ICRA COMMENTS ON RBI'S FOURTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2020-21

MPC maintains status quo on Repo rate; signals ample liquidity will continue

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HIGHLIGHTS

The MPC kept the policy rate and accommodative stance unchanged in the last scheduled review for 2020.

It made substantial upward revisions to its inflation and growth forecasts.

With real GDP forecast to grow in Q3 FY2021 and Q4 FY2021, the MPC indicated that the Indian economy has exited from recession.

An adverse outlook for inflation indicates negligible room for further rate cuts.

The Central Bank clarified that various instruments will be used at an appropriate time, and in a calibrated manner, to ensure systemic liquidity remains ample, allaying fears of an early withdrawal of liquidity.

- In a unanimous vote, the six-member Monetary Policy Committee (MPC) decided to maintain status quo on the policy Repo rate under the Liquidity Adjustment Facility (LAF) at 4.0%, and continue with the accommodative stance for as long as necessary -at least during the current financial year, and into the next financial year, to durably revive growth and mitigate the impact of Covid-19 on the Indian economy, whilst ensuring that inflation remains within the target of 2-6% going forward, in the Fourth Bi-Monthly Monetary Policy Statement for FY2021.
- Other policy rates, such as the Marginal standing facility (MSF) rate, Reverse Repo rate and bank rate were also kept unchanged at 4.25%, 3.35%, and 4.25%, respectively.
- After the substantial hardening in the CPI inflation since the last review held in October 2020, the MPC sharply revised its projection of the CPI inflation to 6.8% for Q3 FY2021, 5.8% for Q4 FY2021 and 4.6-5.2% for H1 FY2022, with risks broadly balanced, from the previous forecasts of 4.5-5.4% in H2 FY2021, and 4.3% in Q1 FY2022, in October 2020 meeting.
- On the growth front, MPC revised its full year GDP forecasts to 7.5% in FY2021, from the earlier 9.5% projected in October 2020, with downside risks. The upward revision in Q3 FY2021 (to +0.1% from -5.6%) and Q4 FY2021 (to +0.7% from +0.5%) in today's policy review relative to the earlier forecasts provided in October 2020, resulted in a shallower GDP contraction forecast for the full year.
- Given the surplus liquidity situation and decline in short-term rates below the Reverse Repo rate, the banks have significantly repaid the funding availed from the RBI under various Long-Term Repo Operations (LTROs). Hence the availability of on-tap TLTRO funding to banks is unlikely to be an incremental incentive for banks from a funding point of view.

Outlook: In our view, the adverse outlook for inflation, the concern that price pressures are spreading, and the strong commentary around monitoring threats to price stability to anchor macroeconomic and financial stability, indicate that the room for further rate cuts is negligible. However, an extended pause is likely, which will mean that rates will remain low for a long period of time.

The Central Bank clarified that various instruments will be used at an appropriate time, and in a calibrated manner, to ensure systemic liquidity remains ample, which has allayed fears of an early withdrawal of liquidity. Despite these assurances and the comments surrounding orderly market movements, the reaction of the 10-year bond yield was rather muted, with a modest reversal to 5.9%. In our view, G-sec yields may remain range-bound in the rest of this month. Subsequent triggers will be any revision to the Central Government's borrowing progamme for Q4 FY2021, the announced size of the planned state government issuance in that quarter, as well as the fiscal roadmap for FY2022 that gets revealed in the upcoming Union Budget.

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MPC unanimously maintained status quo on the policy Repo rate and "accommodative stance"

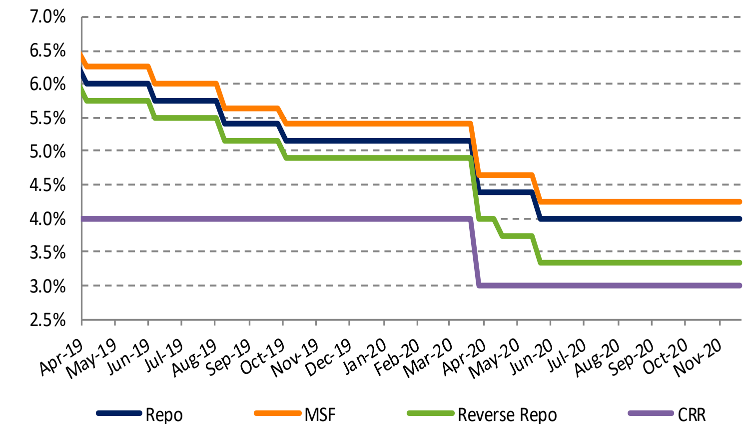
In the December 2020 policy review, the MPC voted unanimously to maintain the Repo rate unchanged at 4.0%. It also voted unanimously to continue with the accommodative stance for as long as necessary- at least during the current financial year, and into the next financial year, to durably revive growth and mitigate the impact of Covid-19 on the Indian economy, whilst ensuring that inflation remains within the target of 2-6% going forward, as opposed to one dissent in the October 2020 policy review.

After the MPC's last meeting in October 2020, retail inflation data released by the NSO had revealed a further hardening in the headline CPI inflation to a 77-month high 7.6% in October 2020 from 7.3% in September 2020, driven by food and beverages (especially pulses, oils and fats, vegetables and eggs), on account of multiple supply chain disruptions. Moreover, the core-CPI inflation (CPI excluding food and beverages, fuel and light, and petrol and diesel index for vehicles) rose to 5.7% in October 2020 from 5.5% in September 2020. Notably, the headline inflation prints during April-October 2020 have continuously overshot the upper band of the MPC's medium-term inflation target range of 4%+/-2%.

Looking ahead, the Committee expects the prices of cereals to soften with healthy kharif arrivals, while vegetable prices may ease on the back of the winter crop. However, the outlook has worsened for prices of other food items, and commodities such as crude oil. Additionally, the wide wedge between the CPI and WPI inflation reflects the supply-side bottlenecks and high margins being levied on consumers. The MPC remarked that further efforts are required to mitigate supply-side inflationary pressures. Further, it touched on demand-side pressures, revealing an apprehension that core inflation may rise further as the economy revives. Taking all these factors into account, the MPC sharply revised its projection of the CPI inflation to 6.8% for Q3 FY2021, 5.8% for Q4 FY2021 and 4.6-5.2% for H1 FY2022, with risks broadly balanced, from the previous forecasts of 4.5-5.4% in H2 FY2021, and 4.3% in Q1 FY2022 in October 2020 meeting.

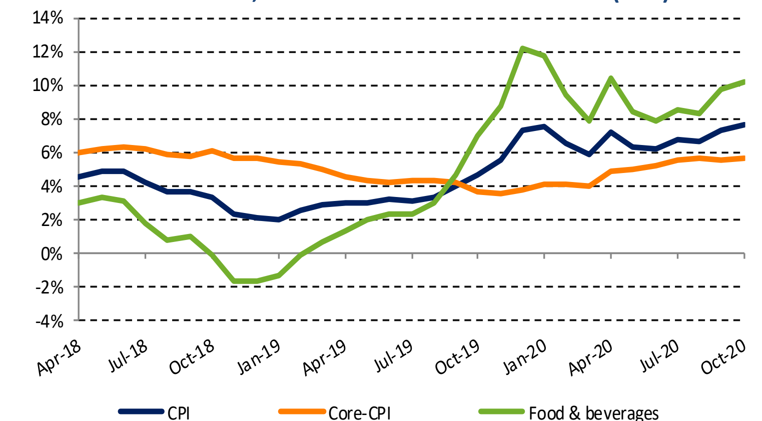
On the growth front, MPC highlighted a further strengthening of rural demand, and improvement in urban demand (as the economy unlocks), business sentiment and the outlook for exports (following the vaccine progress). However, private investment remains feeble, capacity utilisation has not fully recovered, and demand for contact-intensive services is likely to remain subdued on account of social distancing norms and risk aversion. Moreover, a rise in Covid-19 infections in some states may trigger local containment measures, posing a risk to the growth outlook. Overall, the MPC revised its forecasts for real GDP for FY2021 to a shallower contraction of 7.5%, with risks broadly balanced, from the earlier 9.5% projected in October 2020, with downside risks. This was driven by an upward revision in the expected YoY performance for Q3 FY2021 (to +0.1% from -5.6%) and Q4 FY2021 (to +0.7% from +0.5%). Moreover, the Committee indicated a wide range in the GDP growth of 6.5-21.9% in H1 FY2022 (+20.6% had been projected for Q1 FY2022 in October 2020), with risks broadly balanced, which likely builds in the expected huge base-effect led variation in its two quarters.

Chart 1: Movement in Key Rates



***Source**: RBI; CEIC; ICRA Research*

Chart 2: CPI Inflation, CPI-food and core-CPI inflation (YoY)



***Source**: NSO; CEIC; ICRA Research*

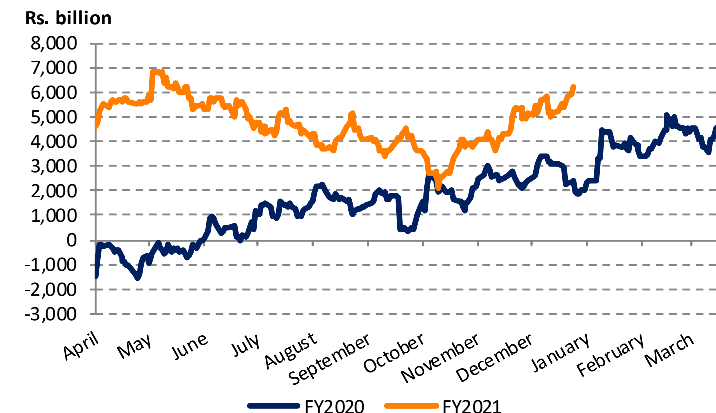
The daily average liquidity surplus under the LAF has increased sharply from ~Rs. 3.5 trillion in Q2 FY2021 to ~Rs. 4.7 trillion in Q3 FY2021 (till December 3, 2020), following record foreign capital inflows and liquidity operations by the RBI. In recent months, the daily average liquidity surplus increased from ~Rs. 3.3 trillion in September 2020 to ~Rs. 4.1 trillion in October 2020, and to ~Rs. 5.3 trillion in November 2020. Subsequently, the daily average liquidity surplus rose further to ~Rs. 6.0 trillion during December 2020 (till December 3, 2020). With risk aversion contributing to a persistently slow credit offtake, and a recent decline in short term rates, the surplus liquidity parked by banks under Reverse Repo window stood at Rs. 7.4 trillion as on December 3, 2020 (refer Exhibit 3).

With the recent sharp rise in the liquidity surplus, fears had emerged of an early withdrawal of liquidity support measures. However, the Central Bank has clarified that various instruments will be used at an appropriate time, and in a calibrated manner, to ensure systemic liquidity remains ample, allaying fears of an early withdrawal of liquidity.

The RBI has injected liquidity of Rs. 2.4 trillion through OMO purchases of Government of India securities (G-secs) during the current financial year. Out of this, Rs. 0.8 trillion worth of OMO purchases were conducted during October-November 2020. The RBI conducted one-way announced OMO of Rs. 200 billion each on October 15, 2020 and October 29, 2020, contributing to the higher liquidity surplus over the month. In addition, the RBI has conducted ten "Twist OMOs" of Rs. 100.0 billion each during the current financial year, three of which have been conducted in November 2020. The RBI has conducted OMO purchase of State Developments Loans worth Rs. 100 billion each on October 22, 2020 and November 5, 2020 to improve liquidity.

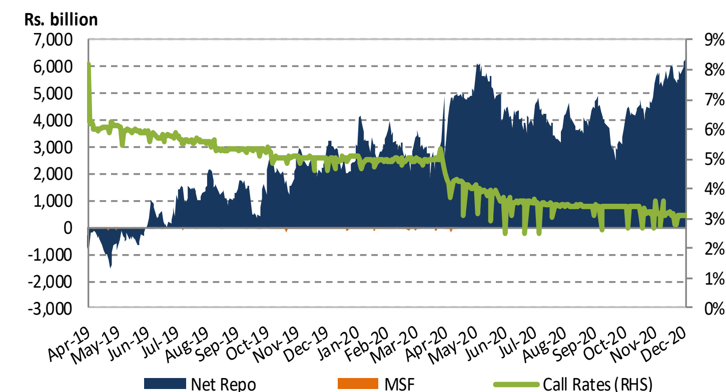
The daily weighted average call money rate had eased from 3.38% in September 2020 to 3.25% in October 2020, and further to 3.12% in November 2020, falling below the Reverse Repo rate. The daily weighted average call money rate eased from 3.74% in Q1 FY2021 to 3.41% in Q2 FY2021 and to 3.18% in Q3 FY2021 (till December 3, 2020; refer Exhibit 4), the lowest in a decade, benefitting from the reduction in rates in the early part of 2020.

Chart 3: Liquidity Infusion (-)/ absorption (+)
(Net overnight & term Repos/Reverse Repos; MSF; SLF; MSS)



***Source**: RBI; CEIC; ICRA Research*

Chart 4: Call money rates



***Source**: RBI; ICRA Research*

The RBI provided an update on the various other initiatives undertaken to enhance liquidity for certain targeted sectors, conservation of capital among banks and NBFCs, strengthening of supervision through audit functions of banks and NBFCs and deepening of financial markets.

1) On-Tap Targeted Long-term Repo operations (TLTROs) – Extension of eligible sectors

In its previous policy, the RBI had announced a facility of on-tap TLTROs for banks of up to Rs 1.0 trillion, which will be available till March 31, 2021, at the Repo rate for up to three years. This facility was initially available for certain identified sectors in a) Agriculture, b) Agri-infrastructure, c) Secured Retail, d) Micro, Small and Medium enterprises (MSMEs) and e) Drugs, Pharmaceuticals and Healthcare.

In its statement today, the RBI has extended the on-tap TLTRO facility to the 26 stressed sectors identified by the Kamath Committee. The funds availed under this mechanism can be deployed by banks as loans and advances, or investments in corporate bonds.

Given the surplus liquidity situation and decline in short-term rates below the reverse repo rate, the banks have significantly repaid the funding availed from the RBI under various LTROs. The amount outstanding against the past LTROs stood at Rs. 0.77 trillion as on December 3, 2020, against the total LTRO operations of Rs 2.12 trillion.

Hence, in our view, the availability of on-tap TLTRO funding to banks is unlikely to be an incremental incentive for banks from a funding point of view.

2) Facilitating More Efficient Liquidity Management for Regional Rural Banks (RRBs)

The RRBs are currently not permitted to access the liquidity windows of the RBI as well as the call/notice money market. The RBI has proposed to extend the LAF and MSF access to the RRBs and permit them to participate in the Call/Notice money market, both as borrowers and lenders.

As per our view, while the RRBs have a strong deposit base because of their rural presence, however their lending abilities are constrained because of weak capital position, thereby creating huge liquidity surpluses with these banks. Accordingly, access to call /notice money market, and the LAF and MSF windows of the RBI could enable them to manage their surplus liquidity and generate better returns, especially in the current environment when short-term rates have crashed below the reverse repo rate. In the longer-run, access to LAF/MSF will enhance their liquidity position in case of any unforeseen funding requirements.

3) Dividend distribution by banks and NBFCs:

In the backdrop of the stress in asset quality induced by Covid-19, during April 2020, the RBI had restricted banks from paying dividends out of their profits for FY2020 and this decision was to be reviewed after the Q2 FY2021 financial results of the banks. With continued uncertainty, the RBI has decided that the banks will conserve capital and not pay any dividend out of profits for FY2020.

Further, unlike banks, there are no guidelines for dividend payment by NBFCs and given the increasing significance of NBFCs, the RBI has proposed to formulate guidelines for dividend distribution by NBFCs based on a matrix of parameters. The Central Bank will issue guidelines in this regard shortly.

In our view, given the uncertainty on asset quality, curtailment of dividend for banks is a positive move from the capital conservation point of view. Many larger NBFCs have continued to pay dividends in FY2021 from profits of FY2020, despite some of them raising capital in FY2021. The proposal to converge rules for NBFC as well, with the objective to conserve capital is positive.

4) Scale based regulatory framework for NBFCs and strengthening of audit system of banks and NBFCs:

The rapid growth of the NBFC sector and increasing inter-connectedness of NBFCs with the banking sector is reflected in the increase in the share of bank credit to NBFCs to over 9% now from less than 5% in August 2017. Accordingly, in line with changing risk profile, the RBI has proposed to review the regulatory framework of NBFCs and proposed to introduce scale-based regulatory approach linked to the systemic risk contribution of NBFCs. A Discussion Paper will be issued before January 15, 2021 for public comments.

With an objective of strengthening supervision, the RBI had recently unified its supervisory functions to bring the standard of supervision of NBFCs at par with that for commercial banks. Risk Based Internal Audit (RBIA) has been in place for commercial banks since 2002, and now the RBI has decided to issue guidelines to large NBFCs on adoption of RBIA. This will enable the creation of independent risk focused internal audit systems. To improve the quality of financial reporting, the RBI has also decided to harmonise guidelines on appointment of Statutory Auditors for banks and NBFCs.

In our view, given the increasing inter-connectedness of NBFCs with the banking sector and risk they pose to system stability in case of a failure, the proposal to have increased regulatory supervision for larger NBFCs is positive. Like banks, this could include more regulatory filings at higher frequency by NBFCs to the RBI for effective monitoring. While this may increase the compliance burden on larger NBFCs, it will be positive for systemic stability and also nudge larger NBFCs to convert to a bank. This coupled with the proposal to harmonise guidelines for appointment of statutory auditors for commercial banks and NBFCs, with an objective of improving financial reporting, is likely to improve investor confidence in larger NBFCs.

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