MONETARY POLICY REVIEW

06 February 2020

RBI signals banks to lend

MPC members kept policy rate and stance unchanged and reiterated room for further rate cuts. We expect next rate cut in Oct'20. More importantly, RBI announced significant changes in its liquidity framework by withdrawing 1% ceiling of banks to borrow from RBI and introduced LTROs. It also incentivised banks to deduct auto, mortgage and MSME loans from CRR computation and extended sops to commercial real estate projects (1-year extension). We believe these measures are structurally positive and send signal to banks to lend.

Sameer Narang
+91 22 6698 5713
chief.economist@bankofbaroda.com

Dipanwita Mazumdar
dipanwita.mazumdar@bankofbaroda.com

Aditi Gupta
aditi.gupta3@bankofbaroda.com

KEY HIGHLIGHTS

- Inflation forecast for H1FY21 revised upward to 5.2 from 3.9% earlier.
- GDP growth to recover to 6% in FY21.
- Scope remains for further accommodation.

Status quo by MPC: As expected MPC members kept policy rate and stance unchanged as CPI inflation is at 7.4% versus RBI's target of 4%. Given that Q3FY20 CPI at 5.8% is higher than RBI's Oct'19 projection by 70bps, CPI forecast for Q4 has been revised upwards to 6.5% from 3.7% and for H1FY21 the revised projection is 5.2% (3.9% earlier). While vegetable prices are easing, milk and pulses are likely to sustain on the higher side. On an overall basis, rabi sowing is higher by 9% which gives us optimism that food inflation will ebb.

Negative output gap: RBI expects GDP growth to recover to 6% in FY21 from 5% in FY20 on the back of 1) higher rabi sowing and better terms of trade for agriculture, 2) improved transmission of earlier rate cuts, 3) government spending on infrastructure, and 4) higher consumption after rationalisation of personal income tax. However, the outbreak of coronavirus may impinge on global demand and thus exports. Output gap remains negative and there is room for 40bps rate cuts in 2020 as inflation falls, in our view.

Liquidity and credit policy changes: RBI announced significant changes in liquidity framework and credit policy. On liquidity front, the ceiling of 1% of NDTL has been withdrawn and now banks can borrow as much as they need from RBI to on-lend. In addition, long term repos (LTROs) of Rs 1tn upto 3 years have been announced. This will inject durable liquidity at a low cost.

On the credit front, to incentivise lending to auto, residential real estate and MSMEs, new loans up to Jul'20 will be deducted from NDTL for CRR purpose. MSME loan restructuring has been extended. Medium enterprises will qualify for external benchmark loans. For commercial real estate sector, a one year extension has been given for date of completion. Overall, these measures are signal to spur banks to lend to retail, MSME and real estate sectors.

Regulatory announcements

- RBI has announced the revised Liquidity Management Framework. This incorporates 1) weighted average call rate (WACR) to be the operating target as earlier, 2) liquidity management corridor is also retained with the width unchanged at 50bps (reverse repo rate being 25 basis points below repo and MSF rate 25 basis points above the repo), 3) As WACR is the single operating target, there is no need for specifying a one-sided target for liquidity provision of one percent of NDTL. Thus, daily fixed rate repo and four 14-day term repos conducted every fortnight, are being withdrawn. 4) Instruments of liquidity management will include fixed and variable rate repo/reverse repo auctions, OMOs, forex swaps and others to ensure adequate liquidity.
- In an effort to increase durable liquidity in the system, RBI shall conduct term repos of one and three year tenors for up to a total amount of Rs 1tn at the policy repo rate from the fortnight beginning 15 Feb 2020.
- To incentivise credit flow to the productive sectors of the economy, RBI has allowed SCBs to deduct the equivalent of incremental credit disbursed by them as retail loans for automobiles, residential housing and loans to MSMEs; over and above the outstanding level of credit as at the fortnight ending 31 Jan 2020 from NDTL for maintenance of CRR. This exemption will be available up to the fortnight ending 31 Jul 2020.
- RBI has also mandated SCBs to link pricing of loans for medium enterprises to an external benchmark from 1 Apr 2020.
- Further, RBI has also extended the benefit of one-time restructuring without an asset classification downgrade to GST registered MSMEs that were in default as on 1 Jan 2020. This has to be implemented latest by 31 Dec 2020.
- RBI has permitted to extend the date of commencement of commercial operations (DCCO) of project loans for commercial real estate which have been delayed due to unavoidable reasons by another one year without downgrading the asset classification.
- RRBs have been allowed to act as merchant acquiring banks, using Aadhaar Pay-BHIM app and POS terminals.
- With respect to digital payments and settlement systems, the RBI announced the following: 1) creation of a "Digital Payments Index", to be published from Jul'20, 2) introduction of a framework for establishing a Self-Regulatory Organistaion (SRO) for various payment systems by Apr'20 and 3) extension of Cheque Truncation System (CTS) to all India level.

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For further details about this publication, please contact:

Economics Research Department

Bank of Baroda

+91 22 6698 5713

chief.economist@bankofbaroda.com