Third Bi-monthly Monetary Policy Statement, 2020-21

October 09, 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 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

Incoming data point to a recovery in global economic activity in Q3 of 2020 in sequential terms, although downside risks have risen with the renewed surge in infections in many countries. Global financial markets remain supported by highly accommodative monetary and liquidity conditions. Soft fuel prices and weak aggregate demand have kept inflation below target in AEs, although in some EMEs, supply disruptions have imparted upward price pressures.

On the domestic front, high frequency indicators suggest that economic activity is stabilising in Q2:2020-21 after the 23.9 percent year-on-year (y-o-y) decline in real GDP in Q1 (April-June). Cushioned by government spending and rural demand, manufacturing – especially consumer non-durables – and some categories of services, such as passenger vehicles and railway freight, have gradually recovered in Q2. The outlook for agriculture is robust. Headline CPI inflation increased to 6.7 percent during July-August 2020 as pressures accentuated across food, fuel and core constituents on account of supply disruptions, higher margins and taxes.

Domestic financial conditions have eased substantially, with systemic liquidity remaining in large surplus. Reserve money increased by 13.5 percent on a y-o-y basis (as on October 2, 2020), driven by a surge in currency demand (21.5 percent). Growth in money supply (M3), however, was contained at 12.2 percent as on September 25, 2020. Banks' non-food credit growth remains subdued. India's foreign exchange reserves stood at US$ 545.6 billion on October 2, 2020.

Outlook

Turning to the outlook for inflation, kharif sowing portends well for food prices. Pressures on prices of key vegetables like tomatoes, onions and potatoes should also ebb by Q3 with kharif arrivals. International crude oil prices have traded with a softening bias in September on a weak demand outlook, but domestic pump prices may remain elevated in the absence of any roll back of taxes. COVID-19-related supply disruptions, including labour shortages and high transportation costs, could continue to impose cost-push pressures, but these risks are getting mitigated by progressive easing of lockdowns and removal of restrictions on inter-state movements. Taking into consideration all these factors, CPI inflation is projected at 6.8 percent for Q2:2020-21, at 5.4-4.5 percent for H2:2020-21 and 4.3 percent for Q1:2021-22, with risks broadly balanced

Turning to the growth outlook, the recovery in the rural economy is expected to strengthen further, while the turnaround in urban demand is likely to be lagged in view of social distancing norms and the elevated number of COVID-19 infections. Both private investment and exports are likely to be subdued, especially as external demand is still anaemic. Taking into consideration the above factors and the uncertain COVID-19 trajectory, real GDP growth in 2020-21 is expected to be negative at (-)9.5 per cent, with risks tilted to the downside: (-)9.8 percent in Q2:2020-21; (-)5.6 percent in Q3; and 0.5 percent in Q4. Real GDP growth for Q1:2021-22 is placed at 20.6 percent

The MPC is of the view that revival of the economy from an unprecedented COVID-19 pandemic assumes the highest priority in the conduct of monetary policy. While inflation has been above the tolerance band for several months, the MPC judges that the underlying factors are essentially supply shocks which should dissipate over the ensuing months as the economy unlocks, supply chains are restored, and activity normalises. Accordingly, they can be looked through at this juncture while setting the stance of monetary policy. Taking into account all these factors, the MPC decides to maintain status quo on the policy rate in this meeting and await the easing of inflationary pressures to use the space available for supporting growth further

All 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 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:** The RBI has decided to conduct on tap TLTRO with tenors of upto three years for a total amount of upto ₹1,00,000 crs at a floating rate linked to the policy repo rate. Liquidity availed by banks under the scheme has to be deployed in corporate bonds, commercial papers, and non-convertible debentures issued by the entities in specific sectors over and above the outstanding level of their investments in such instruments as on September 30, 2020. 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). **SLR Holdings in Held to Maturity (HTM) category:** RBI has decided to extend the dispensation of enhanced HTM limits of 22 percent up to March 31, 2022 from March 31, 2021 for securities acquired between September 1, 2020 and March 31, 2021.

3). **Open Market operations (OMOs) in State Developments Loans (SDLs):** RBI has decided to conduct open market operations (OMOs) in SDLs as a special case during the current financial year. The OMOs would be conducted for a basket of SDLs comprising securities issued by states.

4). **Individual Housing Loans – Rationalisation of Risk Weights:** Recognising the criticality of real estate sector in the economic recovery, given its role in employment generation and the interlinkages with other industries, it has been decided, as a countercyclical measure, to rationalise the risk weights by linking them only with LTV ratios for all new housing loans sanctioned up to March 31, 2022. Such loans shall attract a risk weight of 35 per cent where LTV is less than or equal to 80 per cent, and a risk weight of 50 per cent where LTV is more than 80 per cent but less than or equal to 90 percent. This measure is expected to give a fillip to bank lending to the real estate sector.

5). **Round-the-Clock availability of Real Time Gross Settlement System (RTGS):** To support the ongoing efforts aimed at global integration of Indian financial markets, facilitate India's efforts to develop international financial centers and to provide wider payment flexibility to domestic corporates and institutions, it has been decided to make available the RTGS system round the clock on all days. With this, India will be one of the very few countries globally with a 24x7x365 large value real time payment system. This facility will be made effective from December 2020.

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 6.02% before the policy announcement went up by 8 bps to close at 5.94%. There is significantly surplus liquidity in the system. RBI has also indicated continuing with its accommodative policy (at least during the current financial year and into the next financial year) 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. RBI has announced series of measures to boost confidence in the market and provide liquidity- Increase in the size of OMOs (₹20,000 cr), OMOs in SDL for the first time as a special case in this financial year, on-tap TLTRO upto ₹1,00,000 crs. The yields may remain soft and range bound in the short term with RBI ensuring liquidity and taking various measures to support economy in the light of COVID 19 pandemic. 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.