

RBI Monetary Policy Review

04 December 2020

RBI keeps rates on hold but remains dovish

The monetary policy committee (MPC) of the Reserve Bank of India (RBI) unanimously decided to keep rates on hold as was widely expected while reiterating that it would maintain the accommodative stance for as long as necessary. This is despite an upward revision in inflation projections to 6.8% for 3QFY21, 5.8% for 4QFY21 and 4.6-5.2% for 1H FY22. The MPC is of the view that inflation is expected to remain elevated, barring transient relief in the winter months from prices of perishables. This constrains monetary policy from using the space available to support growth. At the same time, the statement also notes that signs of economic recovery are far from being broad-based and are dependent on sustained policy support. We continue to expect another 25bps of rate cuts as inflation eases in 1H FY21. GDP growth for FY21 has been revised up to -7.5% from -9.4% earlier. The RBI expects return to positive growth at 0.1% in 3QFY21 and 0.7% in 4QFY21. Our own GDP forecast for FY21 stands at -8.5% with a 2% decline in 3QFY21 and flat growth in 4QFY21. Recovery in rural demand is expected to strengthen further while urban demand is also gaining momentum. In other developments, the RBI Governor highlighted at the press conference that actual NPAs may be lower than the 12-14% indicated earlier. Moreover, the on-tap TLTROs have been made available for the 26 stressed sectors identified by the Kamath Committee.

The inflation outlook: The statement notes that the outlook for inflation has turned adverse relative to expectations in the last two months. The substantial wedge between wholesale inflation and retail inflation points to supply-side bottlenecks and large margins being charged to the consumers. While cereal prices may continue to soften with the bumper kharif harvest arrivals and vegetable prices may ease with the winter crop, other food prices are likely to persist at elevated levels. Crude oil prices have picked up on optimism of demand recovery and continuation of OPEC+ production cuts. Crude oil is expected to remain volatile in the near term. Cost-push pressures continue to impinge on core inflation, which has remained sticky and could firm up as economic activity normalises and demand picks up. Taking into consideration all these factors, CPI inflation is projected at 6.8% for 3QFY21, 5.8% for 4QFY21 and 4.6-5.2% for 1H FY22, with risks broadly balanced. Our own estimates are not very different; we expect CPI inflation to average 6.5% in 3QFY21, 5.6% in 4QFY21 and 5% in 1H FY22. The RBI indicated in its press conference that it does not see liquidity driving inflation at the current juncture and would be vigilant on the same.

The growth outlook: The recovery in rural demand is expected to strengthen further while urban demand is also gaining momentum as unlocking spurs economic activity and employment (especially of labour displaced by COVID-19). However, these positive impulses are clouded by a possible rise in renewed COVID-19 infections in some parts of the country, prompting fresh local containment measures. At the same time, the recovery rate has crossed 94% and there is considerable optimism about the success of ongoing vaccine trials. Consumers remain optimistic about the outlook and business sentiment of manufacturing firms is gradually improving. Fiscal stimulus is increasingly moving beyond being supportive of consumption and liquidity to supporting growth-generating investment. On the other hand, private investment is still slack and capacity utilisation has not fully recovered. While exports are on an uneven recovery trajectory, their prospects have brightened with the progress on the vaccines. Demand for contact-intensive services is likely to remain subdued for some time due to social distancing norms and risk aversion. Taking these factors into consideration, real GDP growth is projected at (-)7.5% in FY21: (+)0.1% in 3QFY21, (+)0.7% in 4QFY21 and (+)6.5% to +21.9% in 1H FY22, with risks broadly balanced.

The interest rate outlook: The MPC is of the view that inflation is expected to remain elevated, barring transient relief in the winter months from prices of perishables, which constrains monetary policy from using the space available to support growth. At the same time, the statement also notes that the signs of economic recovery are far from being broad-based and are dependent on sustained policy support. Consequently, we continue to expect another 25bps of rate cuts as inflation eases in 1H FY21.

Extension of TLTROs to 26 stressed sectors: The on-tap TLTRO will be extended to 26 stressed sectors (identified by Kamath Committee) and covered by the Government's Emergency Credit Lending Guarantee Scheme (ECLGS) 2.0.

Cancellation of dividend payments for banks for FY20: In view of the COVID-19 related economic shock, it was announced in April 2020 that scheduled commercial banks (SCBs) and cooperative banks shall not make any dividend payouts from profits pertaining to the financial year ended March 31, 2020 until further instructions, which shall be reassessed based on financial results of banks for the quarter ending September 30, 2020. In view of the ongoing stress and the heightened uncertainty on account of COVID-19, it is imperative that banks continue to conserve capital to support the economy and absorb losses, if any. In order to further strengthen the banks' balance sheets while at the same time supporting lending to the real economy, it has been decided, on a review, that SCBs and cooperative banks shall not make any dividend payout from the profits pertaining to financial year 2019-20.

Regional Rural Banks allowed to tap RBI liquidity window: The Regional Rural Banks (RRBs) are currently not permitted to access the RBI's liquidity windows as well as the call/notice money market. Two new measures have been proposed to address these issues. (i) In order to facilitate more efficient liquidity management by the RRBs at competitive rates, it has been decided to extend the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) to the RRBs. (ii) It has also been decided to permit the RRBs to participate in the Call/Notice money market, both as borrowers and lenders.

Increase in limit for contactless payments and UPI: To further the adoption of digital payments in a safe and secure manner, it is 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 Rs2,000 to Rs5,000 from January 1, 2021.

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