RBI's Monetary Policy Review (FY20-21)

October 10, 2020

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Status Quo For Now But Guidance Of Lower Rates For Longer

- India's Monetary Policy Committee (MPC) kept interest rates unchanged at its October FY21 review.
- The benchmark repo rate was left unchanged at 4% and reverse repo rate at 3.35%.
- The committee, maintained an accommodative stance, with five of the six committee members voting to hold that view into next financial year.
- The committee opted to look through the current high inflation scenario, stressing that its objective remains to revive growth in a durable manner while maintaining inflation within the targeted range of 4 (+/-2)%.
- The central bank sees the Indian economy contract 9.5% in FY21, with a downside bias to those forecasts.
- According to the committee, recovery in the rural economy is expected to strengthen further, while the turnaround in urban demand is likely to lag.
- Manufacturing firms expect capacity utilisation to recover in Q3 FY21, while contact intensive services will take time to revert to pre-covid levels, according to the committee.
- It expects, both private investment and exports may remain subdued, especially as external demand is still anemic, according to the committee.
- It expects inflation at 6.8% for Q2 FY21, at 5.4-4.5% for H2 FY21 and 4.3% for Q1 FY22, with risks broadly balanced.
- Supply disruptions, including labour shortages and high transportation costs, are getting mitigated by progressive easing of lockdowns, according to the committee.
- The RBI assured that it would maintain comfortable liquidity conditions to ensure that the government borrowing program and private borrowing goes through smoothly.
- The RBI will conduct outright and special open market operations to keep liquidity conditions comfortable. The size of auctions will be increased to Rs 20,000 crore per auction.

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GDP Outlook

For FY2021-22, real GDP growth is estimated at 10.1%.

The MPC noted that the uncertainty about COVID-19's spread and trajectory continues to fog the outlook and makes forecasts of real GDP growth extremely challenging. The MPC assumes that economic activity will gradually normalise in H2 FY2020-21. Real GDP is projected to contract by 9.5% in FY2020-21 (-9.8% YoY in Q2, -5.6% YoY in Q3 and 0.5% YoY in Q4), with risks tilted to the downside.

For FY2021-22, assuming supply chains are fully restored with the availability of effective vaccines, a normal monsoon, no major exogenous or policy shocks and a large favourable base effect, the committee estimates real GDP growth at 10.1%.

According to the committee, the significant monetary accommodation already provided through cuts in the policy repo rate, and ample liquidity infusion announced by the government would be expected to add to the upside. On the other hand, a more protracted spread of the pandemic, delayed development and availability of vaccines, deviations from the forecast of a normal monsoon in FY2021- 22 and global financial market volatility are the key downside risks.

Inflation Outlook

For FY2021-22, Inflation is estimated to move in a range of 4.1-4.4%.

A bumper rabi crop, moderate increases in minimum support prices (MSPs) for kharif crops, a normal monsoon, sizeable buffer stocks and good water storage levels in major reservoirs augur well for the inflation outlook, according to MPC. At the same time, the persistence of COVID-related supply bottlenecks, higher taxes and their cost-push implications could impart upward pressures on inflation, the committee noted.

According to MPC estimates, CPI inflation will be at 6.8% YoY in Q2 FY2020- 21; subsequently, large favourable base effects are expected to pull it down to 5.4% YoY in Q3, and 4.5% YoY in Q4.

For FY2021-22, assuming a normalisation of supply chains with the availability of effective vaccines against COVID-19, a normal monsoon, and no major exogenous or policy shocks, the MPC estimates inflation will move in a range of 4.1-4.4%.

Key Notes from Monetary Policy

- **<u>Liquidity Measures:</u>**

- The RBI assured markets that it would maintain comfortable liquidity conditions to ensure that the government borrowing program and private borrowing goes through smoothly.

- The RBI stands ready to conduct market operations needed to keep financial conditions comfortable. In particular, the RBI will conduct outright and special open market operations to keep liquidity conditions comfortable.

- The size of auctions will be increased to Rs 20,000 crore per auction. It will also, for the first time, conduct open market operations in state development loans.

- The RBI also announced an on-tap targeted long term repo operations. Rs 1 lakh crore in funds will be available ununder this facility for a period of three-years. Liquidity availed under this facility should be deployed in corporate bonds, debentures and bank loans to specific sectors.

- The enhanced held-to-maturity limit of 22% of government bonds has been extended till March 2022.

- Governor Das, in a rare comment, said that "financial market stability and the orderly evolution of the yield curve are public goods and both market participants and the RBI have a shared responsibility in this regard."

- Market participants need to take a broader time perspective and display bidding behaviour that reflects "a sensitivity to the signals from the RBI in the conduct of monetary policy and debt management," Das said.

- "We look forward to cooperative solutions for the borrowing programme for the second half of the year. It is said that it takes at least two views to make a market, but these views can be competitive without being combative", he added.

Our View

As expected, the central bank's guidance was very dovish. While scope for rate cuts remains small till February, real policy support will continue to come.

The slew of measures proposed by the RBI Governor to ease the financing conditions and provide an adequate liquidity is a bonanza. The increase in the quantum of the OMO is something the market had asked for. Found the TLTRO, HTM measures very significant for the bond market. The RBI's announcement of OMOs in SDLs should reduce the spread of yields over GSECs.

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