IndiaFirst LIFE INSURANCE

First Bi-monthly Monetary Policy Statement, 2020-21

May 22, 2020

Policy Actions

Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 40 basis point to 4.00 percent from 4.40 percent with immediate effect.

Accordingly, the marginal standing facility (MSF) rate and the Bank Rate stand reduced to 4.25 percent from 4.65 percent.

The reverse repo rate under the LAF stands reduced by 40 basis points to 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 in standstill under COVID-19 related lockdowns and social distancing. Among the key advanced economies (Aes), economic activity contracted in the US, Euro area, Japan and the UK in Q1:2020. Among emerging market economies (EMEs), the Chinese economy went into a pronounced decline and data on high frequency indicators suggest that activity may have also shrunk in other EMEs such as Brazil and South Africa.

Global financial markets calmed after a turbulent period in March, and volatility ebbed as swift and large fiscal and monetary policy responses helped to soothe sentiment. Equity markets recovered some lost ground, while government bond yields remained range-bound, although somewhat elevated in some EMEs due to country specific factors. With the US dollar weakening, major EME currencies, which had experienced persistent downward pressure, traded with an appreciating bias.

Crude oil prices firmed up modestly as oil producing countries (OPEC plus) agreed to cut production, and prospects for revival in demand improved on expectations of imminent easing of lockdowns.

Domestic economic activity has been impacted severely by the lockdown which has extended over the past two months. High frequency indicators point to a collapse in demand beginning March 2020 across both urban and rural segments. The only silver lining was provided by agriculture, with the summer sowing of rice, pulses and oilseeds in the country progressing well, with total area sown under the current kharif season up by 43.5 percent so far, and the rabi harvest promising to be a bumper as reflected in record procurement.

Retail inflation, measured by the consumer price index, moderated for the second consecutive month in March 2020 to 5.8 percent after peaking in January. This was mainly due to food inflation easing from double digits in December 2019 – January 2020. In April, however, supply disruptions took a toll and reversed the softening of food inflation, which surged to 8.6 percent from 7.8 percent in March.

Systemic liquidity remained in abundance, with average daily net absorptions under the liquidity adjustment facility (LAF) increasing to ₹5.66 lakh crore in May 2020 (up to May 20) from ₹4.75 lakh crore in April. During 2020-21 (up to May 20), ₹1,20,474 crore was injected through open market operation (OMO) purchases and ₹87,891 crore through three targeted long-term repo operation (TLTRO) auctions and one TLTRO 2.0 auction. In order to distribute liquidity more evenly across the yield curve, the Reserve Bank conducted one 'operation twist' auction involving the simultaneous sale and purchase of government securities for ₹10,000 crore each on April 27, 2020.

Furthermore, the Reserve Bank has provided ₹22,334 crore as refinance to National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI) and National Housing Bank (NHB) so far (as on May 21, 2020) and ₹2,430 crore to mutual funds through a special liquidity facility (SLF) with a view to easing liquidity constraints and de-stress financial markets.

The weighted average lending rates on fresh rupee loans of commercial banks declined by 43 bps in March 2020 alone. Though credit growth remains muted, scheduled commercial banks' investments in commercial paper, bonds, debentures and shares of corporate bodies in this year so far (up to May 8) increased sharply by ₹66,757 crore as against a decline of ₹8,822 crore during the same period last year.

Net foreign direct investment inflows picked up in March 2020 to US$ 2.9 billion from US$ 0.8 billion a year ago. In 2020-21 so far (till May 18), net foreign portfolio investment (FPI) in equities increased to US$ 1.2 billion from US$ 0.8 billion a year ago. In the debt segment, however, there were portfolio outflows of US$ 3.8 billion during the same period as compared with outflows of US$ 1.4 billion a year ago. By contrast, net investment under the voluntary retention route increased by US$ 0.7 billion during the same period. India's foreign exchange reserves have increased by US$ 9.2 billion in 2020-21 so far (up to May 15) to US$ 487.0 billion – equivalent to 12 months of imports.

Outlook

The inflation outlook is highly uncertain. As supply lines get restored in the coming months with gradual relaxations in the lockdown, the unusual spike in food inflation in April is expected to moderate. The forecast of a normal monsoon also portends well for food inflation. Given the current global demand-supply balance, international crude oil prices are likely to remain low although they may firm up from the recent depressed levels. Soft global prices of metals and other industrial raw materials are likely to keep input costs low for domestic firms. These factors, combined with favourable base effects, are expected to take effect and pull down headline inflation below target in Q3 and Q4 of 2020-21.

The growth outlook, economic activity other than agriculture is likely to remain depressed in Q1:2020-21 in view of the extended lockdown For the year as a whole, there is still heightened uncertainty about the duration of the pandemic and how long social distancing measures are likely to remain in place and consequently, downside risks to domestic growth remain significant.

The MPC is of the view that the macroeconomic impact of the pandemic is turning out to be more severe than initially anticipated, and various sectors of the economy are experiencing acute stress. Beyond the destruction of economic and financial activity, livelihood and health are severely affected. With the inflation outlook remaining benign as lockdown-related supply disruptions are mended, the policy space to address growth concerns needs to be used now rather than later to support the economy.

All members voted for a reduction in the policy repo rate and maintaining the accommodative stance as long as it is necessary to revivegrowth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target.

Dr. Pami Dua, Dr. Ravindra H. Dholakia, Dr. Janak Raj, Dr. Michael Debabrata Patra and Shri Shaktikanta Das voted for a reduction in the policy repo rate by 40 bps, while Dr. Chetan Ghate voted for a reduction by 25 bps

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). **Refinancing Facility for Small Industries Development Bank of India (SIDBI):** The RBI had announced a special refinance facility of ₹15,000 crore to SIDBI for on-lending/refinancing at policy repo rate for a period of 90 days. The RBI has decided to roll over the facility at the end of the 90th day for another 90 days.

2). **Export Credit:** RBI permitted an increase in the period of realization and repatriation of export proceeds to India from nine months to 15 months from the date of export in respect of exports made up to or on July 31, 2020. It has also decided to increase the maximum permissible period of pre-shipment and postshipment export credit sanctioned by banks from the existing one year to 15 months, for disbursements made up to July 31, 2020.

3). **Extension of Moratorium on Term Loan Instalments:** Reserve Bank has extended the moratorium on term loan instalments by another three months, i.e., from June 1, 2020 to August 31, 2020.

4). **Deferment of Interest on Working Capital Facilities:** In respect of working capital facilities sanctioned in the form of cash credit/overdraft, lending institutions are being permitted to allow a deferment of another three months, from June1, 2020 to August 31, 2020.

5). **Payment of Interest on Working Capital Facilities for the Deferment Period Moratorium Loans:** The lending institutions are permitted to convert the accumulated interest on working capital facilities over the deferment period (up to August 31, 2020) into a funded interest term loan which shall be repayable not later than the end of the current financial year (i.e., March 31, 2021).

6). **Limit on Group Exposures under the Large Exposures Framework:** The exposure of a bank to a group of connected counterparties shall not be higher than 25% of the bank's eligible capital base at all times. As a one-time measure, Reserve Bank has increased this limit from 25% to 30%. The increased limit will be applicable up to June 30, 2021.

7). **Consolidated Sinking Fund (CSF) of State Governments - Relaxation of Guidelines:** State Governments maintain a CSF with the Reserve Bank as a buffer for repayment of their liabilities. RBI has decided to relax the rules governing withdrawal from the CSF. This measure will enable the states to meet about 45 percent of their redemptions due in 2020-21 through withdrawal from CSF. This change in withdrawal norms will come into force with immediate effect and will remain valid till March 31, 2021.

Our Views & Conclusion:

The 10 yr G-sec yield was at around 5.74 percent before the policy announcement which softened to 5.70 percent. There is significantly surplus liquidity in the system and although the RBI has announced TLTRO and other measures for the Banks to park their money in corporate debt, it is not taking place in a meaningful manner. The credit spreads are at the widest with respect to the sovereign curve which reflects the low economic growth/ contraction in the corporate bond segment. The RBI will need to address to this segment going forward. As of now, we have increased the proportion of sovereign bonds in the ULIPs and increased the duration as well to take advantage of the macroeconomic scenario, abundant liquidity and accommodative stance of the MPC