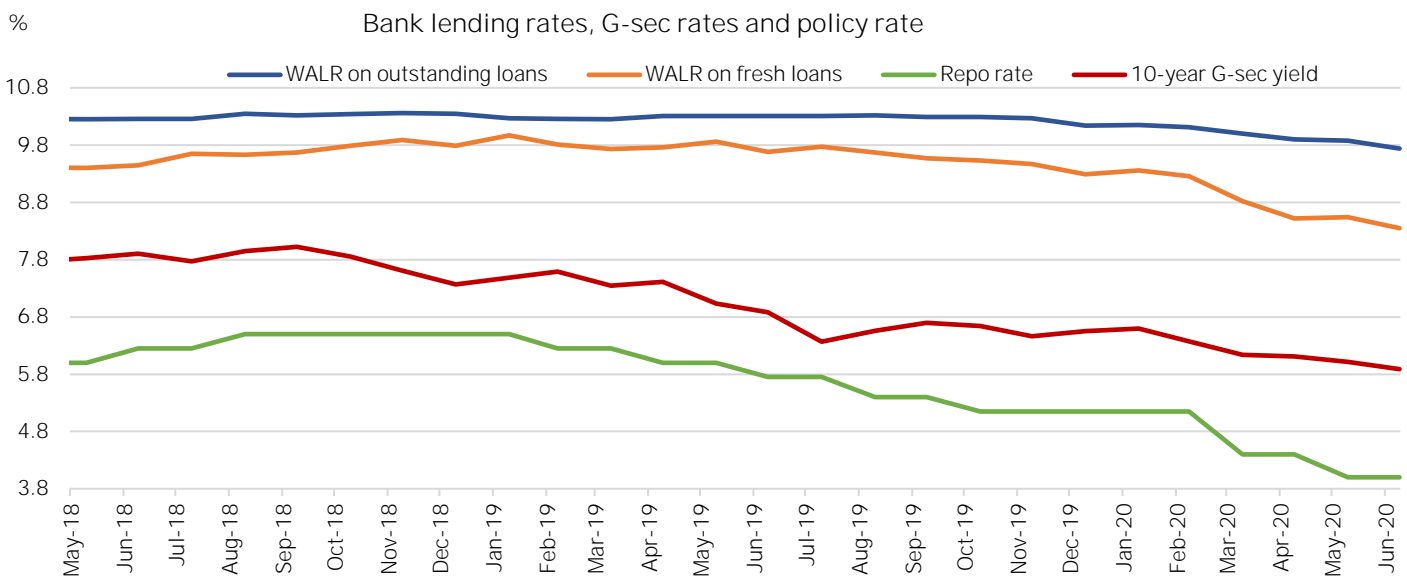
Source: Refinitiv Datastream, NSE.

**Figure 6: Spreads between 10-year G-sec and repo rate**


Source: RBI, Refinitiv Datastream, NSE.

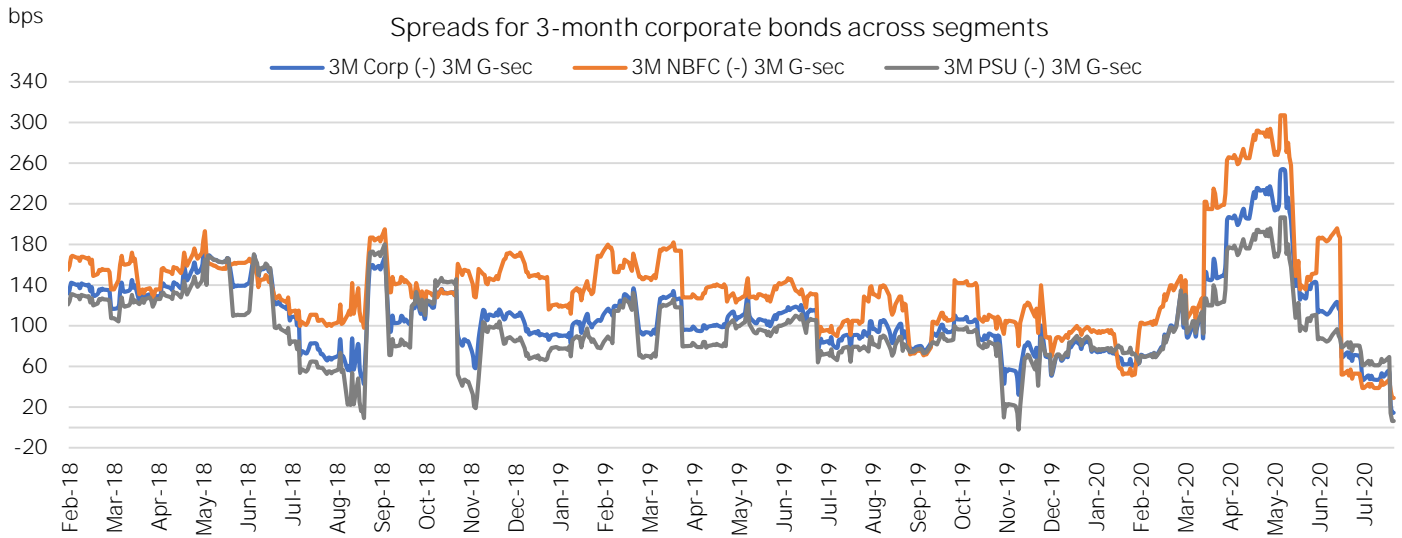
**Figure 7: Bank lending rates vs. policy rate**

The weighted average lending rate for fresh loans has fallen by a steep 100bps since January 2020, bulk of which happened in the month of March and April, even as lending rate on outstanding loans has come off by a mere 41bps during this period.



Source: RBI, Refinitiv Datastream, NSE.

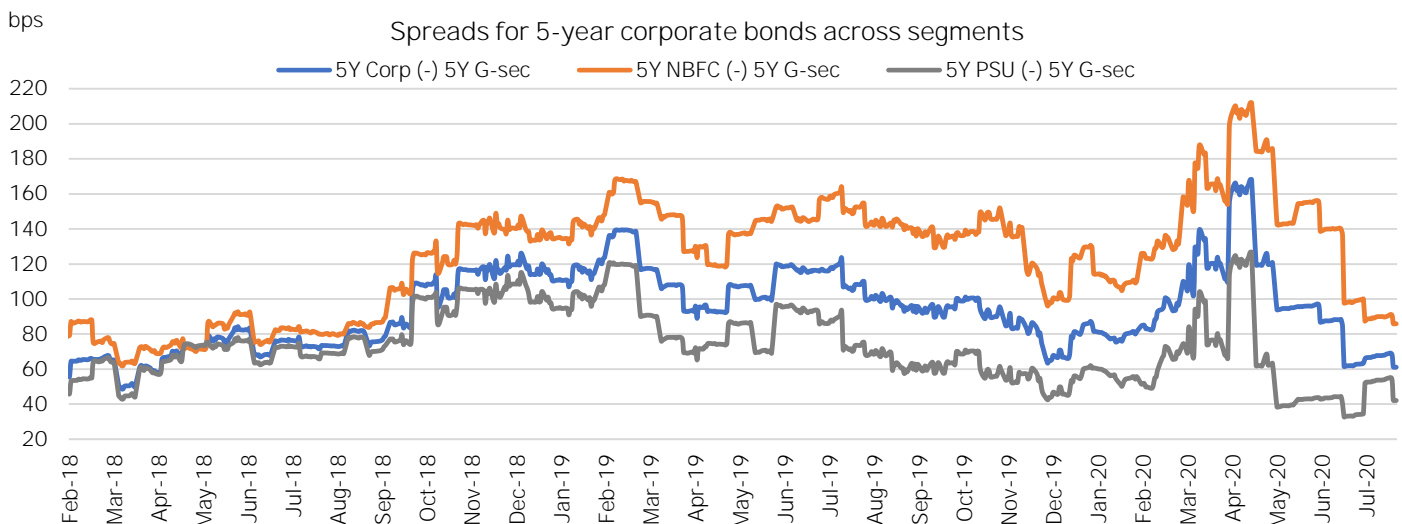
Corporate bond spreads have come off meaningfully over the last couple of months across issuer categories and particularly more so at the shorter end, following a sharp spike during Apr-May following the Franklin Templeton episode. This was largely led by a significant easing of liquidity conditions in the economy, thanks to a slew of measures taken by the Central Bank. The TLTROs led to a surge in demand for corporate bonds by banks thereby reducing credit spreads, even as the yield curve has steepened, in-line with the sovereign yield curve. In fact, the very short-end (3-6-month AAA-rated corporate papers) have been trading below the repo rate since July.

**Figure 8: Spreads for 3-month corporate bonds across segments**


Source: Refinitiv Datastream, Bloomberg, NSE.

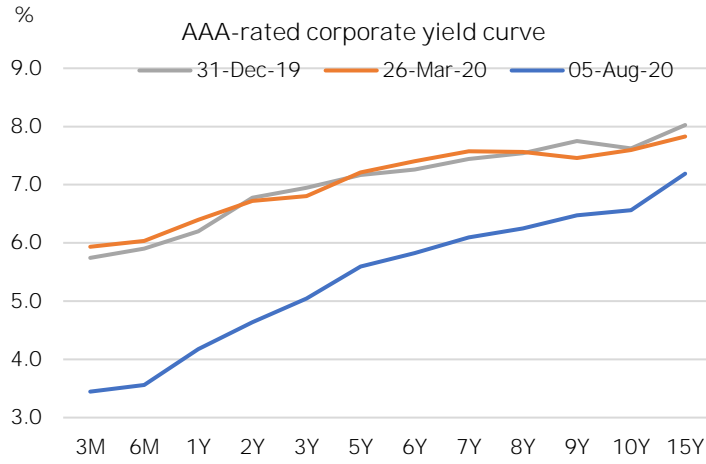
**Figure 9: Spreads for 3-year corporate bonds across segments**


Source: Refinitiv Datastream, Bloomberg, NSE.

**Figure 10: Spreads for 5-year corporate bonds across segments**


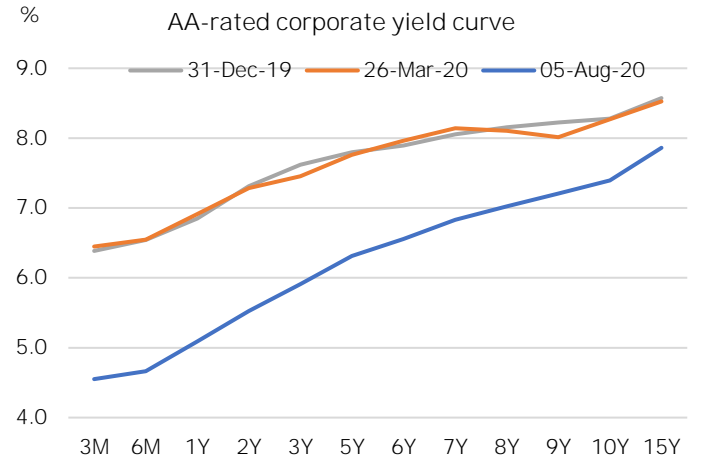
Source: Refinitiv Datastream, Bloomberg, NSE.

Figure 11: AAA-rated corporate bond yield curve



Source: Bloomberg, NSE.

Figure 12: AA-rated corporate bond yield curve



## Economic Policy &amp; Research

Tirthankar Patnaik, PhD	<a href="mailto:tpatnaik@nse.co.in">tpatnaik@nse.co.in</a>	+91-22-26598149
Purna Singhvi, CFA	<a href="mailto:psinghvi@nse.co.in">psinghvi@nse.co.in</a>	+91-22-26598316
Ashiana Salian	<a href="mailto:asalian@nse.co.in">asalian@nse.co.in</a>	+91-22-26598163
Runu Bhakta, PhD	<a href="mailto:rbhakta@nse.co.in">rbhakta@nse.co.in</a>	+91-22-26598163

*Disclaimer*

*This report is intended solely for information purposes. This report is under no circumstances intended to be used or considered as financial or investment advice, a recommendation or an offer to sell, or a solicitation of any offer to buy any securities or other form of financial asset. The Report has been prepared on best effort basis, relying upon information obtained from various sources, but we do not guarantee the completeness, accuracy, timeliness or projections of future conditions provided herein from the use of the said information. In no event, NSE, or any of its officers, directors, employees, affiliates or other agents are responsible for any loss or damage arising out of this report. All investments are subject to risk, which should be considered prior to making any investment decisions. Consult your personal investment advisers before making an investment decision.*