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A dovish RBI maintains a status-quo on rates and forward guidance; projects a V-shaped economic recovery

As expected, the Monetary Policy Committee (MPC) maintained a status-quo on key policy rates and decided *"to continue with the accommodative stance of monetary policy as long as necessary*".

- As per the MPC, the inflation outlook has turned adverse relative to the previous expectations, constraining the use of policy space.
- It revised its inflation projections upward to 6.8%YoY and 5.8%YoY in Q3 FY21 and Q4 FY21 respectively from 5.4-4.5%YoY in H2-FY21 earlier.
- The new projection still leaves space for a rate cut in H1-FY21; however, we now accord a low possibility of another rate cut.
- Given the better than expected data, the RBI upgraded the FY21 economic growth forecast to -7.5%YoY from the previous forecast of -9.5% YoY.
- However, the RBI believes that "signs of recovery are far from being broad-based and are dependent on sustained policy support". This underlies the continuation of an accommodative stance and support towards the more stressed sectors as seen in the expansion of the on-tap LTRO to more sectors.
- Despite some apprehensions in the market about unintended consequences of abundant liquidity in the system, the RBI leaned on the side of caution and did not announce any liquidity draining measures.
- The RBI permitted Regional Rural Banks access to liquidity windows of the RBI as well as the Call/Notice money market, both as borrowers and lenders, which could help with liquidity distribution.
- To help banks conserve capital, the RBI decided that commercial and co-operative banks will retain the profits and not make any dividend pay-out from the profits pertaining to FY20.
- The RBI will issue a draft circular with proposed criteria and parameters for the declaration of dividends by different categories of NBFCs.
- It also announced a slew of measures to deepen financial markets, strengthen supervision through strengthening the audit functions, facilitate external trade by improving ease of doing business for exporters, and upgrade payment system services to expand financial inclusion.

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MPC holds status-quo on rates and maintains forward guidance

As expected, the RBI's Monetary Policy Committee (MPC) maintained a status-quo on key policy rates and the accommodative policy stance. Since its October meeting, the macro-economic picture is looking a bit better with the Q2-FY21 GDP numbers showing a smaller contraction than projected and high-frequency indicators showing continued recovery into Q3. On the other hand, inflation has surprised to the upside. These two developments called for a reassessment of RBI's economic growth and inflation projections while keeping the policy rates and forward guidance unchanged. As such key policy rates stand at their respective levels: Repo Rate: **4%,** Reverse Repo Rate: **3.35%,** Marginal Standing Facility Rate (MSF): **4.25%,** Bank Rate: **4.25%.** With regard to the policy stance and forward guidance, it made no change from the October meeting announcement. In the previous meeting, the MPC had enhanced its forward guidance by introducing a time-frame to its accommodative policy by deciding *"to continue with the accommodative stance of monetary policy as long as necessary – at least during the current financial year and into the next year*".

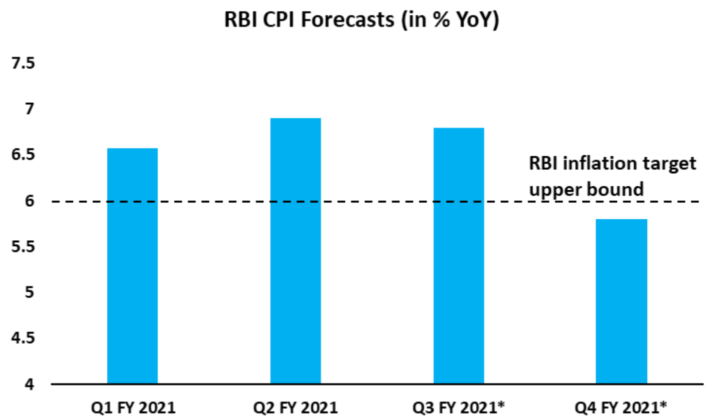
Despite no changes in the key rates and policy stance, there were notable revisions to growth and inflation projections, subtle adjustments in the statement to acknowledge inflation pressures, and hints were dropped for possible actions in the future to mop-up extra liquidity. We shall discuss these in detail below.

Inflation pressures constrain the monetary policy

The MPC did acknowledge that the elevated inflation is constraining monetary policy at the current juncture from using the space available to act in support of growth. Therefore, it's not a surprise that the policy statement did not repeat the wordings from the October meeting when it *"decided to look through the current inflation hump as transient and address the more urgent need to revive growth".* Inflation has remained above the upper bound of RBI's inflation target range of 4%+/-2% since Dec'19 (except in March'20). It has risen above 7% in September and October 2020, due to higher vegetable prices and cost-push factors. Consequently, the RBI now assesses that the inflation outlook has turned adverse relative to the expectations in the last two months. It expects cereal prices to soften further with the bumper Kharif harvest arrivals and vegetable prices to ease with the winter crop. However, other food prices are likely to persist at elevated levels. Accordingly, it has revised its inflation projections upward compared to the forecast released in the October meeting. CPI inflation is now projected at 6.8% for Q3:2020-21, 5.8% for Q4:2020-21; and 5.2% to 4.6% in H1:2021-22. In October, it had projected CPI inflation at 6.8% for Q2:2020-21, at 5.4-4.5% for H2:2020-21, and 4.3% for Q1:2021-22. The new projection still leaves space for a rate cut in H1-FY21; however, we now accord a low possibility of another rate cut.

It is important to note that the RBI seems to have emphasized the supply side management to control inflation pressures, thereby hinting that it may not be in a hurry to change its accommodative policy stance and forward guidance in the near-term. Any changes in that would have impinged on the credibility of the enhanced forward guidance introduced in the October meeting.

RBI projects inflation to remain near the upper bound of the target range until Q4 FY21

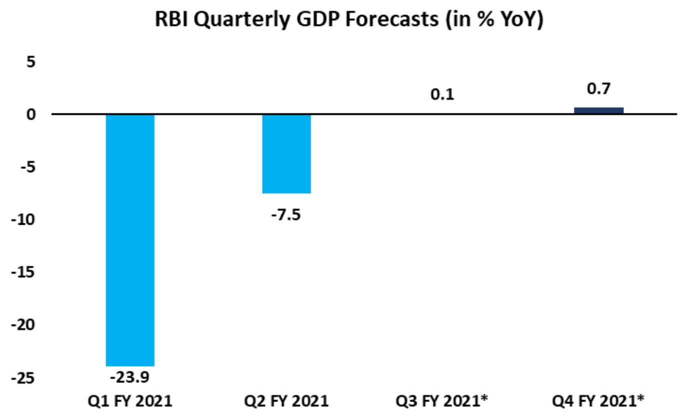


Source: RBI; * indicates RBI's forecast

RBI projects a V-shaped economic recovery

The RBI reassessed its economic growth projections for the FY21. It upgraded its FY21 economic growth projection to -7.5%YoY from the previous forecast of -9.5%. It expects the economy to expand in Q3-FY21 by +0.1% YoY compared to (-)5.6% projected earlier while the estimate for Q4-FY21 was changed marginally to 0.7% in Q4 up from 0.5%. This upgrade was necessitated by economic contraction coming shallower than what the RBI had expected in Q2-FY21 as well as the economic recovery gaining traction in Q3-FY21. For H1-FY22, the RBI sees growth in the range of 21.9% YoY to 6.5% YoY. Despite the improved trajectory of economic recovery, the RBI believes that *"the signs of recovery are far from being broad-based and are dependent on sustained policy support".* Accordingly, it is likely to maintain an accommodative stance into next year to "*nurturing the recovery beyond the meeting of pent-up demand and focus on setting it on a firm trajectory of sustained, high-quality growth".* As such, the RBI decided to expand the on tap targeted long term repo operations announced on October 9, 2020, to cover other stressed sectors in synergy with the credit guarantee available under the Emergency Credit Line Guarantee Scheme (ECLGS 2.0). This step should incentivize banks to extend credit support to stressed sectors at a lower cost.

RBI projects growth to rebound from H2 FY21 onwards

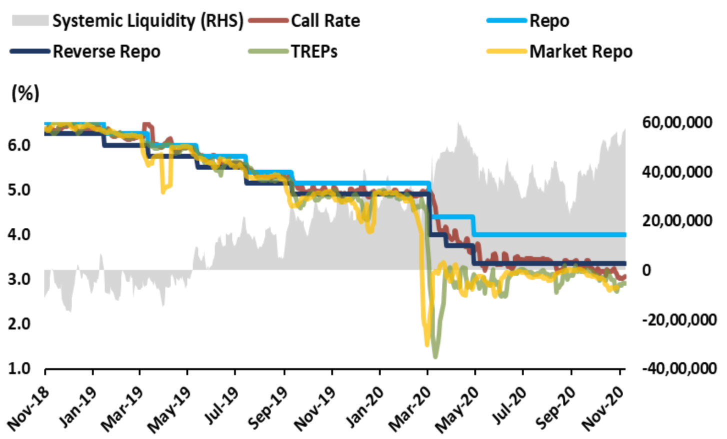


Source: RBI; * indicates RBI's forecast

RBI leaned on the side of caution and did not announce any liquidity draining measures

There have been apprehensions about the unintended consequences of surplus systemic liquidity. Accordingly, there have been early discussions in the markets about RBI's exit strategy from the enormous amount of liquidity that it has injected through conventional and unconventional measures in the system since February 2020 in response to the COVID-19 shock. These measures have helped prevent a market freeze and pushed rates lower for corporates and governments than otherwise might have been the case. This liquidity has also allowed the government's sizeable borrowing program to run without any major hiccups so far. However, RBI's liquidity measures and unsterilized FX intervention has led to a varied impact across rate tenors. Abundant liquidity has led to a crash in the short-term rates some of which are trading below the reverse repo rate (the floor of the policy corridor). The weighted average call rate (RBI's operating target), tri-party repo rate (TREPs) and the market repo rate traded 23 bps, 43 bps, and 89 bps respectively below the reverse repo rate on average in November. However, these money market rates have been trading below the reverse repo rate given the abundance of liquidity in the system. Similarly, T-bill issuances (91-day tenor) have also seen cutoffs below the reverse repo in nearly every auction since June now, however, these still pertain to the risk-free segment of the lending curve.

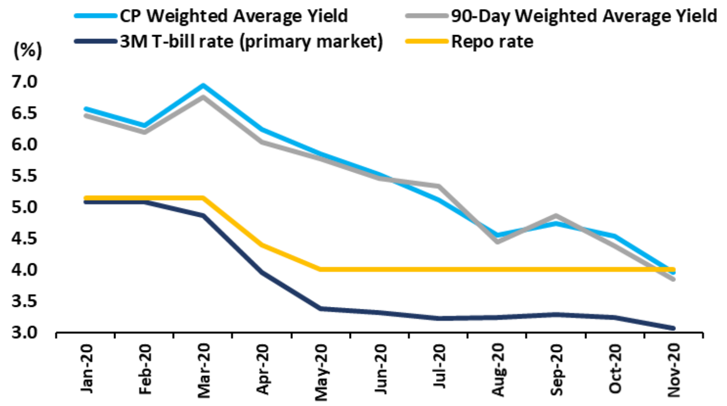
Money market rates fall below the reverse repo (floor of the policy corridor)



Source: RBI, CMIE

However, the near-term papers of corporates that bear credit risk have started to fall below the repo rate and the reverse repo also in some tenors. Part of this has transpired as mutual funds, and other financial entities cannot participate in the inter-bank market and are left directing their surplus funds into these commercial papers. This accords a negative credit premium to these entities that are raising money below the risk-free benchmark rate and poses a mispricing issue. It could also foster the asset-liability mismatch issue for some issuers.

Commercial papers rates slide below the repo rate



Source: Bloomberg Quint, RBI

These discussions have gathered steam in recent weeks on the future course of liquidity management. The RBI had already given an option to banks to reverse their previous LTRO's and TLTRO's to drain the excess liquidity. This has met with some success; however, systemic liquidity remains significant, averaging a surplus of INR 5.3 trillion in November. A sharp rise in foreign capital inflows has complicated RBI's liquidity management. The FX intervention by the RBI to absorb foreign capital inflows has helped keep the Rupee from appreciating this year but at the same time has added to a deluge of domestic liquidity. The RBI governor has acknowledged this challenge in his statement today. He hinted that any measures to adjust surplus liquidity would be used “at the appropriate time” while drawing caution on any misgivings by markets participants towards a turn in the policy stance and reiterated that that ample liquidity would be available in the system. Inflation concerns are also primarily driven by supply-side shocks at this point, with demand still awaiting to see a sustained pick-up. As such, we believe that the RBI will be more patient and shall wait until a sustained pick-up in growth is witnessed before turning the plug on its ultra-accommodative policy stance.

Moreover, the RBI is expected to ensure the government’s sizeable borrowing program, along with possible extra borrowings in Q4, goes smoothly. As such, it may consider measures to adjust liquidity after the announcement of the budget for FY22 and the GDP print for Q3-FY21, which would give it more confidence towards the economy’s path of recovery ahead. The RBI could then adopt different instruments such as a standing deposit facility or a market stabilization scheme bonds to park the excess money with the RBI or allowing nonbanks (mutual) option to park surplus funds with the RBI.

The RBI also announced a slew of developmental and regulatory policy measures to enhance liquidity support to regional rural banks, deepen financial markets, conserve capital among banks and NBFCs through regulatory initiatives, strengthen supervision through the audit function, facilitate external trade by improving ease of doing business for exporters and upgrade payment system services to expand financial inclusion and improve customer service. These are detailed below.

Measures to enhance liquidity support

- The RBI permitted Regional Rural Banks (RRBs) to access liquidity windows of the RBI as well as the Call/Notice money market, both as borrowers and lenders, to facilitate more efficient liquidity management

Measures on regulation and supervision

- Commercial banks and co-operative banks will not make dividend pay-outs from profits pertaining to FY 2020. Meanwhile, guidelines on dividend distribution by NBFCs will be formulated and issued shortly for public comments.
- A discussion paper on the Scale-based Regulatory Framework for NBFCs will be issued before January 15, 2021, for public comments keeping in mind the changing risk profile of NBFCs.
- The RBI has decided to issue guidelines to large UCBs and NBFCs on the adoption of Risk-Based Internal Audit (RBIA). This will enable the creation of an independent risk-focused internal audit system. The RBI has also decided to harmonize guidelines on the appointment of Statutory Auditors for commercial banks, UCBs, and NBFCs.
- The RBI has proposed to issue Reserve Bank of India (Digital Payment Security Controls) Directions, 2020 for regulated entities to set up a robust governance structure for digital payment systems in India and implement common minimum standards of security controls.
- It decided to expand the reach of the Centres for Financial Literacy at every block in the country in a phased manner by March 2024.
- It has also decided to put in place a comprehensive framework to strengthen and improve the efficacy of the internal grievance redress mechanism of banks and provide better customer service.

Measures on external trade

- RBI has decided to allow the direct dispatch of shipping documents for all exporters by AD Banks that was earlier only permitted for cases up to USD 1 mn of export shipment.
- It has decided to delegate the power of allowing write-off of unrealized export bills to the AD banks, without limits in specified circumstances.
- Permit AD banks to allow Indian companies to set-off their export receivables against import payables in respect of goods and services with their overseas group/associate companies through a centralized treasury arrangement or otherwise.
- Allow AD banks to consider refund requests without insisting on the import of goods

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Measures on payments and settlements system

- Enabling Posting of Settlement Files of Payment Systems (viz., AePS, IMPS, NETC, NFS, RuPay, UPI) on all days of the week

- The RBI has proposed to enhance, at the discretion of the user, the limits for contactless card transactions and e-Mandates for recurring transactions through cards (and UPI) from INR 2,000 to INR 5,000 from January 1, 2021.

Measures on deepening financial markets –

- The RBI to review the guidelines for Credit Default Swaps. Revised draft directions will be issued shortly.

- Review of the comprehensive guidelines on Derivatives. Draft directions are being issued by the RBI today.

- Draft directions on the comprehensive review of money markets are being released today for public feedback.

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