Reserve Bank of India leaves rates on hold but boosts liquidity

Interest rates at record lows, the banking system's awash with liquidity and the central bank's committed to supporting augmented government borrowing to fund the budget deficit. What more can the Reserve Bank of India do?

Glass half empty? Reserve Bank of India Governor, Shaktikanta Das

No rate surprise

The Reserve Bank of India decided to leave its key policy interest rates – the repo rate and reverse repo rate - unchanged at 4.00% and 3.35% respectively. There was no change to the banks' cash reserve ratio either, currently 3.00%.

The stable policy rates were in line with the unanimous market consensus. It was also a unanimous vote by all six members of the Monetary Policy Committee -- a revamped MPC after three new external members joined this week.

More liquidity support

The MPC also decided to continue with the accommodative policy stance for as long as necessary.

Governor Shaktikanta Das unveiled additional liquidity and regulatory easing measures to facilitate the economic recovery from this crisis. Among the main announcements here are:

- Conduct INR 1 trillion of on-tap targeted long-term repo operations (TLTRO) with tenors up to three years at a floating rate linked to the repo rate. Banks are required to deploy funds obtained from this window in key sectors (with both backward and forward linkages) either by lending to companies in such sectors or investing in their bonds, commercial papers or non-convertible debentures.
- Extension of enhanced 22% limit on banks investment in SLR securities held to maturity until March 2022. The limit was increased from 19.5% of net demand and time liabilities (NDTL) in September for securities obtained from then until March 2021.
- Conduct open market operations in State Development Loans (SDLs) as a special case during the current financial year.
- Higher credit flow to the retail sector via an increase in banks' exposure to retail lending from INR 50 million to 75 million per borrower.
- Enhancement of scheme of "Co-lending" by banks and certain non-bank finance companies (NBFCs) for priority sectors to include all NBFC and housing finance companies.
- Efficient payments system with round-the-clock availability of the real-time gross settlement (RTGS) system for high-value transactions.

RBI's economic outlook

A typical focus in the RBI policy statement is the central bank's forecast of GDP growth and CPI inflation. You can find more details of that here.

The RBI sees the economy shrinking by 9.5% in the current financial year, FY2020-21 (April-March), with the balance of risk tipped on the downside. The Covid-19 lockdown dented GDP by 24% year-on-year in the April-June quarter. The central bank expects another 9.8% and 5.6% GDP fall in the subsequent two quarters and a 0.5% rise in the final quarter of the year.

Inflation has been running above the RBI's 2-6% monetary policy target for the year so far – 6.6% year-to-date. The central bank forecasts it returning to the target zone in the second half of the year with these hopes pinned on the restoration of supply chains affected by the Covid-19 lockdown.

What do we think?

The stable interest rate policy for two consecutive RBI meetings suggests that the RBI easing cycle has almost neared its limits. We expect policy rates to stay at their current record lows for a foreseeable future.

The central bank is pushing forward with its liquidity boosting measures, while the system remains awash with liquidity and persistently weak business confidence deters borrowers from tapping. This is further reflected by accelerated money supply (M3) growth and slowing bank lending growth, currently 13.4% YoY and 5.5% respectively. As such, any additional monetary stimulus isn't going to be of much use for the economy. The confidence has to return first.

The central bank's growth and inflation views appear to be optimistic

Lastly, the central bank's growth and inflation views appear to be optimistic. The recovery from an unprecedented dip in the April-June quarter will likely be hampered by the continued rapid spread of the pandemic. We anticipate double-digit GDP contractions in all remaining quarters of FY2020-21 as well. We have recently cut our GDP forecast for the year to -16.4% from -10.3% earlier. And, the high-base effect starting in December is the best hope for inflation returning to the RBI's target zone. Aside from that, main drivers behind high inflation, the food and transport prices, are likely to remain in play.

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