NSE

Macro Review

October 09, 2020 | Vol. 2, Issue. 34

RBI Monetary Policy: Liquidity support over rate cuts for now

In its first meeting, the new Monetary Policy Committee (MPC) of the RBI unanimously decided to keep policy rates unchanged in the bi-monthly policy review. The tone turned incrementally more dovish with the MPC a) acknowledging the recent spike in inflation trajectory being primarily supply-led; b) considering reviving growth as its utmost policy priority at this juncture, and finally, c) committing sustenance of an accommodative stance at least through the current and the next financial year. While headline inflation is expected to gradually taper off in the second half of FY21 (RBI's est.: 5.4-4.5%), the RBI expect GDP to contract by 9.5% in FY21 (our est. at -10.5%, detailed note here), with risks tilted to the downside given an uncertain COVID-19 trajectory.

The policy focussed at reviving growth through a) increased liquidity support: On-tap TLTROs (Targeted Long-term Repo Operations) to be earmarked for specific sectors, extension of HTM (hold-to-maturity) limit hikes, enhanced outright and special OMOs (open market operations) and the first-ever OMOs on SDLs; and b) facilitating credit flow to specific sectors: increase in banks' exposure limit to retail borrowers, rationalisation of risk weights on housing loans. Additional measures announced today would not only align the G-sec/SDL market with the prevailing comfortable liquidity conditions, thereby supporting transmission across the board, but also help ease cost of funds and crowding out effect on the private sector in the wake of an augmented Govt. borrowing plan.

The RBI is expected to continue to focus on liquidity infusion and effective monetary transmission to support growth for now, while keeping policy rates unchanged amidst an elevated inflation trajectory. That said, space should open for a rate cut by Q4FY21 as inflation subsides, with our expectations of another 25-50bps cut.

- **Policy rates kept unchanged:** In the wake of persistence of recent inflation trajectory above the RBI's tolerance band, the newly appointed MPC unanimously decided to maintain status quo on policy rates in its bimonthly review meeting and awaits an opportune time to utilise the available policy space. 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 commentary, however, was incrementally far more dovish. The MPC not only acknowledged the recent spike in headline inflation being primarily driven by supply shocks, but also highlighted supporting economic growth as its utmost policy priority at this juncture. Accordingly, the Committee provided a clear guidance to the markets by committing to maintaining an accommodative stance at least through this and the next financial year to revive growth on a durable basis.

RBI keeps policy rates unchanged but commits to on maintaining an accommodative stance at least through this and the next financial year.

- **Headline inflation to ease in the second half:** The MPC expects inflation to remain elevated at 6.8% in the second quarter of FY21, but ease gradually to 5.4% in Q3 and 4.5% in Q4FY21. This is on the back of expectations of easing food prices as *kharif* production enters the market, a favourable *rabi* season given high reservoir storage levels and a gradual restoration of supply chains amidst continued lifting of restrictions, with a favourable base providing an added support. This, however, is expected to be partly offset by higher prices of pulses and oilseeds due to high import duties and sticky domestic fuel prices. Headline inflation in FY22 is expected in the range of 4.1 to 4.4% assuming a normalisation of supply chains with the availability of COVID-19 vaccine and a normal monsoon.

Headline inflation is expected to ease to 5.4% in Q3FY21 and 4.5% in Q4.

- **GDP to contract by 9.5% in FY21:** Following an unprecedented contraction of 23.9% in Q1FY21, the Indian economy recovered at a snail pace in July and August, but recovery strengthened in September with several high-frequency indicators slowly moving back to the pre-COVID levels. That said, the outlook continues to remain heavily dependent on the COVID-19 spread and trajectory and development of an effective vaccine. The RBI's expects a GDP contraction of 9.5% in FY21 (our est.: -10.5%) in the baseline scenario that assumes a gradual

The RBI expects GDP to contract by 9.5% in FY21 and record a growth of 10.1% in FY22 in the baseline scenario.

normalisation of economic activity in H2FY21, with the economy expected to move into a positive growth trajectory by Q4FY21. Risks, however, remain titled to the downside given an uncertain COVID-19 trajectory. The baseline GDP growth in FY22 is expected at 10.1% (our est.: 10.0%), supported by a large favourable base.

In a favourable scenario that assumes a faster normalisation of supply chains owing to an early breakthrough in vaccine development, GDP is expected to contract by 7.5% in FY21, accompanied by a stronger rebound of 11.6% in FY22. In an adverse scenario that assumes a second wave of infections and heightened financial market volatility, GDP is expected to record a deeper contraction of 11.5% in FY21, followed by a tepid recovery of 7.2% in FY22.

- **On-tap TLTROs and OMOs to support yields:** Even as the COVID-19 uncertainty looms large, the economy is slowly coming back on track with the gradual lifting of lockdown restrictions. To support the ongoing recovery, the RBI today announced a host of additional measures, particularly targeted at enhancing liquidity support and improving credit flow to certain sectors. Continuing with its efforts on ensuring adequate liquidity in the system, the RBI decided to conduct on-tap TLTROs worth Rs1trn at repo-linked floating rates with tenors of up to three years, available until March 31st, 2021. The liquidity availed under this scheme would be earmarked for deployment in corporate bonds, commercial papers and non-convertible debentures issued by specific sectors with backward and forward linkages and can also be used by banks to extend loans to these sectors as well as to reverse transactions under TLRO and TLTRO 2.0. This would further bring down cost of funds for corporate borrowers. The RBI also decided to extend the dispensation of enhanced HTM limit of 22% (announced on Aug 31st) up to March 31st, 2022 for fresh acquisition of SLR securities between Sep 1st, 2020 and March 31st, 2021. Besides enhanced outright and special OMOs (amount increased from Rs100bn to 200bn), the RBI for the first time ever decided to conduct OMOs on SDLs (state development loans), thereby improving liquidity and pricing of the SDL market.

Liquidity measures announced today include on-tap TLTROs, extension of HTM limit hike until Mar'22, enhanced outright and special OMOs and the first-ever OMOs on SDLs.

- **...and ease credit flow:** To improve credit flow to individuals and small businesses, the RBI has revised the absolute threshold limit on the maximum aggregate retail exposure to one counterparty from Rs50mn to Rs75mn. The RBI also announced rationalisation of risk weights on individual housing loans by linking them with only LTV ratios (loan-to-value ratio) as opposed to the size of the loan and LTV ratio earlier, wherein loans with LTV<=80% would have a risk weight of 35% and 50% for loans with LTV>80%. This would encourage banks to enhance lending to the real estate sector. Other measures included: a) extension of the "Co-Lending Model" to all NBFCs, b) round-the-clock availability of the RTGS facility, and c) discontinuation of the Automatic Caution-listing of exporters.

Increase in banks' exposure limit to retail borrowers and relaxed risk weights on housing loans should ease credit flow to small businesses and real estate sector respectively.

- **Liquidity support to remain the RBI's focus for now:** The additional measures announced today would not only align the G-sec/SDL market with the prevailing comfortable liquidity conditions, thereby supporting transmission across the board, but also help ease cost of funds and crowding out effect on the private sector in the wake of an augmented Government borrowing programme. The RBI is expected to continue to focus on liquidity infusion and ensuring effective monetary transmission to support growth for now, while keeping policy rates unchanged in the wake of an elevated inflation trajectory. That said, an expected easing of inflation trajectory should open space for a rate cut by the fourth quarter of this fiscal, with our expectations of another 25-50bps cut in the current easing cycle.

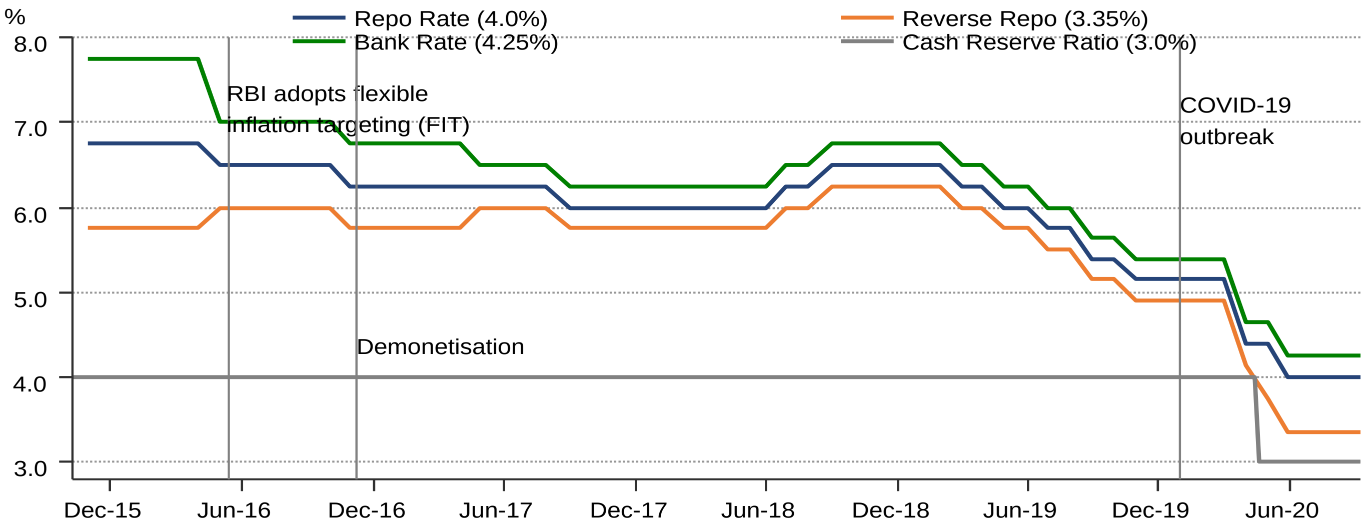
The RBI is expected to continue to focus on liquidity infusion and ensuring effective monetary transmission to support growth for now.

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)	18.0%

Source: RBI

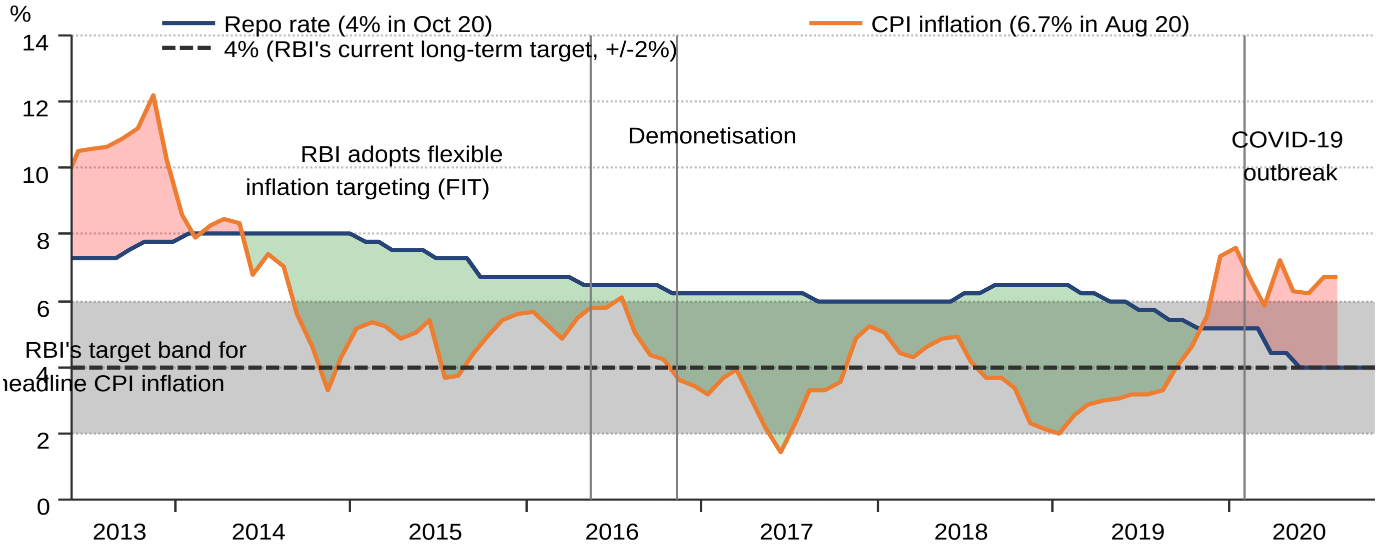
Figure 2: Policy rates kept unchanged



Source: Refinitiv Datastream.

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

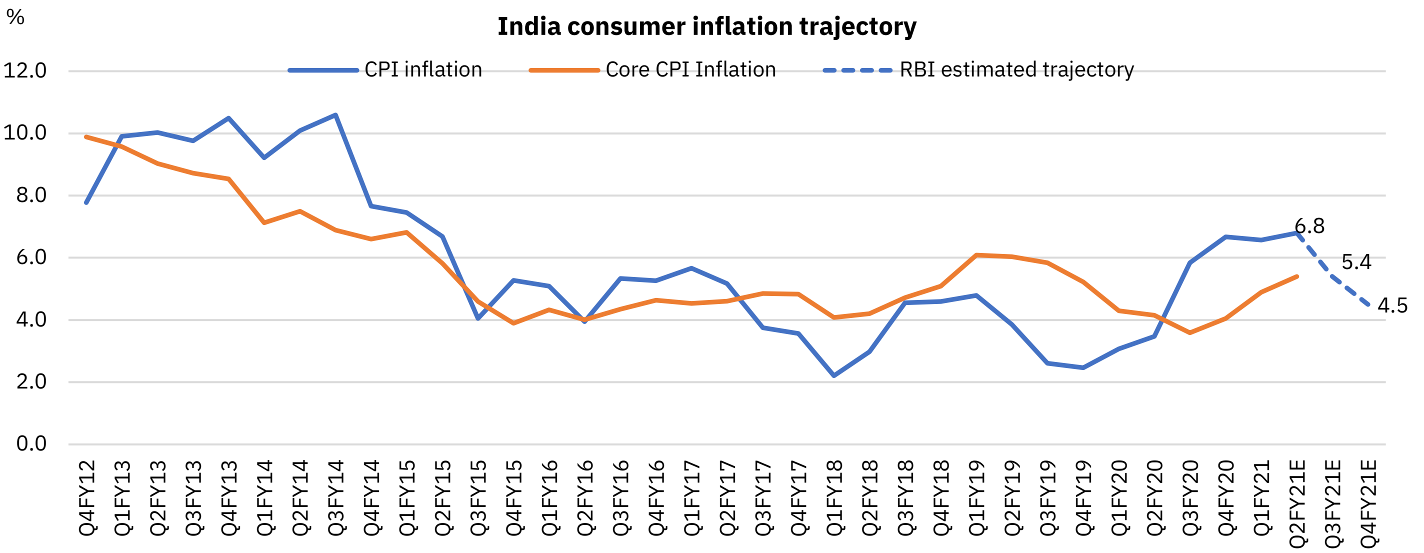
India headline CPI inflation has remained closer to or above the upper-bound of the RBI's target range of 4% +/- 2% since Dec'19. This has translated into persistence of negative real interest rates for almost a year now.



Source: Refinitiv Datastream.

RBI expects inflation to ease to sub-5% by Q4FY21: The MPC expects inflation to remain elevated at 6.8% in the second quarter of FY21, but ease gradually to 5.4% in Q3 and 4.5% in Q4FY21. This is on the back of expectations of easing food prices as *kharif* production enters the market, a favourable *rabi* season given high reservoir storage levels and a gradual restoration of supply chains amidst continued lifting of restrictions, with a favourable base providing an added support. This, however, is expected to be partly offset by higher prices of pulses and oilseeds due to high import duties and sticky domestic fuel prices. Headline inflation in FY22 is expected in the range of 4.1 to 4.4% assuming a full normalisation of supply chains with the availability of COVID-19 vaccine and a normal monsoon.

Figure 4: RBI expects headline CPI inflation to moderate from 6.8% in Q2FY21 to 4.5% in Q4FY21

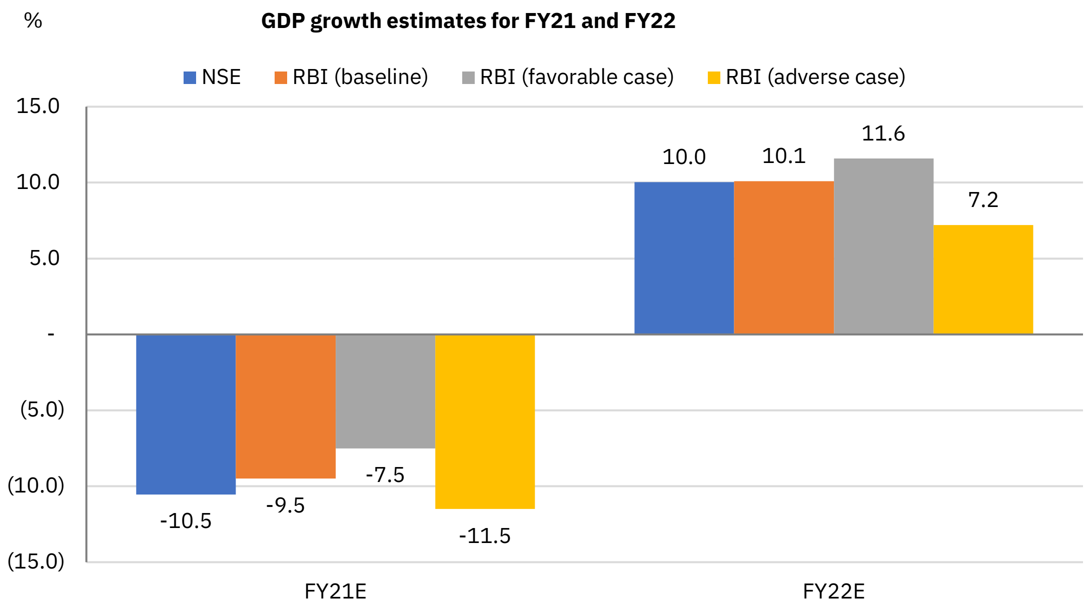


Source: RBI. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

GDP to contract by 9.5% in FY21: The RBI's expects a GDP contraction of 9.5% in FY21 (our est.: -10.5%) in the baseline scenario that assumes a gradual normalisation of economic activity in H2FY21, with the economy expected to move into a positive growth trajectory by Q4FY21. Risks, however, remain titled to the downside given an uncertain COVID-19 trajectory. The baseline GDP growth in FY22 is expected at 10.1% (our est.: 10.0%), supported by a large favourable base.

In a favourable scenario that assumes a faster normalisation of supply chains owing to an early breakthrough in vaccine development, GDP is expected to contract by 7.5% in FY21, accompanied by a stronger rebound of 11.6% in FY22. In an adverse scenario that assumes a second wave of infections and heightened financial market volatility, GDP is expected to record a deeper contraction of 11.5% in FY21, followed by a tepid recovery of 7.2% in FY22.

Figure 5: GDP growth estimates for FY21 and FY22



Source: RBI, NSE.

Figure 6: Assumptions for RBI's baseline projections

Indicator	MPR April 2020	MPR October 2020
Crude oil (Indian basket)	US$35/bbl during FY21	US$40.9/bbl during FY21
Exchange rate	Rs75/US$	Rs73.6/US$
Monsoon	Normal for 2020	9% above Long Period Average (LPA)
Global growth	Contraction in 2020	-4.9% in 2020 5.4% in 2021
Fiscal deficit (% of GDP)	To remain within FY21 budget estimates: Centre: 3.5% Combined: 6.1%	Expected to be significantly higher
Domestic macroeconomic/structural policies during the forecast period	No major change	No major change

Source: RBI.

Liquidity support remained the RBI's preferred route to support economic growth: Besides cutting policy repo rate by 115bps (and reverse repo by a higher 135bps), liquidity infusion to support financial conditions and facilitate monetary transmission has remained the RBI's focus area to support growth. The total liquidity support provided by the RBI since February 6th until September 30th, 2020 amounted to Rs11.1trn or 5.5% of GDP (based on FY20 nominal GDP). With today's Rs1trn on-tap TLTROs and enhanced OMO purchases amounting to Rs200bn (SLD OMOs quantum not announced yet), the support increases to ~6.1% of GDP. Adequate liquidity infusion into the markets, particularly in the wake of a heavy borrowing calendar of the Centre as well as states, has significantly helped in monetary transmission in money as well as credit markets, even as the G-sec market hasn't enjoyed a commensurate benefit, reflecting a consequence of strained Government's finances.

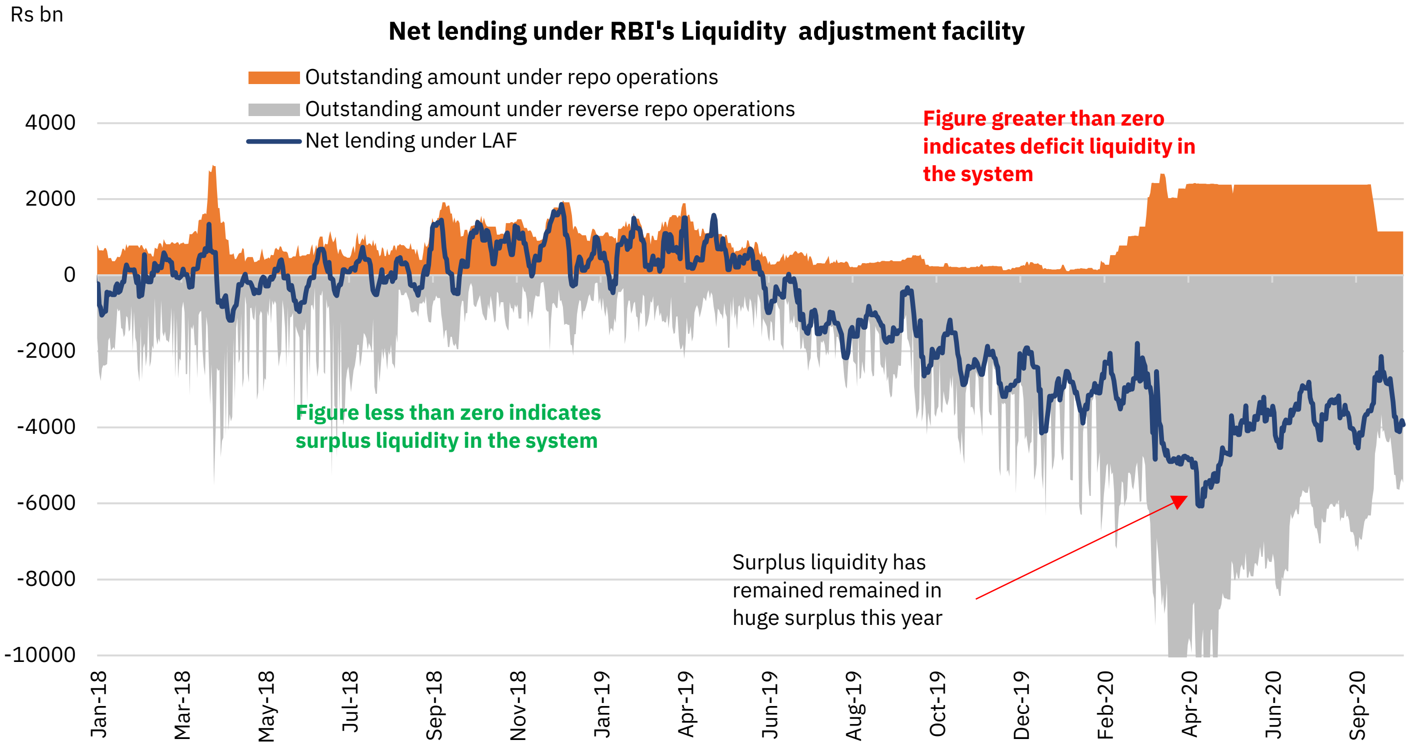
Figure 7: Monetary and liquidity measures announced since February 6th (up to September 30th, 2020)

Measures	Amount (Rs bn)
LTRO	2,000
Variable repo rate	1,750
SLR for primary dealers	72
CRR cut	1,370
MSF (dip by 1% in SLR)	1,370
TLTRO	1,000
TLTRO 2.0	500
Net OMO purchases	500
Special liquidity facility for mutual funds	500
Refinance to NABARD, SIDBI, NHB and Exim Bank	750
Special liquidity scheme for NBFCs	300
56-day term repo	1,000
Total	**11,112**
% of GDP*	**5.5**

Source: RBI. *Based on FY20 nominal GDP.

Figure 8: Net lending under RBI's Liquidity Adjustment Facility

Surplus liquidity in the banking system has remained in a huge surplus since more than a year now, averaging at ~Rs4trn since April 2020.

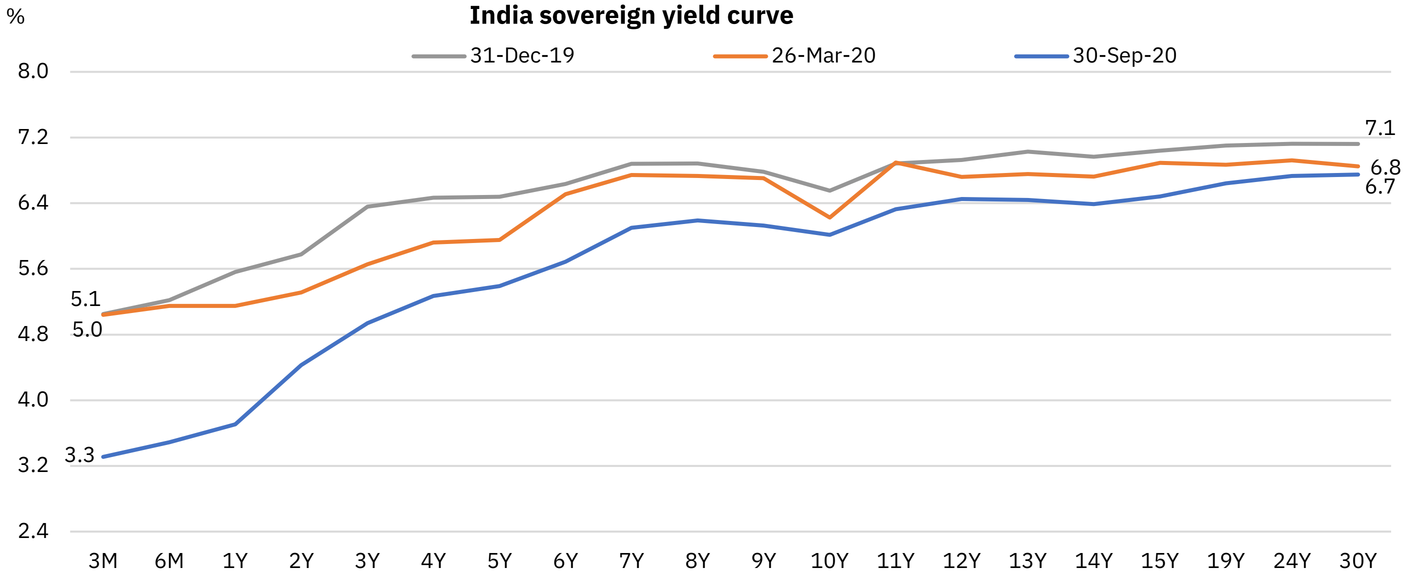


Source: CMIE Economic Outlook, NSE

Monetary transmission has improved meaningfully since April 2020: A steep cut in policy rates, coupled with the host of liquidity measures announced since March 2020 (Figure 7), has significantly improved monetary transmission in money, credit as well as lending markets, as shown in the charts below. The weighted average lending rate (WALR) on fresh loans and 5-year AAA corporate bond yield have fallen by ~91bps and ~79bps since March 2020 as compared to a drop in policy repo rate of 115bps. The fall in 10-year G-sec yield, however, has been a meagre 25bps, while short-end of the sovereign curve has fallen sharply, resulting in a significant steepening of the yield curve, reflecting strengthened concerns on the Government's fiscal balances. The additional measures announced today would not only align the G-sec/SDL market with the prevailing comfortable liquidity conditions, thereby supporting transmission across the board, but also help ease cost of funds and crowding out effect on the private sector in the wake of an augmented Government borrowing programme.

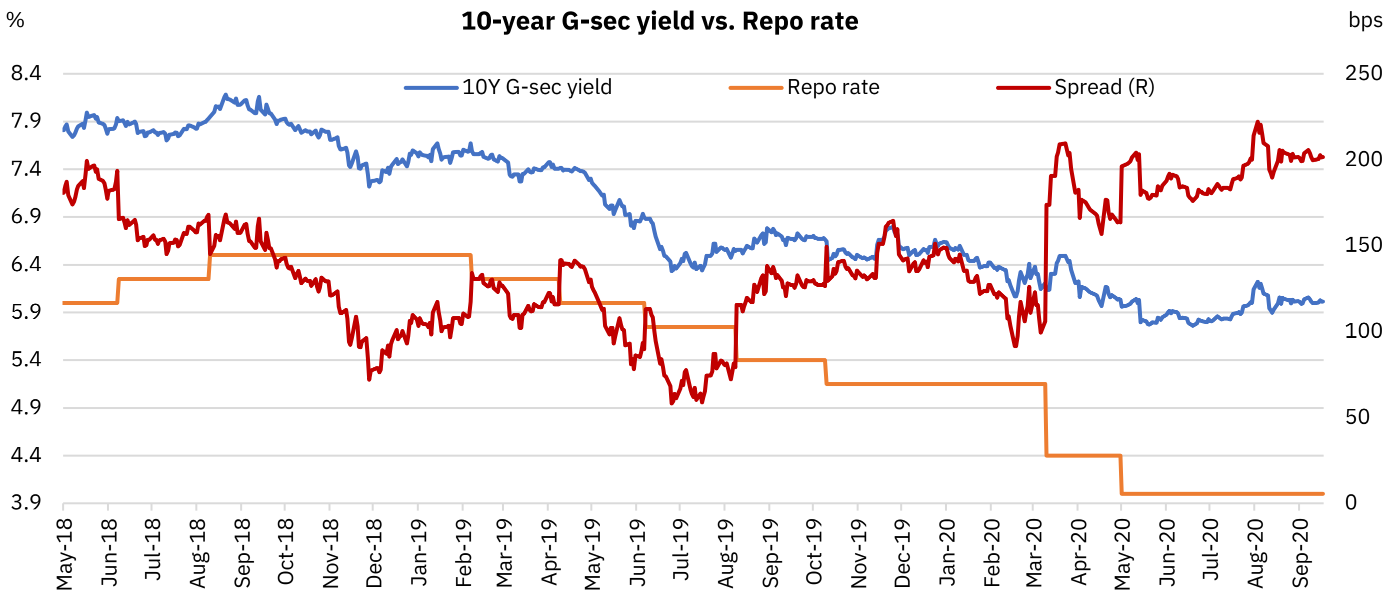
Figure 9: India sovereign yield curve

The India sovereign yield curve has steepened sharply since the RBI's first policy response to the COVID-19 outbreak. While the short-end has fallen by as much as 175bps since March 26th, the longer-end of the curve (10-year and above) has come down by an average of ~50bps, reflecting strengthened concerns on the Government's fiscal balances.



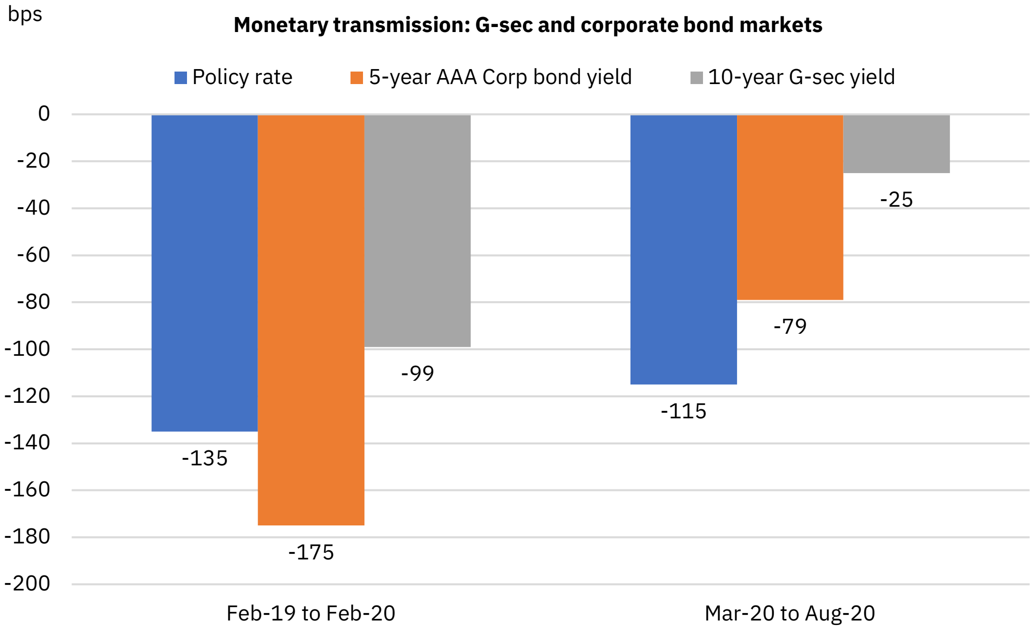
Source: Refinitiv Datastream, NSE.

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



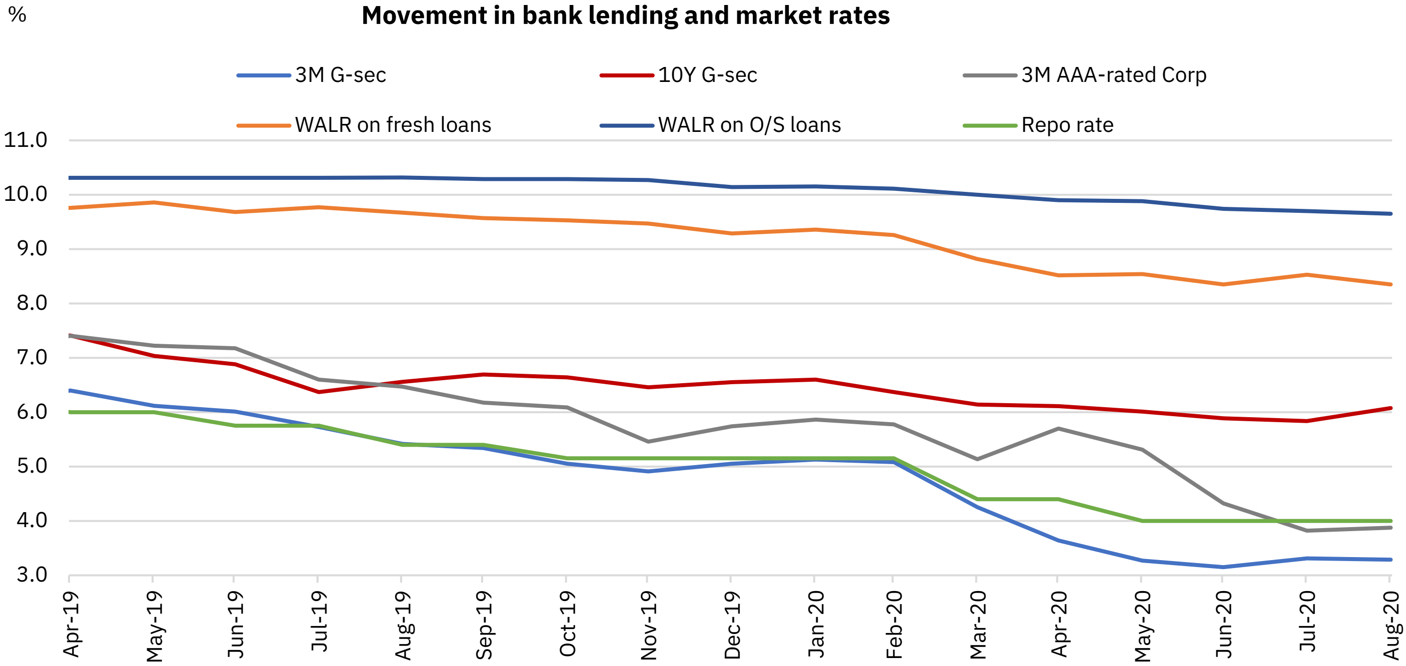
Source: Refinitiv Datastream, NSE.

Figure 11: Monetary transmission in G-sec and corporate bond markets



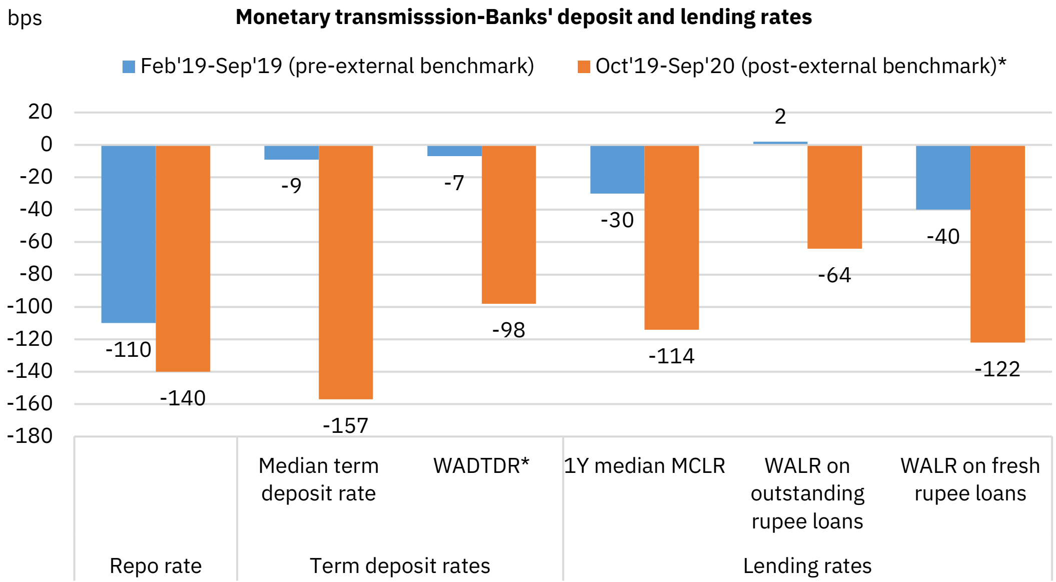
Source: RBI.

Figure 12: Movement in bank lending rates and market rates vs. policy repo rate



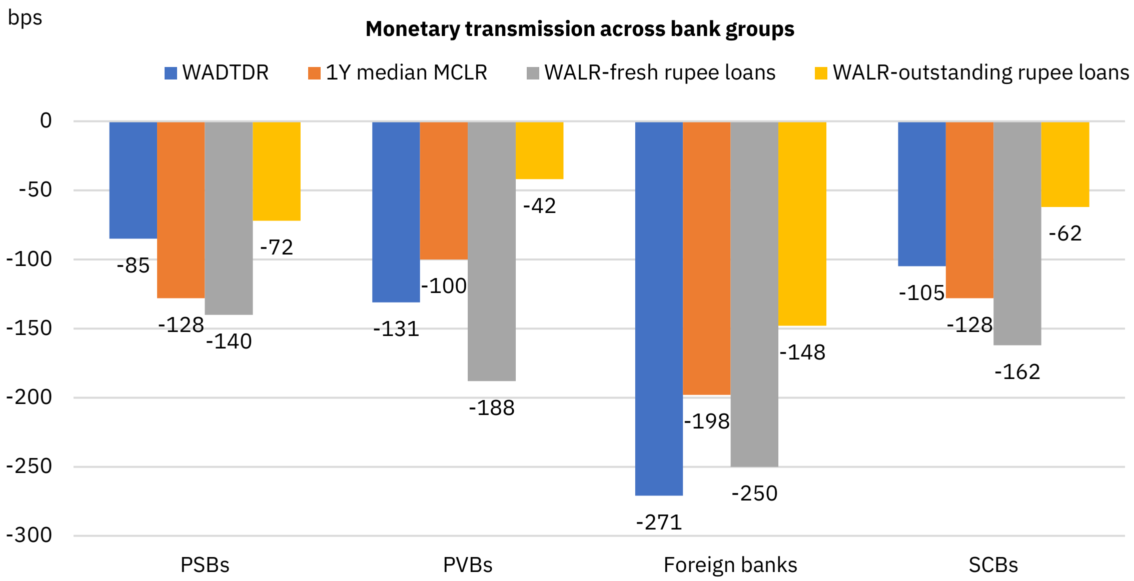
Source: RBI, Refinitiv Datastream, NSE.

Figure 13: Bank lending rates vs. policy rate



Source: RBI. * WADTDR: Weighted Average Domestic Term Deposit Rate. MCLR: Marginal cost of funds-based lending rate. WALR: Weighted Average Lending Rate.

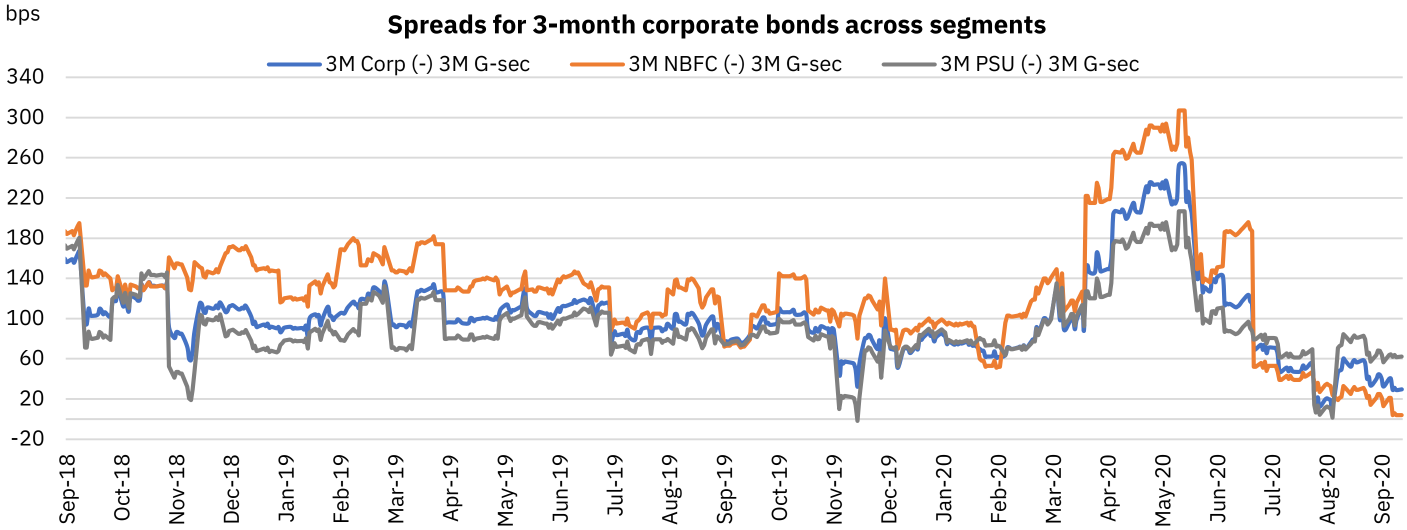
Figure 14: Monetary transmission across bank groups



Source: RBI. Note: WADTDR: Weighted Average Domestic Term Deposit Rate. MCLR: Marginal cost of funds-based lending rate. WALR: Weighted Average Lending Rate.

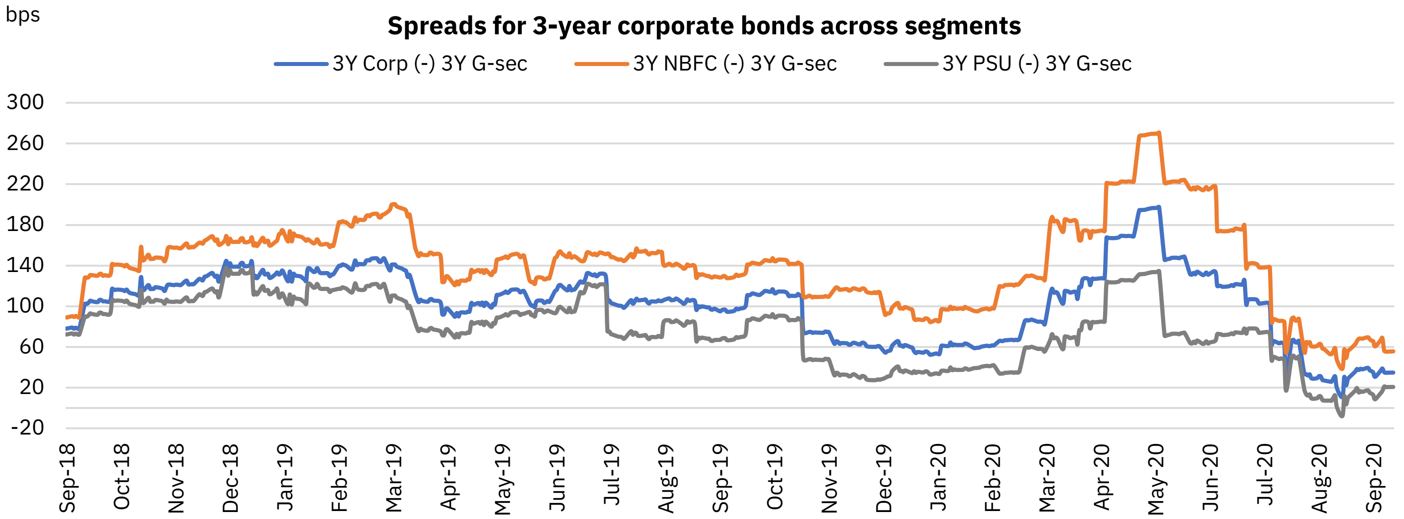
Corporate bond spreads have also declined meaningfully since April 2020 across issuer categories and tenors, benefiting from an ample domestic liquidity and a surge in demand for good-rated corporate bonds following RBI's TLTROs. That said, corporate bond curve has also steepened, in-line with the sovereign curve.

Figure 15: Spreads for 3-month corporate bonds across segments



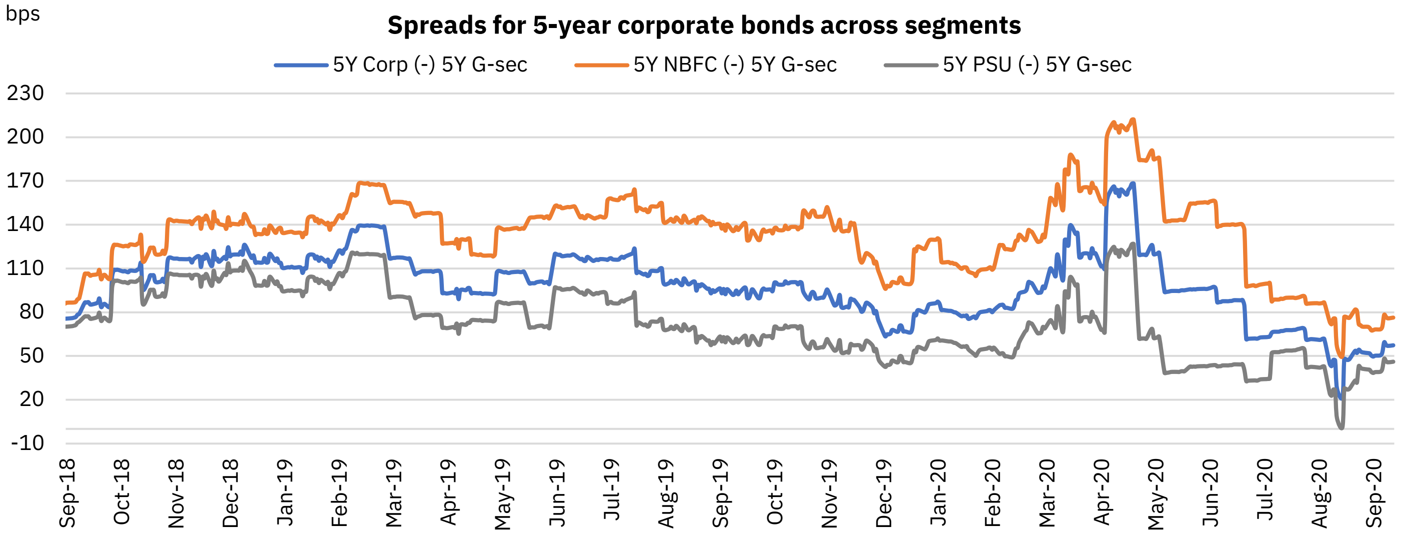
Source: Refinitiv Datastream, Bloomberg, NSE. Data is as of September 21st, 2020.

Figure 16: Spreads for 3-year corporate bonds across segments.



Source: Refinitiv Datastream, Bloomberg, NSE. Data is as of September 21st, 2020.

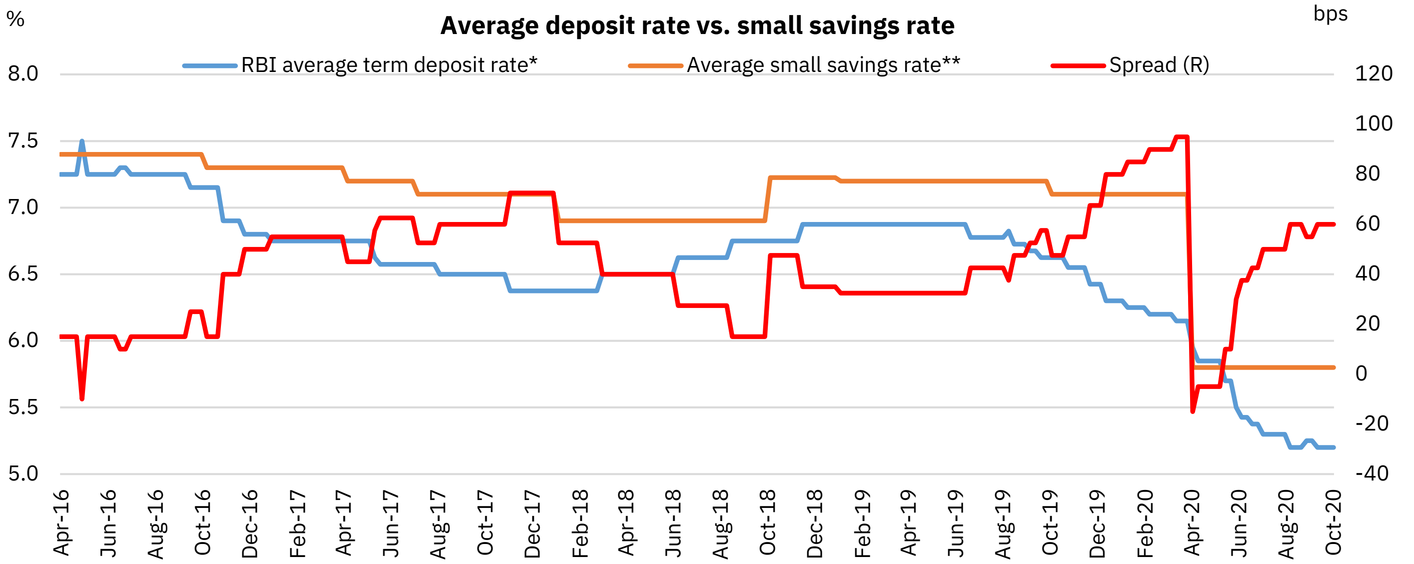
Figure 17: Spreads for 5-year corporate bonds across segments



Source: Refinitiv Datastream, Bloomberg, NSE. Data is as of September 21st, 2020.

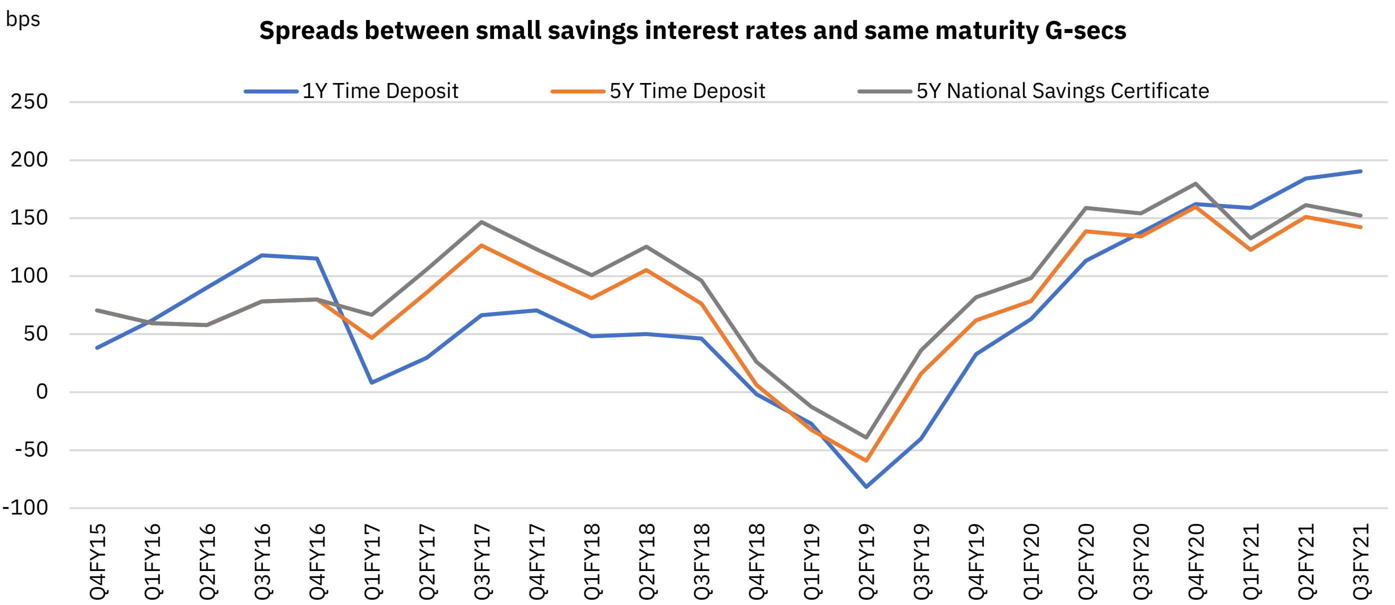
High interest rates on small savings have implications on monetary transmission: Interest rates on small savings instruments are linked to comparable maturity G-secs and are adjusted on a quarterly basis. After a sharp drop in Q1FY21, small savings interest rates were left unchanged for Q2FY21 and Q3FY21 despite a significant drop in similar maturity G-secs, thereby significantly widening the spreads between the two. This, in turn, may hinder monetary transmission in the economy.

Figure 18: Average deposit rate vs. small savings rate



Source: CMIE Economic Outlook, RBI. *Average term deposit rate is the average of minimum and maximum deposit rate for deposits more than one year. ** Average small savings rate is the average of 1 to 5-year time deposits.

Figure 19: Spreads between small savings rates and comparable maturity G-secs



Source: CMIE Economic Outlook, Refinitiv Datastream, RBI.

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