

*Monetary Policy Statement, 2020-21 Resolution of the Monetary Policy Committee (MPC) August 4 to 6, 2020**

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) at its meeting today (August 6, 2020) decided to:

- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.0 per cent.

Consequently, the reverse repo rate under the LAF remains unchanged at 3.35 per cent and the marginal standing facility (MSF) rate and the Bank Rate at 4.25 per cent.

- The MPC also decided to continue with the accommodative stance as long as it is necessary to revive growth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward.

These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 per cent within a band of +/- 2 per cent, while supporting growth.

The main considerations underlying the decision are set out in the statement below.

Assessment

Global Economy

2. Since the MPC met in May 2020, global economic activity has remained fragile and in retrenchment in several geographies. While the uneasy and differently-

paced withdrawal of COVID-19 lockdown restrictions in some countries enabled a sequential improvement in high frequency indicators during May-July, a renewed surge in COVID-19 infections in major economies and threats of a second wave of infections appear to have weakened these early signs of revival. Contractions in economic activity have been more severe in Q2:2020 than in Q1, and the near-term outlook points to a slow, uneven and hesitant recovery pushed into the second half of the year, with risks steeply slanted to the downside. Among advanced economies (AEs), output in the US and the Euro area underwent a deeper contraction in Q2:2020 than in the preceding quarter. Emerging market economies (EMEs) are expected to shrink in Q2 as reflected in high frequency indicators.

3. Global financial markets have rebounded since end-March 2020 with intermittent pauses, shrugging off the volatility and sharp correction recorded in Q1:2020. Portfolio flows returned to EMEs in Q2 after a massive reversal, though there was moderation in July from the previous month's level. EME currencies have also appreciated in close co-movement, tracking weakening of the US dollar. Crude oil prices have remained supported on supply cuts by oil producing countries (OPEC *plus*) and improved demand prospects on the gradual easing of lockdown restrictions since May. Gold prices have rallied to an all-time high on August 5 on the back of safe haven demand. In AEs, benign fuel prices and soft aggregate demand have kept inflation subdued. In many EMEs, however, cost-push pressures arising from supply disruptions and demand revival have shown up in consumer prices in June 2020. Global food prices are elevated across the board.

Domestic Economy

4. On the domestic front, economic activity had started to recover from the lows of April-May following the uneven re-opening of some parts of the country in

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June; however, surges of fresh infections have forced re-clamping of lockdowns in several cities and states. Consequently, several high frequency indicators have levelled off.

5. The agricultural sector has emerged as a bright spot. Its prospects have strengthened on the back of good spatial and temporal progress of the south-west monsoon. The cumulative monsoon rainfall was 1 per cent below the long-period average (LPA) up to August 5, 2020. Spurred by the expanding precipitation, the total area sown under *kharif* crops on July 31 was 5.9 per cent higher than the normal area measured by the average over the period 2014-15 to 2018-19. As on July 30, 2020, the live storage in major reservoirs was 41 per cent of the full reservoir level (FRL), which bodes well for the *rabi* season. These developments have had a salutary effect on rural demand as reflected in fertiliser production and sales of tractors, motorcycles and fast-moving consumer goods.

6. The pace of contraction of industrial production, measured by the index of industrial production (IIP), moderated to (-) 34.7 per cent in May from (-) 57.6 per cent a month ago, with the easing of lockdowns in different parts of the country. All manufacturing sub-sectors, except pharmaceuticals, remained in negative territory. The output of core industries in June contracted for the fourth successive month though with a considerable moderation. The Reserve Bank's business assessment index (BAI) for Q1:2020-21 hit its lowest mark in the survey's history. The manufacturing PMI remained in contraction, shrinking further to 46.0 in July from 47.2 in the preceding month.

7. High frequency indicators of services sector activity for May-June indicate signs of a modest resumption of economic activity, especially in rural areas, although at levels lower than a year ago. Notably, the decline in passenger vehicle sales moderated to (-) 49.6 per cent in June from (-) 85.3 per cent in May, indicative of tentative urban demand, and

faster recovery of sales in rural areas. On the other hand, domestic air passenger traffic and cargo traffic continued to post sharp contraction. Construction activity remained tepid – cement production fell and finished steel consumption moderated sharply in June. Imports of capital goods – a key indicator of investment activity – declined further in June. The services PMI continued in contractionary zone in July to 34.2, although the downturn eased relative to the May and June readings.

8. The National Statistical Office (NSO) released data on headline CPI for the month of June 2020 on July 13, 2020, along with imputed back prints of the index for April and May 2020. This resulted in a sharp upward revision of food inflation for the month of April and May. During Q1:2020-21 food inflation moderated from 10.5 per cent in April to 7.3 per cent in June 2020. Meanwhile, fuel inflation edged up as international kerosene and LPG prices firmed up. Inflation excluding food and fuel was at 5.4 per cent in June, reflecting a spike in prices across most sub-groups. Inflation in transport and communication, personal care and effects, pan-tobacco and education registered significant increases in June. Headline CPI inflation, which was at 5.8 per cent in March 2020 was placed at 6.1 per cent in the provisional estimates for June 2020.

9. For the second successive round, households' three months ahead expectations remained above their one year ahead expectations, indicating their anticipation of lower inflation over the longer horizon. Producers' sentiments on input prices remained muted as their salary outgoes fell. Their selling prices contracted in Q1 in the April-June round of the Reserve Bank's industrial outlook survey. The contraction in output prices is also corroborated by firms participating in the manufacturing PMI survey.

10. Domestic financial conditions have eased substantially and systemic liquidity remains in large surplus, due to the conventional and unconventional

measures by the Reserve Bank since February 2020. Cumulatively, these measures assured liquidity of the order of ₹9.57 lakh crore or 4.7 per cent of GDP. Reflecting these developments, reserve money (RM) increased by 15.4 per cent on a year-on-year basis (as on July 31, 2020), driven by a surge in currency demand (23.1 per cent). Growth in money supply (M3), however, was contained at 12.4 per cent as on July 17, 2020. Average daily net absorptions under the liquidity adjustment facility (LAF) moderated from ₹5.3 lakh crore in May 2020 to ₹4.1 lakh crore in June as government spending slowed. In July, average daily net absorptions under the LAF moderated further to ₹4.0 lakh crore, as government spending remained subdued. During 2020-21 (up to July 31), ₹1,24,154 crore was injected through open market operation (OMO) purchases. In order to distribute liquidity more evenly across the term structure and improve transmission, the Reserve Bank conducted 'operation twist' auctions involving the simultaneous sale and purchase of government securities for ₹10,000 crore on July 2, 2020. Furthermore, the utilisation of refinance provided by the Reserve Bank to the National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI) and the National Housing Bank (NHB) increased to ₹34,566 crore on July 31, 2020 from ₹22,334 crore during the May policy.

11. The transmission to bank lending rates has improved further, with the weighted average lending rate (WALR) on fresh rupee loans declining by 91 bps during March-June 2020. The spreads of 3-year AAA rated corporate bonds over G-Secs of similar maturity declined from 276 bps on March 26, 2020 to 50 bps by end-July 2020. Even for the lowest investment grade bonds (BBB-), spreads have come down by 125 bps by end-July 2020. Lower borrowing costs have led to record primary issuance of corporate bonds of ₹2.1 lakh crore in the first quarter of 2020-21.

12. India's merchandise exports contracted for the fourth successive month in June 2020, although the pace of fall moderated on improving shipments of agriculture and pharmaceutical products. Imports fell sharply in June in a broad-based manner, reflecting weak domestic demand and low international crude oil prices. The merchandise trade balance recorded a surplus in June (US\$ 0.8 billion), after a gap of over 18 years. The current account balance turned into a marginal surplus of 0.1 per cent of GDP in Q4 of 2019-20 as against a deficit of 0.7 per cent a year ago. On the financing side, net foreign direct investment moderated to US\$ 4.4 billion in April-May 2020 from US\$ 7.2 billion a year ago. In 2020-21 (till July 31), net foreign portfolio investment (FPI) in equities at US\$ 5.3 billion was higher than US\$ 1.2 billion a year ago. In the debt segment, however, there were outflows of US\$ 4.4 billion during the same period as against inflows of US\$ 2.0 billion a year ago. Net investment under the voluntary retention route increased by US\$ 0.9 billion during the same period. India's foreign exchange reserves have increased by US\$ 56.8 billion in 2020-21 so far (up to July 31) to US\$ 534.6 billion – equivalent to 13.4 months of imports.

Outlook

13. Supply chain disruptions on account of COVID-19 persist, with implications for both food and non-food prices. A more favourable food inflation outlook may emerge as the bumper *rabi* harvest eases prices of cereals, especially if open market sales and public distribution offtake are expanded on the back of significantly higher procurement. The relatively moderate increases in minimum support prices (MSP) for the *kharif* crops and monsoon are also supportive of benign inflation prospects. Nonetheless, upside risks to food prices remain. The abatement of price pressure in key vegetables is delayed and remains contingent upon normalisation of supplies. Protein

based food items could also emerge as a pressure point, given the tight demand-supply balance in the case of pulses. The inflation outlook of non-food categories is, however, fraught with uncertainty. Higher domestic taxes on petroleum products have resulted in elevated domestic pump prices and will impart broad-based cost-push pressures going forward. Volatility in financial markets and rising asset prices also pose upside risks to the outlook. Taking into consideration all these factors, headline inflation may remain elevated in Q2:2020-21, but may moderate in H2:2020-21 aided by large favourable base effects.

14. Turning to the growth outlook, the recovery in the rural economy is expected to be robust, buoyed by the progress in *kharif* sowing. Manufacturing firms responding to the Reserve Bank's industrial outlook survey expect domestic demand to recover gradually from Q2 and to sustain through Q1:2021-22. On the other hand, consumer confidence turned more pessimistic in July relative to the preceding round of the Reserve Bank's survey. External demand is expected to remain anaemic under the weight of the global recession and contraction in global trade. Taking into consideration the above factors, real GDP growth in Q2-Q4 is expected to evolve along the lines noted in the May resolution. For the year 2020-21, as a whole, real GDP growth is expected to be negative. An early containment of the COVID-19 pandemic may impart an upside to the outlook. A more protracted spread of the pandemic, deviations from the forecast of a normal monsoon and global financial market volatility are the key downside risks.

15. The June release of headline inflation after a gap of two months and imputed prints of the CPI for April-May have added uncertainty to the inflation outlook. The NSO has adopted best practices in producing these imputations for the purpose of business continuity in the face of challenges to data collection due to the nation-wide lockdown. The NSO has, however,

not provided inflation rates for April and May. For the purpose of monetary formulation and conduct, therefore, the MPC is of the view that CPI prints for April and May can be regarded as a break in the CPI series.

16. The MPC noted that the economy is experiencing unprecedented stress in an austere global environment. Extreme uncertainty characterises the outlook, which is heavily contingent upon the intensity, spread and duration of the pandemic – particularly the heightened risks associated with a second wave of infections – and the discovery of the vaccine. In these conditions, supporting the recovery of the economy assumes primacy in the conduct of monetary policy. In pursuit of this objective, the stance of monetary policy remains accommodative as long as it is necessary to revive growth and mitigate the impact of COVID-19 on the economy. While space for further monetary policy action in support of this stance is available, it is important to use it judiciously and opportunistically to maximise the beneficial effects for underlying economic activity.

17. At the same time, the MPC is conscious that its primary mandate is to achieve the medium-term target for CPI inflation of 4 per cent within a band of +/- 2 per cent. It also recognises that the headline CPI prints of April-May, 2020 require more clarity. At the current juncture, the inflation objective itself is further obscured by (a) the spike in food prices because of floods in eastern India and ongoing lockdown related disruptions; and (b) cost-push pressures in the form of high taxes on petroleum products, hikes in telecom charges, rising raw material costs reflected in upward revisions in steel prices and rise in gold prices on safe haven demand. Given the uncertainty surrounding the inflation outlook and taking into consideration the extremely weak state of the economy in the midst of an unprecedented shock from the ongoing pandemic, it is prudent to pause and remain watchful of incoming data as to how the outlook unravels.

18. Meanwhile, the cumulative reduction of 250 basis points since February 2019 is working its way through the economy, lowering interest rates in money, bond and credit markets, and narrowing down spreads. Financing conditions have eased considerably, enabling financial flows *via* financial markets, especially at a time when banks remain highly risk averse. Accordingly, the MPC decides to stay on hold with regard to the policy rate and remain watchful for a durable reduction in inflation to use the available space to support the revival of the economy.

19. All members of the MPC – Dr. Chetan Ghate, Dr. Pami Dua, Dr. Ravindra H. Dholakia, Dr. Mridul K. Saggi, Dr. Michael Debabrata Patra and Shri Shaktikanta Das – unanimously voted for keeping the policy repo rate unchanged and continue with the accommodative stance as long as necessary to revive growth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward.

20. The minutes of the MPC's meeting will be published by August 20, 2020.