Fourth Bi-monthly Monetary Policy Statement, 2020-21

December 04, 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 (at least during the current financial year and into the next financial year) to revive growth on a durable basis and mitigate the impact of coronavirus (COVID-19) on the economy, while ensuring that inflation remains within the target going forward.

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

The outlook for Q4 (October-December) of 2020 is overcast with a surge in COVID-19 infections in a second wave across Europe, the US and major emerging market economies (EMEs), with accompanying lockdowns. Progress on vaccine candidates has, however, generated some offsetting optimism. World trade recorded a rebound in Q3 as lockdowns were eased, but it is likely to slow in Q4 as pent-up demand is exhausted, inventory restocking is completed, and trade-related uncertainty is rising with the second wave.

In India, the data release of the National Statistical Office (NSO) on November 27 showed a contraction of 7.5 percent in real GDP in Q2:2020-21 (July-September). In Q3:2020-21, high frequency indicators point to a recovery gaining traction, with double digit growth in passenger vehicles and motorcycle sales, railway freight traffic, and electricity consumption in October, although there was moderation in some of these indicators in November. Riding on the favourable monsoon, the outlook for agriculture remains bright, with rabi sowing up 4.0 per cent from the acreage covered at this time last year under supportive soil moisture and reservoir conditions.

CPI inflation rose sharply to 7.3 percent in September and further to 7.6 percent in October 2020, with some evidence that price pressures are spreading. Food inflation surged to double digits in October across protein-rich items including pulses, edible oils, vegetables and spices on multiple supply shocks. Core inflation, i.e., CPI excluding food and fuel, also picked up from 5.4 percent in September to 5.8 percent in October.

Domestic financial conditions remained easy in October-November and systemic liquidity continued to be in large surplus. Reserve money increased by 15.3 per cent (y-o-y) (as on November 27, 2020), driven by a surge in currency demand. India's foreign exchange reserves were US$ 574.8 billion (as on November 27), up from US$ 545.6 billion on October 2 at the time of the MPC's last resolution.

Outlook

The outlook for inflation has turned adverse relative to expectations in the last two months. The substantial wedge between wholesale and retail inflation points to the supply-side bottlenecks and large margins being charged to the consumer. While cereal prices may continue to soften with the bumper kharif harvest arrivals and vegetable prices may ease with the winter crop, other food prices are likely to persist at elevated levels. Crude oil prices have picked up on optimism of demand recovery, continuation of OPEC plus production cuts and are expected to remain volatile in the near-term. Taking into consideration all these factors, CPI inflation is projected at 6.8 percent for Q3:2020-21, 5.8 percent for Q4:2020-21; and 5.2 per cent to 4.6 per cent in H1:2021-22, with risks broadly balanced.

Turning to the growth outlook, the recovery in rural demand is expected to strengthen further, while urban demand is also gaining momentum as unlocking spurs activity and employment, especially of labour displaced by COVID-19. These positive impulses are, however, clouded by a possible rise in infections in some parts of the country, prompting some local containment measures. Private investment is still slack and capacity utilisation has not fully recovered. Real GDP growth is projected at (-)7.5 per cent in 2020-21: (+)0.1 percent in Q3:2020-21 and (+)0.7 percent in Q4:2020-21; and (+)21.9 percent to (+)6.5 per cent in H1:2021-22, with risks broadly balanced.

The MPC is of the view that inflation is likely to remain elevated, barring transient relief in the winter months from prices of perishables. This constrains monetary policy at the current juncture from using the space available to act in support of growth. At the same time, the signs of recovery are far from being broadbased and are dependent on sustained policy support. A small window is available for proactive supply management strategies to break the inflation spiral being fuelled by supply chain disruptions, excessive margins and indirect taxes. Further efforts are necessary to mitigate supply-side driven inflation pressures.

All members of the MPC unanimously voted for keeping the policy repo rate unchanged. Further, all members of the MPC voted unanimously to continue with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year – to revive growth on a durable basis 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). **On Tap TLTRO– Extension of Sectors and Synergy with ECLGS 2.0:** The RBI has included 26 stressed sectors identified by the Kamath committee within the ambit of sectors eligible under on tap TLTRO. Banks can avail funds from RBI under TLTRO and seek guarantee under ECLGS 2.0 to provide credit support to stressed sectors. Liquidity availed by banks under the scheme has to be deployed in corporate bonds, commercial papers, and non-convertible debentures. Investments made by banks under this facility will be classified as held to maturity (HTM) even in excess of 25 percent of total investment permitted to be included in the HTM portfolio.

2). **Facilitating More Efficient Liquidity Management for Regional Rural Banks (RRBs):** RBI has Extended the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) to Regional Rural Banks (RRBs) and permitting the RRBs to participate in the call/Notice money market both as borrowers and lenders

3). **Dividend Distribution by Banks:** RBI has decided that Schedule Commercial Banks and cooperative banks shall not make any dividend pay-out from the profits pertaining to financial year 2019-20.

4). **Dividend Distribution Policy for NBFCs:** RBI has decided to formulate guidelines on dividend distribution by NBFCs. Different categories of NBFCs would be allowed to declare dividend as per a matrix of parameters, subject to a set of generic conditions.

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 5.92 percent before the policy announcement and closed at 5.90 percent. RBI has indicated that it will continue with its accommodative stance as long as necessary- at least during the current financial year and into the next financial year- to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward. There is significantly surplus liquidity in the system. RBI has clearly indicated that it will use various instruments like OMO purchases, operation twists and reverse repos at the appropriate time, calibrating them to ensure that ample liquidity is available to the system. The RBI revised up its inflation forecast for Q3 to 6.8 percent and 5.8 percent for Q4 from its earlier estimate of 4.5-5.4 percent for H2 FY21.The yields may remain soft and range bound with RBI ensuring liquidity and taking various measures to support economy in the light of COVID 19 pandemic. We will remain invested in the medium segment of the yield curve under our ULIP Funds mostly in Sovereign and AAA rated bonds.