RBI Policy Update

March 27, 2020

An assessment of 7th Bi-monthly Monetary Policy Statement, FY 2019-20

Monetary Policy Stance:

After the government announced measures to strengthen the economy, the RBI joined hands to fight the pandemic by a massive interest rate move. The Monetary Policy Committee (the MPC), based on the assessment of the current and evolving macroeconomic situation, has decided to sizably **reduce the repo rate by 75 basis points to 4.40%** supported by the MPC Members with a 4-2 vote by MPC Members. The MPC also continued its **accommodative stance of monetary policy as long as necessary to revive growth**, mitigate the impact of COVID-19, while ensuring that inflation remains within the target.

- reduce the policy repo rate under the liquidity adjustment facility (LAF) **by 75 basis points from 5.15% to 4.40%** with immediate effect;
- widen the LAF corridor by reducing the reverse repo rate **by 90 basis points to 4.00%;**
- continue the monetary policy stance as **'accommodative'.**

Variable	Stands at
Repo	4.40%
Reverse Repo	4.00%
CRR	3.00%
MSF	4.65%
SLR	18.25%

Source: www.rbi.org.in

Policy Stance &Rationale:

- The first ever emergency monetary policy meeting of FY20, conducted one week prior to the scheduled MPC date, chaired by the Reserve Bank of India governor Shaktikanta Das, concluded with a majority decision (of 4-2 in favour) of substantially reducing the interest rates by 75 basis points (2 members voted for 50bps) and announced steps to boost liquidity and provide stimulus to minimize the economic impact of the Covid-19 pandemic. The Committee voted 6-0 in favour of the rate cut decision and in the favour of continuation of the "accommodative" stance as long as it is necessary to revive growth, while ensuring that inflation remains within the target. In addition, to widen the LAF corridor, the reverse repo rate under the LAF reduced by 90 basis points to 4.00%, and the marginal standing facility (MSF) rate and the Bank Rate at 4.65%.The RBI also cut the Cash Reserve Ratio by 100 basis points to 3.00% to boost liquidity.

- On the global front, Covid-19 impacted major economies with a probable notion of a recession like situation in the large parts of globe. Markets across the globe had been highly volatile since the outbreak of Covid-19 since Jan'20. On the back of risk aversion, emerging as well as advanced markets are facing currency depreciation pressure with USD being an exception. In the recent past, Brent Crude price plunged significantly, could impact the inflation across the major economies including emerging and advanced. Due to the Covid-19 impact on major economies, their respective central banks and governments have initiated several conventional and unconventional measures targeted at easing financial conditions to avoid a demand collapse and to prevent financial markets from freezing up due to illiquidity.

- Domestically, on the back of expansion of growth of merchandise export and import moving in positive territory, the trade deficit widened marginally and current account moved to near balance with a marginal deficit of 0.2% of GDP. In recent months, the private final consumption indicator has contracted, including the service sector which has declined due to the pandemic Covid-19. CPI inflation which peaked in Jan'20 saw a significant fall in Feb'20 as a result of reduction in food inflation. During the month of Feb'20, the retail inflation excluding food and fuel eased due to reduction in transport and communication prices. As highlighted by the RBI, the decision to reduce the interest rates is intended to mitigate the negative impact of the virus and revival of growth and preserve financial stability.

- In the past, the RBI has taken number of steps to inject liquidity and significant measures to alleviate financial stress while keeping the financial system functioning. Several OMOs executed to ensure better monetary transmission including the LTROs (Long Term Repo) as well as enhancement of amount under the Standing Liquidity Facility (SLF) available for standalone primary dealers from Rs. 2,800 crs to Rs. 10,000 crs. The RBI also took steps to reinforce monetary transmission so that bank credit flows are done on easier terms, efforts to ease financial stress by relaxing repayment pressures and improving access to working capital. With the multi-pronged approach, comprising both targeted and system-wide liquidity provision adopted by RBI would ease the Covid-19 related liquidity constraints. The measures relating to Targeted LTRO, CRR and MSF will inject a total liquidity of Rs. 3.74 lakh crore to the system.

Outlook:

- Slew of monetary and liquidity measures from the Monetary Policy Committee (the MPC) and the RBI has brought relief to markets as it was reeling under pressure from shallow liquidity in non-SLR market coupled with March redemption pressures. An unexpected 75 basis points cut from RBI coupled with 100 basis points CRR cut immediately led to a huge rally in both corporate bond markets (G-Sec markets had not sold off so much on account of OMO purchases by RBI). Yields on 1-3 year dropped by anywhere between 125-150 basis points. Announcement of targeted Long-term repo (TLTRO) specifically for corporate bonds, commercial papers further added fuel to fire, bringing much needed relief to the corporate and money markets.

- While RBI rate cut was expected, a delay in the decision led to huge volatility, especially in money and corporate bond markets. The introduction of TLTRO is a game changer for corporate bond markets. While G-Sec gets regular support from RBI in form of OMO purchases, this is first time it is being done for corporate bonds. Under this facility, banks can use the funds availed for investment upto 50% in primary market and 50% in secondary market corporate bonds or commercial papers, giving boost to corporate issuers in these exceptional times.

- From a macroeconomic perspective, growth is likely to be adversely impacted due to the pandemic. The shutdown is likely to weaken aggregate demand and any future lockdowns are going to exacerbate the situation. Inflation has been high in past few readings. However sharp drop in oil prices is likely to bring down both fuel as well as core inflation. Weak aggregate demand could further dent core inflation. Globally, developed economies are likely facing recession in FY21. In such a scenario, a quick recovery is unlikely and global economies are likely to face a hard and slow road to recovery.

- G-Sec markets are likely to driven by the borrowings in FY2021. Government has already announced a package of 1.7 lac crore for the economy primarily targeted at providing essential items / cash to the weaker sections of society in the current lockdown. A package for corporate sector is still awaited. While a sharp drop in oil prices will shore up revenues for the government (as it is expected to increase excise duty further on petrol/diesel), lower direct/indirect tax revenues are likely as economy slows down sharply in 1QFY2021. Government may have to continue to provide fiscal stimulus to aid economic recovery. This may lead to large government / state borrowings (similar to 2009) which may impact the G-Sec curve negatively.

- Corporate bonds should find relief from RBI measures especially TLTRO aimed at investment in commercial papers and corporate bonds. This will likely push corporate bond rates lower. Further with global recession imminent, local growth will likely be lower in FY21. This means the corporate demand for funds for capital expenditure will likely remain muted, and most of the demand is likely to be working capital related or refinancing. Less supply pressure is likely to be positive for bonds.

- In current scenario, growth will remain under pressure. Central Banks across the world have slashed rates and are pumping liquidity. In this scenario, rates are likely to go lower and remain low for prolonged period of time. While G-Sec market will feel pressure from government borrowings, corporate bonds will likely benefit from rate cuts and excess liquidity injected by RBI. The spread has further become attractive with repo rate cut of 75 bps. Spread on 2-3-year corporate paper is now 225-275 bps over repo. We continue to recommend funds investing in high quality corporate bond and money market instruments. We recommend investments in Low Duration, Short Duration and Corporate Bond funds depending on investment horizon of investors.