October, 2020

As good as it gets…

The newly appointed Monetary Policy Committee (MPC), with the three newly inducted external members came out with their first MPC statement today, announcing a slew of measures to ensure adequate liquidity in the system, easing of financial conditions and enabling a smooth market borrowing programme for the Centre and States

Key announcements on policy rates

- The MPC unanimously voted for keeping the policy rates unchanged and continue with an accommodative stance as long as required to revive growth, while keeping a tab on the mandated inflation target
- **The MPC voted 5-1 to continue the accommodative stance during FY2021 and into FY2022, <u>thereby relying on more elaborate forward rate guidance as an additional tool to ensure monetary transmission</u>**

While RBI had refrained earlier from giving any estimates on the expected GDP growth and CPI trajectory, they came out with expectations on both CPI and GDP growth

- The MPC expects CPI inflation to be in the range of 4.5-5.4% in H2-FY2021 and at 4.3% in Q1-FY2022
- The GDP is estimated to contract in FY2021 by 9.5% (with risks tilted to the downside), while moving into positive territory in Q4-FY2021
- However, the MPC also believes that given the momentum that has picked up in some of the sectors, vis-à-vis agriculture and green shoots in the manufacturing sector, a faster rebound is plausible

The MPC categorically stated that **underlying factors for the current high CPI are essentially supply related and that <u>they can be looked through at this juncture.</u>** This drastically reduces the risk and data dependency around the upcoming CPI prints, which are expected to be on the higher side. This also implies that as soon as CPI comes durably below 6%, this MPC may be keener to ease policy rates further. Thus, in our view, **<u>the chances of another 25-50 bps rate cuts in the Jan-Mar quarter has meaningfully increased.</u>**

The MPC reiterated that they were committed to taking all steps necessary to ensure market participants access to liquidity and easy financial conditions. Some of the steps announced towards that are:

- **On Tap TLTRO:** RBI has decided to conduct on tap TLTRO with tenors ranging up to 3 years for an amount of INR 1,00,000 crore at the prevailing policy Repo Rate till March 31, 2021. These funds can be deployed in Corporate Bonds, Commercial Papers as well as loans and advances issued by entities in a specific sector
- **SLR holdings in HTM category:** RBI has now extended the period of increased HTM limits of 22.0% till Mar-22 from Mar-21 earlier (for securities acquired between September 2020 and March 2021)
- **Increase in OMO/OT auction size:** The RBI will continue to conduct market operations in the form of outright and special OMOs with an increase in auction size to INR 20,000 crore (from the earlier INR 10,000 crore)
- **OMO in State Development Loans (SDLs):** In an unprecedented move to ensure liquidity and price efficiency, the RBI decided to conduct OMOs in SDLs (as a special case) in FY2021

These measures are in direct response to the market concern that RBI's recent signalling to the bond markets was somewhat confusing. The measures announced have given a clear answer to some of these lingering questions about the **<u>RBI's intentions to not just provide an upper cap on yields, but also to bring down interest rates across the curve and also in SDLs and by extension in corporate bonds as well.</u>**

Market Impact

Although the MPC did not make any changes to the policy rate, the RBI more than delivered positively through the measures announced. Government Securities across the curve moved down by 10-15 bps, with the 10 year G-Sec benchmark at 5.93% vs 6.02% earlier. The impact was slightly more in AAA Corporate bonds which saw a movement of 10-20 bps across the curve, with the impact seen more in the 5 -10 year segment.

Outlook

While we were expecting a dovish tilt by the new look MPC, the Policy has surprised us (and the markets) much more than expected

- RBI has chosen to go down the path of forward rate guidance, giving comfort that policy will be accommodative in FY21 and into FY22. **This clearly shows that we are likely to remain in a low rate environment for a fairly long period of time**
- While RBI so far has been fairly restrained in offering OMO support to the bond markets, this is likely to change given the nature of announcements today. **Inclusion of SDLs in OMOs is significant and is likely to lead to spread compression for SDLs as well as corporate bonds**
- While we were expecting limited room for further rate cuts earlier, **we now believe that the probability of 25-50 bps additional rate cuts by this MPC has increased**, and this could happen as soon as CPI moves durably below 6% i.e., January to March period in our view
- The RBI also stands committed to ensure that the financial markets are provided with ample liquidity and financial conditions remain easy to avoid any disruptions in markets

Source: RBI Press Release, Internal