Second Bi-monthly Monetary Policy Statement, 2020-21

August 06, 2020

Policy Actions

Keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.00 percent.

Accordingly, the marginal standing facility (MSF) rate and the Bank Rate remains unchanged at 4.25 percent and the reverse repo rate under the LAF remains at 3.35 percent.

The MPC also decided to continue with the accommodative stance as long as it is necessary to revive growth and mitigate the impact of coronavirus (COVID-19) on the economy, while ensuring that inflation remains within the target.

These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 percent within a band of +/- 2 percent, while supporting growth.

Policy Assessment

Global economic activity has remained fragile and in retrenchment in several geographies. Contractions in economic activity have been more severe in Q2:2020 than in Q1, and the near-term outlook points to a slow, uneven and hesitant recovery pushed into the second half of the year, with risks steeply slanted to the downside. Among advanced economies (AEs), output in the US and the Euro area underwent a deeper contraction in Q2:2020 than in the preceding quarter. Emerging market economies (EMEs) are expected to shrink in Q2 as reflected in high frequency indicators.

Global financial markets have rebounded since end-March 2020 with intermittent pauses, shrugging off the volatility and sharp correction recorded in Q1:2020. Portfolio flows returned to EMEs in Q2 after a massive reversal, though there was moderation in July from the previous month's level. Crude oil prices have remained supported on supply cuts by oil producing countries (OPEC plus) and improved demand prospects on the gradual easing of lockdown restrictions since May. Gold prices have rallied to an all-time high on August 5 on the back of safe haven demand.

Domestic economic activity had started to recover from the lows of April-May following the uneven re-opening of some parts of the country in June; however, surges of fresh infections have forced re-clamping of lockdowns in several cities and states. Consequently, several high frequency indicators have levelled off.

The total area sown under kharif crops on July 31 was 5.9 per cent higher than the normal area measured by the average over the period 2014-15 to 2018-19. As on July 30, 2020, the live storage in major reservoirs was 41 per cent of the full reservoir level (FRL), which bodes well for the rabi season. These developments have had a salutary effect on rural demand as reflected in fertiliser production and sales of tractors, motorcycles and fastmoving consumer goods.

The pace of contraction of industrial production, measured by the index of industrial production (IIP), moderated to (-) 34.7 percent in May from (-) 57.6 percent a month ago, with the easing of lockdowns in different parts of the country. All manufacturing sub-sectors, except pharmaceuticals, remained in negative territory.

High frequency indicators of services sector activity for May-June indicate signs of a modest resumption of economic activity, especially in rural areas, although at levels lower than a year ago. Notably, the decline in passenger vehicle sales moderated to (-) 49.6 percent in June from (-) 85.3 percent in May, indicative of tentative urban demand, and faster recovery of sales in rural areas. Construction activity remained tepid – cement production fell and finished steel consumption moderated sharply in June. Imports of capital goods – a key indicator of investment activity – declined further in June.

During Q1:2020-21 food inflation moderated from 10.5 percent in April to 7.3 percent in June 2020. Meanwhile, fuel inflation edged up as international kerosene and LPG prices firmed up. Inflation excluding food and fuel was at 5.4 percent in June, reflecting a spike in prices across most sub-groups. Inflation in transport and communication, personal care and effects, pan-tobacco and education registered significant increases in June. Headline CPI inflation, which was at 5.8 per cent in March 2020 was placed at 6.1 per cent in the provisional estimates for June 2020.

Average daily net absorptions under the liquidity adjustment facility (LAF) moderated from ₹5.3 lakh crore in May 2020 to ₹4.0 lakh crore in July as government spending remained subdued. During 2020-21 (up to July 31), ₹1,24,154 crore was injected through open market operation (OMO) purchases. The utilisation of refinance provided by the Reserve Bank to the National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI) and the National Housing Bank (NHB) increased to ₹34,566 crore on July 31, 2020 from ₹22,334 crore during the May policy.

The transmission to bank lending rates has improved further, with the weighted average lending rate (WALR) on fresh rupee loans declining by 91 bps during March-June 2020. The spreads of 3-year AAA rated corporate bonds over G-Secs of similar maturity declined from 276 bps on March 26, 2020 to 50 bps by end-July 2020. Even for the lowest investment grade bonds (BBB-), spreads have come down by 125 bps by end-July 2020. Lower borrowing costs have led to record primary issuance of corporate bonds of ₹2.1 lakh crore in the first quarter of 2020-21.

Trade balance recorded a surplus in June (US$ 0.8 billion), after a gap of over 18 years. Net foreign direct investment moderated to US$ 4.4 billion in April-May 2020 from US$ 7.2 billion a year ago. In 2020-21 (till July 31), net foreign portfolio investment (FPI) in equities at US$ 5.3 billion was higher than US$ 1.2 billion a year ago. In the debt segment, however, there were outflows of US$ 4.4 billion during the same period as against inflows of US$ 2.0 billion a year ago. India's foreign exchange reserves have increased by US$ 56.8 billion in 2020-21 so far (up to July 31) to US$ 534.6 billion – equivalent to 13.4 months of imports.

Outlook

Supply chain disruptions on account of COVID-19 persist, with implications for both food and non-food prices. A more favourable food inflation outlook may emerge as the bumper rabi harvest eases prices of cereals, especially if open market sales and public distribution offtake are expanded on the back of significantly higher procurement. Upside risks to food prices remain. The inflation outlook of non-food categories is, however, fraught with uncertainty. Higher domestic taxes on petroleum products have resulted in elevated domestic pump prices and will impart broad-based cost-push pressures going forward. Headline inflation may remain elevated in Q2:2020-21, but may moderate in H2:2020-21 aided by large favourable base effects.

Turning to the growth outlook, the recovery in the rural economy is expected to be robust, buoyed by the progress in kharif sowing. External demand is expected to remain anemic under the weight of the global recession and contraction in global trade. 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 outlook. A more protracted spread of the pandemic, deviations from the forecast of a normal monsoon and global financial market volatility are the key downside risks.

The MPC noted that the economy is experiencing unprecedented stress in an austere global environment. Extreme uncertainty characterises the outlook, which is heavily contingent upon the intensity, spread and duration of the pandemic – particularly the heightened risks associated with a second wave of infections – and the discovery of the vaccine. In these conditions, supporting the recovery of the economy assumes primacy in the conduct of monetary policy. In pursuit of this objective, the stance of monetary policy remains accommodative as long as it is necessary to revive growth and mitigate the impact of COVID-19 on the economy. While space for further monetary policy action in support of this stance is available, it is important to use it judiciously and opportunistically to maximise the beneficial effects for underlying economic activity

At the same time, the MPC is conscious that its primary mandate is to achieve the medium-term target for CPI inflation of 4 percent within a band of +/- 2 percent. It also recognises that the headline CPI prints of April-May, 2020 require more clarity. Given the uncertainty surrounding the inflation outlook and taking into consideration the extremely weak state of the economy in the midst of an unprecedented shock from the ongoing pandemic, it is prudent to pause and remain watchful of incoming data as to how the outlook unravels

All the members of the MPC unanimously voted for keeping the policy repo rate unchanged and continue with the accommodative stance as long as necessary to revive growth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward.

Statement on Development and Regulatory Policies

This Statement sets out various developmental and regulatory policy that directly address the stress in financial conditions caused by COVID-19.

1). **Additional Liquidity Facility for National Housing Bank:** The RBI has been decided to provide an additional standing liquidity facility (ASLF) of ₹5,000 crore to NHB – over and above ₹10,000 crore already provided – for supporting housing finance companies (HFCs). The facility will be for a period of one year and will be charged at the RBI's repo rate.

2). **Additional Liquidity Facility for NABARD:** The RBI has been decided to provide an additional standing liquidity facility (ASLF) of ₹5,000 crore to NABARD over and above ₹25,000.

3). **Restructuring of MSME debt:** In respect of MSME borrowers facing stress on account of the economic fallout of the pandemic, lending institutions may restructure the debt under the existing framework, provided the borrower's account was classified as standard with the lender as on March 1, 2020. This restructuring shall be implemented by March 31, 2021.

4). **Advances against Gold Ornaments and Jewellery:** RBI has decided to increase the permissible loan to value ratio (LTV) for loans against pledge of gold ornaments and jewellery for non-agricultural purposes from 75 per cent to 90 per cent. This relaxation shall be available till March 31, 2021.

5). **Resolution Framework for COVID-19-related Stress:** The "Prudential Framework on Resolution of Stressed Assets" dated June 7, 2019 provides a principle-based resolution framework for addressing borrower defaults under a normal scenario. The RBI is constituting an Expert Committee (Chairman: Shri K.V. Kamath) which shall make recommendations to the RBI on the required financial parameters, along with the sector specific benchmark ranges for such parameters, to be factored into each resolution plans for COVID-19 related stress. The final notification in this regard shall be issued by the Reserve Bank after considering the recommendations.

Our Views & Conclusion:

On the expected lines, the MPC opted for pause in the policy rates. The 10 yr G-sec yield was at around 5.80% before the policy announcement went up by 6 bps to close at 5.86%. There is significantly surplus liquidity in the system. RBI has also indicated continuing with its accommodative policy to revive growth and aid the economy in the light of COVID 19 pandemic effect of lockdowns, while ensuring to keep the inflation within the targets going forward. RBI has also indicated that there may still be a space for rate action with durable decline in the inflation. The yields may remain range bound in the short term with RBI ensuring liquidity with OMOs and TWISTs. Considering the above factors, we will remain invested in the medium segment of the yield curve under our ULIP Funds mostly in Sovereign and AAA rated bonds.