Seventh Bi-monthly Monetary Policy Statement, 2019-20

March 27, 2020

Policy Actions

Reduce the policy repo rate under the liquidity adjustment facility (LAF) by 75 basis point to 4.40 percent from 5.15 percent with immediate effect.

Accordingly, the marginal standing facility (MSF) rate and the Bank Rate stand reduced to 4.65 per cent from 5.40 percent.

The reverse repo rate under the LAF stands reduced by 90 basis points to 4.0 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 come to a near standstill as COVID-19 related lockdowns and social distancing are imposed across a widening swathe of affected countries. The outlook is now heavily contingent upon the intensity, spread and duration of the pandemic. There is a rising probability that large parts of the global economy will slip into recession.

Financial markets have become highly volatile from January onwards due to the outbreak of COVID-19. Panic sell-offs have resulted in wealth destruction in equity markets across advanced and emerging economies alike. In the former, flight to safety has pulled down government bond yields to record lows.. Emerging and advanced economy currencies are experiencing severe depreciation pressure on a daily basis because of fire sales due to extreme risk aversion. At this point, only the US dollar remains safe haven in a highly uncertain outlook.

International crude prices initially traded with a softening bias from January in anticipation of demand weakening due to the COVID-19 outbreak. Production cut disagreements among key oil producers, however, set off retaliatory supply scale-ups and a price war that plunged international Brent crude prices to a low of US$ 25 per barrel on March 18, 2020.

The second advance estimates of the National Statistics Office released in February 2020 implied real GDP growth of 4.7 percent for Q4:2019-20 within the annual estimate of 5 percent for the year as a whole. This is now at risk from the pandemic's impact on the economy. The outlook for agriculture and allied activities appears to be the only silver lining, with foodgrains output at 292 million tonnes being 2.4 percent higher than a year ago.

Most service sector indicators for January and February 2020 moderated or declined. Since then anecdotal evidence suggests that several services such as trade, tourism, airlines, the hospitality sector and construction have been further adversely impacted by the pandemic. Dislocations in casual and contract labour would result in losses of activity in other sectors as well.

Retail inflation, measured by the consumer price index, peaked in January 2020 and fell by a full percentage point in February 2020 to 6.6 percent. Price pressures, however, remain firm across protein-rich items, edible oils and pulses; but the shock to demand from COVID-19 may weaken them going forward. While fuel inflation increased sharply in February on the back of the delayed domestic adjustment to international LPG prices, the plunge in international crude prices in March may bring a measure of relief to the extent it is allowed to pass-through.

Domestic financial conditions have tightened considerably, with equity markets facing massive sell-offs by foreign portfolio investors (FPIs). In the bond market too, yields have risen on sustained FPI selling, while redemption pressures, drop in trading activity and generalised risk aversion have pushed up yields to elevated levels in commercial paper, corporate bond and other fixed income segments. In the forex market, the Indian rupee (INR) has been under continuous downward pressure. Under these conditions, the Reserve Bank has endeavoured to keep financial markets liquid, stable and functioning normally.

Systemic liquidity surplus, as reflected in net absorptions under the LAF, averaged ₹2.86 lakh crore in March (up to March 25, 2020). In addition, the Reserve Bank undertook unconventional operations in the form of auctions of what is called 'operation twist' involving the simultaneous sale of short-term government securities (of ₹28,276 crore) and purchase of long-term securities (of ₹40,000 crore), cumulatively injecting a net amount of ₹11,724 crore. The Reserve Bank also conducted five long term repo auctions of 1 year and 3 years tenors of a cumulative amount of ₹1.25 lakh crore. It also conducted two sell-buy swap auctions to inject cumulatively US dollar liquidity into the forex market to the tune of US$ 2.71 billion on March 16 and 23. Open market purchase operations of ₹10,000 crore on March 20 and ₹15,000 crore each on March 24 and March 26 have been conducted to bolster liquidity and smoothen financial conditions.

Portfolio investment recorded net outflows of US$ 5.2 billion during 2019-20 (up to March 25), down from US$ 6.6 billion a year ago. India's foreign exchange reserves reached a level of US$ 487.2 billion on March 6, 2020 – an increase of US$ 74.4 billion over their end-March 2019 level.

Outlook

In the sixth bi-monthly resolution of February 2020, CPI headline inflation was projected at 6.5 per cent for Q4:2019-20. The prints for January and February 2020 indicate that actual outcomes for the quarter are running 30 bps above projections. Looking ahead, food prices may soften even further under the beneficial effects of the record food grains and horticulture production, at least till the onset of the usual summer uptick. Furthermore, the collapse in crude prices should work towards easing both fuel and core inflation pressures, depending on the level of the pass-through to retail prices. As a consequence of COVID-19, aggregate demand may weaken and ease core inflation further.

Turning to growth, apart from the continuing resilience of agriculture and allied activities, most other sectors of the economy will be adversely impacted by the pandemic, depending upon its intensity, spread and duration. If COVID19 is prolonged and supply chain disruptions get accentuated, the global slowdown could deepen, with adverse implications for India.

The MPC is of the view that macroeconomic risks, both on the demand and supply sides, brought on by the pandemic could be severe. The need of the hour is to do whatever is necessary to shield the domestic economy from the pandemic. Central banks across the world have responded with monetary and regulatory measures – both conventional and unconventional.

Governments across the world have unleashed massive fiscal measures, including targeted health services support, to protect economic activity from the impact of the virus. To mitigate the economic difficulties arising out of the virus outbreak, the Government of India has announced a comprehensive package of ₹1.70 lakh crore, covering cash transfers and food security, for vulnerable sections of society, including farmers, migrant workers, urban and rural poor, differently abled persons and women. The MPC notes that the Reserve Bank has taken several measures to inject substantial liquidity in the system. Nonetheless, the priority is to undertake strong and purposeful action in order to minimise the adverse macroeconomic impact of the pandemic. It is in this context that the MPC unanimously votes for a sizable reduction in the policy repo rate, but with some differences in the quantum of reduction. Banks and other financial institutions should do all they can to keep credit flowing to economic agents facing financial stress on account of the isolation that the virus has imposed.

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

Dr. Ravindra H. Dholakia, Dr. Janak Raj, Dr. Michael Debabrata Patra and Shri Shaktikanta Das voted for a 75 bps reduction in the policy repo rate. Dr. Chetan Ghate and Dr. Pami Dua voted for a 50 bps reduction in the policy repo rate.

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). **Targeted Long Term Repos Operations (TLTROs):** Reserve Bank will conduct auctions of targeted term repos of up to three years tenor of appropriate sizes for a total amount of up to ₹1,00,000 crore at a floating rate linked to the policy repo rate. Liquidity availed under the scheme by banks has to be deployed in investment grade corporate bonds, commercial paper, and non-convertible debentures over and above the outstanding level of their investments in these bonds as on March 27, 2020.

2). **Cash Reserve Ratio:** i). Reserve Bank has decided to reduce the cash reserve ratio (CRR) of all banks by 100 basis points to 3.0 percent of net demand and time liabilities (NDTL) with effect from the reporting fortnight beginning March 28, 2020. This reduction in the CRR would release primary liquidity of about ₹1,37,000 crore uniformly across the banking system in proportion to liabilities of constituents rather than in relation to holdings of excess SLR.

ii). Reserve Bank has decided to reduce the requirement of minimum daily CRR balance maintenance from 90 percent to 80 percent effective from the first day of the reporting fortnight beginning March 28, 2020. This is a one-time dispensation available up to June 26, 2020.

3). **Marginal Standing Facility (MSF):** Under the marginal standing facility (MSF), banks can borrow overnight at their discretion by dipping up to 2 per cent into the Statutory Liquidity Ratio (SLR). The Reserve Bank has decided to increase this limit of 2 percent to 3 per cent with immediate effect. This will be applicable upto June 30, 2020.

4). **Widening of the Monetary Policy Rate Corridor:** Reserve Bank has decided to widen the existing policy rate corridor from 50 bps to 65 bps. Under the new corridor, the reverse repo rate under the liquidity adjustment facility (LAF) would be 40 bps lower than the policy repo rate. The marginal standing facility (MSF) rate would continue to be 25 bps above the policy repo rate.

5). **Moratorium on Term Loans:** All commercial banks (including regional rural banks, small finance banks and local area banks), co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies and micro-finance institutions) ("lending institutions") are being permitted to allow a moratorium of three months on payment of instalments in respect of all term loans outstanding as on March 1, 2020.

6). **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 three months on payment of interest in respect of all such facilities outstanding as on March 1, 2020. The accumulated interest for the period will be paid after the expiry of the deferment period.

7). **Easing of Working Capital Financing:** In respect of working capital facilities sanctioned in the form of cash credit/overdraft, lending institutions may recalculate drawing power by reducing margins and/or by reassessing the working capital cycle for the borrowers.

8). **Deferment of Implementation of Net Stable Funding Ratio (NSFR):** the Basel Committee on Banking Supervision (BCBS) had introduced the Net Stable Funding Ratio (NSFR) which reduces funding risk by requiring banks to fund their activities with sufficiently stable sources of funding over a time horizon of a year in order to mitigate the risk of future funding stress. As per the prescribed timeline, banks in India were required to maintain NSFR of 100 per cent from April 1, 2020. It has now been decided to defer the implementation of NSFR by six months from April 1, 2020 to October 1, 2020.

9). **Deferment of Last Tranche of Capital Conservation Buffer (CCB):** As per Basel standards, the CCB was to be implemented in tranches of 0.625 per cent and the transition to full CCB of 2.5 per cent was set to be completed by March 31, 2020. Reserve Bank has decided to defer the implementation of the last tranche of 0.625 per cent of the CCB from March 31, 2020 to September 30, 2020.

Our Views & Conclusion:

The 10 yr G-sec yield was at around 6.30% before the policy announcement which softened to 6.1%. Although the market was in surplus liquidity of ₹2.8 lakh crores, the RBI has given further liquidity to the tune of ₹3.37 lakh crores. This will mainly see spread compression in the short term segment for both the G-sec and corporate bonds. However, as the Corona virus situation is still evolving, we will need to monitor the situation accordingly. Since the market is significantly surplus on liquidity and growth may be slower to pick up, the yields are likely to remain soft for the forseeable future.