MONETARY POLICY REVIEW

09 October 2020

Lender of last resort

MPC members unanimously voted to keep policy rate unchanged. With a 5-1 vote, members decided to maintain accommodative stance into current and next financial year. RBI now expects GDP to contract by 9.5% in FY21 with positive growth in Q4. Inflation too is likely to ease in the range of 4.1-4.4% in FY22 which is higher than target of 4%. Thus we believe liquidity measures will be the bulwark of supporting growth. Today, RBI announced on tap TLTROs, SDL OMOs, extension of HTM limits and lower risk weight for housing.

Sameer Narang
Sonal Badhan | Jahnavi
chief.economist@bankofbaroda.com

Focus on liquidity: MPC members unanimously voted to keep key policy rates unchanged. With a 5-1 vote, MPC decided to maintain accommodative stance at least during current and next financial year. On the liquidity front, RBI introduced on tap TLTRO of Rs 1tn for providing additional liquidity to sectors with backward and forward linkages to growth; extended SLR holding limits under HTM till Mar'22; announced OMOs for SDLs to compress the rising spreads; increasing banks' exposure to retail and small business borrowers from Rs 50mn to Rs 75mn; and rationalising risk weights on fresh retail housing loans *(Details in the Regulatory Announcements section).*

CPI to ease in H2: CPI inflation is projected at 6.8% in Q2FY21, 5.4% in Q3 and 4.5% in Q4. MPC members will look through current inflation as a 'transient hump'. In FY22, CPI inflation is projected in the range of 4.1-4.4%. The underlying assumption is normalisation of supply chains and availability of vaccine against COVID-19. Our projections are similar with inflation estimated to come down to 4.3% in FY22.

GDP to contract by 9.5% in FY21: MPC expects GDP growth to contract by 9.2% in Q2FY21 and by 5.6% in Q3. Growth is expected to be marginally positive at 0.5% in Q4. For FY21, it estimates GDP to contract by 9.5% in FY21 with downside risks. MPC noted that weak urban demand, hit to the services sector, subdued exports and muted investment growth are likely to impinge on growth. GDP growth is expected to inch up to 20.6% in Q1FY22.

Forward guidance: MPC is awaiting easing of inflationary pressures to use the space available for supporting growth. However, inflation is unlikely to come down below RBI's target of 4% even next year. Thus we believe liquidity and focus on transmission will be the focus areas for RBI rather than easing of policy rates to support growth.

KEY HIGHLIGHTS

- Policy rate kept unchanged at 4%.
- GDP to contract by 9.5% in FY21 before increasing to 10.1% in FY22.
- CPI inflation to moderate to 4.5% in Q4 but to remain above target of 4% in FY22.

Regulatory announcements

- In order to focus liquidity measures to revive specific sectors that have both backward and forward linkages, and multiplier effects on growth, RBI has announced 'On Tap TLTRO' of Rs 1tn with floating rate linked to repo rate. This will include tenors upto 3-years and scheme will be applicable till Mar'21.
- Liquidity availed by banks under earlier TLTRO and TLTRO 2.0 scheme was to be deployed in corporate bonds, commercial papers, and non-convertible debentures issued by the entities in specific sectors. In case of the On Tap TLTRO scheme the liquidity availed can also be used to extend bank loans and advances to these sectors. Investments made by banks under this facility will be classified as held to maturity (HTM) even in excess of 25% of total investment permitted to be included in the HTM portfolio. Banks that had availed of funds earlier TLTRO and TLTRO 2.0 will have the option of reversing these transactions before maturity.
- The enhanced HTM limit of 22% of NDTL for SLR securities acquired by banks after 1 Sep 2020 has been extended by 1 year and will now be valid upto 31 Mar 2022. This will provide greater clarity to banks with respect to their investments amidst the current situation.
- To improve liquidity and facilitate efficient pricing, RBI for the first time has decided to conduct open market operations (OMOs) in SDLs as a special case during FY21. The OMOs would be conducted for a basket of SDLs comprising securities issued by states.
- In order to ease the burden on exporters, RBI has decided to discontinue the Automatic Caution-listing by Authorised Dealers (ADs). RBI will undertake caution-listing for certain cases, based on the recommendations of AD banks.
- To ensure credit flow to productive sectors, RBI has announced the following measures: 1) the maximum aggregated retail exposure limit (for fresh as well as incremental exposures) has been increased to Rs 75mn from Rs 50mn earlier. This will ensure credit flow to small businesses and borrowers, 2) for the real estate sector, it has been decided to link the risk weights to the loan-to-value (LTV) ratios for all new housing loans sanctioned upto 31 Mar 2022.
- RBI has also decided to extend the co-origination model to all NBFCs (including HFCs). Under this scheme, banks and NBFCs can provide joint loans to priority sector subject to certain pre-conditions. This will help in taking advantage of the strengths of banks as well as NBFCs, thus improving credit availability to more sector of the economy.

- It has also been decided to increase the availability of large value Real Time Gross Settlement (RTGS) system on 24*7*365 basis from Dec'20. This will facilitate payments for large businesses and promote ease of doing business.
- On tap authorisation to payment system operators (PSOs) has been extended perpetually (subject to certain conditions) compared with 5 years earlier. This will remove business uncertainty for these PSOs.

FIG 1 – BASE LINE ASSUMPTIONS IN MPR

Indicator	April 2019 MPR	October 2019 MPR	April 2020 MPR	October 2020 MPR
Crude Oil (Indian Basket)	US$ 67 per barrel during FY20	US$ 62.6 per barrel	US$ 35 per barrel during FY20	US$ 40.9 per barrel
Exchange rate	69/US$	71.3/US$	75/US$	73.6/US$
Monsoon	Normal for 2019	10% above LPA	Normal for 2020	9% above LPA
Global growth	3.5% for 2019 & 3.6% in 2020	3.2% in 2019 & 3.5%in 2020	Contraction in 2020	Contraction of 4.9% in 2020, 5.4% growth in 2021
Fiscal deficit	To remain within BE FY20 Centre: 3.4% Combined: 5.9%	To remain within BE 20BE Centre: 3.4% Combined: 5.9%	To remain within BE FY20 Centre: 3.5% Combined: 6.1%	Given the Covid-19 impact on activity, revenues and expenditures and factoring in the additional borrowings announced, fiscal deficits are expected to be significantly higher
Domestic macroeconomic/ structural policies during the forecast period	No major change	No major change	No major change	No major change

Source: RBI, Monetary Policy Report

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For further details about this publication, please contact:

Economics Research Department

Bank of Baroda

chief.economist@bankofbaroda.com