MONETARY POLICY STATEMENT FOR 2019-20

Seventh Bi-monthly Monetary Policy Statement, 2019-20

*Seventh Bi-monthly Monetary Policy Statement, 2019-20 Resolution of the Monetary Policy Committee (MPC) Reserve Bank of India**

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) at its meeting today (March 27, 2020) decided to:

- reduce the policy repo rate under the liquidity adjustment facility (LAF) by 75 basis points to 4.40 per cent from 5.15 per cent with immediate effect;
- accordingly, the marginal standing facility (MSF) rate and the Bank Rate stand reduced to 4.65 per cent from 5.40 per cent;
- further, consequent upon the widening of the LAF corridor as detailed in the accompanying Statement on Developmental and Regulatory Polices, the reverse repo rate under the LAF stands reduced by 90 basis points to 4.0 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 coronavirus (COVID-19) on the economy, while ensuring that inflation remains within the target.

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. Global economic activity has come to a near standstill as COVID-19 related lockdowns and social distancing are imposed across a widening swathe of affected countries. Expectations of a shallow recovery in 2020 from 2019's decade low in global growth have been dashed. The outlook is now heavily contingent upon the intensity, spread and duration of the pandemic. There is a rising probability that large parts of the global economy will slip into recession.

3. Financial markets have become highly volatile from January onwards due to the outbreak of COVID-19. Panic sell-offs have resulted in wealth destruction in equity markets across advanced and emerging economies alike. In the former, flight to safety has pulled down government bond yields to record lows with some hardening in recent days. In the latter, the rush to exit has rendered fixed income markets illiquid and resulted in firming up of yields. Emerging and advanced economy currencies are experiencing severe depreciation pressure on a daily basis because of fire sales due to extreme risk aversion. At this point, only the US dollar remains safe haven in a highly uncertain outlook. Japanese yen and gold – the other two safe havens till the early part of March – have given way to a flight to cash. International crude prices initially traded with a softening bias from January in anticipation of demand weakening due to the COVID-19 outbreak. Production cut disagreements among key oil producers, however, set off retaliatory supply scale-ups and a price war that plunged international Brent crude prices to a low of US$ 25 per barrel on March 18, 2020. These developments are likely to dampen inflation across advanced and emerging economies. Central banks and governments are in war mode, responding to the situation with several conventional and unconventional measures targeted at easing financial conditions to avoid a demand collapse and to prevent financial markets from freezing up due to illiquidity.

* Released on March 27, 2020.

Domestic Economy

4. The second advance estimates of the National Statistics Office released in February 2020 implied real GDP growth of 4.7 per cent for Q4:2019-20 within the annual estimate of 5 per cent for the year as a whole. This is now at risk from the pandemic's impact on the economy. High frequency indicators suggest that private final consumption expenditure has been hit hardest, even as gross fixed capital formation has been in contraction since Q2:2019-20. On the supply side, the outlook for agriculture and allied activities appears to be the only silver lining, with foodgrains output at 292 million tonnes being 2.4 per cent higher than a year ago. A pick-up in manufacturing and electricity generation pulled industrial production into positive territory in January 2020 after intermittent contraction and/or lacklustre activity over the past five months; however, more data will need to be watched to assess whether the recent uptick will endure in the face of COVID-19. Meanwhile, most service sector indicators for January and February 2020 moderated or declined. Since then anecdotal evidence suggests that several services such as trade, tourism, airlines, the hospitality sector and construction have been further adversely impacted by the pandemic. Dislocations in casual and contract labour would result in losses of activity in other sectors as well.

5. Retail inflation, measured by the consumer price index, peaked in January 2020 and fell by a full percentage point in February 2020 to 6.6 per cent, as the ebbing of onion prices brought down food inflation from double digits in the preceding two months. Price pressures, however, remain firm across protein-rich items, edible oils and pulses; but the shock to demand from COVID-19 may weaken them going forward. While fuel inflation increased sharply in February on the back of the delayed domestic adjustment to international LPG prices, the plunge in international crude prices in March may bring a measure of relief to the extent it is allowed to pass-through. CPI inflation excluding food and fuel eased in February under the weight of softer prices of transport and communication, and personal care. Households' inflation expectations a year ahead softened by 20 bps in the March 2020 round of the Reserve Bank's survey.

6. Domestic financial conditions have tightened considerably, with equity markets facing massive sell-offs by foreign portfolio investors (FPIs). In the bond market too, yields have risen on sustained FPI selling, while redemption pressures, drop in trading activity and generalised risk aversion have pushed up yields to elevated levels in commercial paper, corporate bond and other fixed income segments. In the forex market, the Indian rupee (INR) has been under continuous downward pressure. Under these conditions, the Reserve Bank has endeavoured to keep financial markets liquid, stable and functioning normally. Systemic liquidity surplus, as reflected in net absorptions under the LAF, averaged ₹ 2.86 lakh crore in March (up to March 25, 2020). In addition, the Reserve Bank undertook unconventional operations in the form of auctions of what is called 'operation twist' involving the simultaneous sale of short-term government securities (of ₹ 28,276 crore) and purchase of long-term securities (of ₹ 40,000 crore), cumulatively injecting a net amount of ₹ 11,724 crore. The Reserve Bank also conducted five long term repo auctions of 1 year and 3 years tenors of a cumulative amount of ₹ 1.25 lakh crore so far to inject liquidity and improve monetary transmission. It also conducted two sell-buy swap auctions to inject cumulatively US dollar liquidity into the forex market to the tune of US$ 2.71 billion on March 16 and 23. Open market purchase operations of ₹ 10,000 crore on March 20 and ₹ 15,000 crore each on March 24 and March 26 have been conducted to bolster liquidity and smoothen financial conditions.

7. In the external sector, merchandise exports expanded in February 2020 after posting six consecutive months of contraction. Import growth

also moved into positive territory after eight months of continuous decline. Consequently, the trade deficit widened marginally on a year-on-year basis although it was lower than its level a month ago. On March 12, the Reserve Bank released balance of payments data which showed the current account having moved to near balance in Q3:2019-20 with a deficit of only 0.2 per cent of GDP. On the financing side, net FDI inflows at US$ 37.8 billion during April-January 2019-20 were substantially higher than a year ago. Portfolio investment recorded net outflows of US$ 5.2 billion during 2019-20 (up to March 25), down from US$ 6.6 billion a year ago. India's foreign exchange reserves reached a level of US$ 487.2 billion on March 6, 2020 – an increase of US$ 74.4 billion over their end-March 2019 level.

Outlook

8. In the sixth bi-monthly resolution of February 2020, CPI headline inflation was projected at 6.5 per cent for Q4:2019-20. The prints for January and February 2020 indicate that actual outcomes for the quarter are running 30 bps above projections, reflecting the onion price shock. Looking ahead, food prices may soften even further under the beneficial effects of the record foodgrains and horticulture production, at least till the onset of the usual summer uptick. Furthermore, the collapse in crude prices should work towards easing both fuel and core inflation pressures, depending on the level of the pass-through to retail prices. As a consequence of COVID-19, aggregate demand may weaken and ease core inflation further. Heightened volatility in financial markets could also have a bearing on inflation.

9. Turning to growth, apart from the continuing resilience of agriculture and allied activities, most other sectors of the economy will be adversely impacted by the pandemic, depending upon its intensity, spread and duration. If COVID-19 is prolonged and supply chain disruptions get accentuated, the global slowdown could deepen, with adverse implications for India. The slump in international crude prices could, however, provide some relief in the form of terms of trade gains. Downside risks to growth arise from the spread of COVID-19 and prolonged lockdowns. Upside growth impulses are expected to emanate from monetary, fiscal and other policy measures and the early containment of COVID-19.

10. The MPC is of the view that macroeconomic risks, both on the demand and supply sides, brought on by the pandemic could be severe. The need of the hour is to do whatever is necessary to shield the domestic economy from the pandemic. Central banks across the world have responded with monetary and regulatory measures – both conventional and unconventional. Governments across the world have unleashed massive fiscal measures, including targeted health services support, to protect economic activity from the impact of the virus. To mitigate the economic difficulties arising out of the virus outbreak, the Government of India has announced a comprehensive package of ₹ 1.70 lakh crore, covering cash transfers and food security, for vulnerable sections of society, including farmers, migrant workers, urban and rural poor, differently abled persons and women. The MPC notes that the Reserve Bank has taken several measures to inject substantial liquidity in the system. Nonetheless, the priority is to undertake strong and purposeful action in order to minimise the adverse macroeconomic impact of the pandemic. It is in this context that the MPC unanimously votes for a sizable reduction in the policy repo rate, but with some differences in the quantum of reduction. Furthermore, the MPC also notes that the Reserve Bank has decided to undertake several measures to further improve liquidity, monetary transmission and credit flows to the economy and provide relief on debt servicing. It also underscores the need for all stakeholders to fight against the pandemic. Banks and other financial institutions should do all they can to keep credit flowing to economic agents facing financial stress on account of the isolation that the virus has

imposed. Market participants should work with regulators like the Reserve Bank and the Securities and Exchange Board of India (SEBI) to ensure the orderly functioning of markets in their role of price discovery and financial intermediation. Strong fiscal measures are critical to deal with the situation.

11. All members voted for a reduction in the policy repo rate and maintaining 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.

12. Dr. Ravindra H. Dholakia, Dr. Janak Raj, Dr. Michael Debabrata Patra and Shri Shaktikanta Das voted for a 75 bps reduction in the policy repo rate. Dr. Chetan Ghate and Dr. Pami Dua voted for a 50 bps reduction in the policy repo rate.

13. The minutes of the MPC's meeting will be published by April 13, 2020.

Statement on Developmental and Regulatory Policies

This Statement sets out various developmental and regulatory policies that directly address the stress in financial conditions caused by COVID-19. They consist of: (i) expanding liquidity in the system sizeably to ensure that financial markets and institutions are able to function normally in the face of COVID-related dislocations; (ii) reinforcing monetary transmission so that bank credit flows on easier terms are sustained to those who have been affected by the pandemic; (iii) easing financial stress caused by COVID-19 disruptions by relaxing repayment pressures and improving access to working capital; and (iv) improving the functioning of markets in view of the high volatility experienced with the onset and spread of the pandemic. The policy initiatives in this section should be read in conjunction with the MPC's decision on monetary policy actions and stance in its resolution.

I. Liquidity Management

As stated earlier, the first set of measures is intended to ensure that adequate liquidity is available to all constituents so that COVID-19 related liquidity constraints are eased.

1. Targeted Long Term Repos Operations (TLTROs)

The onset and rapid propagation of COVID-19 in India has ignited large sell-offs in the domestic equity, bond and forex markets. With the intensification of redemption pressures, liquidity premia on instruments such as corporate bonds, commercial paper and debentures have surged. Combined with the thinning of trading activity with the COVID outbreak, financial conditions for these instruments, which are used, inter alia, to access working capital in the face of the slowdown in bank credit, have also tightened. In order to mitigate their adverse effects on economic activity leading to pressures on cash flows, it has been decided that the Reserve Bank will conduct auctions of targeted term repos of up to three years tenor of appropriate sizes for a total amount of up to ₹ 1,00,000 crore at a floating rate linked to the policy repo rate.

Liquidity availed under the scheme by banks has to be deployed in investment grade corporate bonds, commercial paper, and non-convertible debentures over and above the outstanding level of their investments in these bonds as on March 27, 2020. Banks shall be required to acquire up to fifty per cent of their incremental holdings of eligible instruments from primary market issuances and the remaining fifty per cent from the secondary market, including from mutual funds and non-banking finance companies. Investments made by banks under this facility will be classified as held to maturity (HTM) even in excess of 25 per cent of total investment permitted to be included in the HTM portfolio. Exposures under this facility will also not be reckoned under the large exposure framework.

The first TLTRO auction will be held today (March 27, 2020). Following a review of the outcome of this auction, the subsequent TLTRO auctions will be announced. Details about this facility are being issued separately.

2. Cash Reserve Ratio

a. Liquidity in the banking system remains ample, as reflected in absorption of surpluses from the banking system under reverse repo operations of the LAF of the order of ₹ 2.86 lakh crore on a daily average basis during March 1-25, 2020. It is observed, however, that the distribution of this liquidity is highly asymmetrical across the financial system, and starkly so within the banking system.

   As a one-time measure to help banks tide over the disruption caused by COVID-19, it has been decided to reduce the cash reserve ratio (CRR) of all banks by 100 basis points to 3.0 per cent of net demand and time liabilities (NDTL) with effect from the reporting fortnight beginning

March 28, 2020. This reduction in the CRR would release primary liquidity of about ₹ 1,37,000 crore uniformly across the banking system in proportion to liabilities of constituents rather than in relation to holdings of excess SLR. This dispensation will be available for a period of one year ending on March 26, 2021.

b. Furthermore, taking cognisance of hardships faced by banks in terms of social distancing of staff and consequent strains on reporting requirements, it has been decided to reduce the requirement of minimum daily CRR balance maintenance from 90 per cent to 80 per cent effective from the first day of the reporting fortnight beginning March 28, 2020. This is a one-time dispensation available up to June 26, 2020.

3. Marginal Standing Facility

Under the marginal standing facility (MSF), banks can borrow overnight at their discretion by dipping up to 2 per cent into the Statutory Liquidity Ratio (SLR). In view of the exceptionally high volatility in domestic financial markets which bring in phases of liquidity stress and to provide comfort to the banking system, it has been decided to increase the limit of 2 per cent to 3 per cent with immediate effect. This measure will be applicable up to June 30, 2020. This is intended to provide comfort to the banking system by allowing it to avail an additional ₹ 1,37,000 crore of liquidity under the LAF window in times of stress at the reduced MSF rate announced in the MPC's resolution.

These three measures relating to TLTRO, CRR and MSF will inject a total liquidity of ₹ 3.74 lakh crore to the system.

4. Widening of the Monetary Policy Rate Corridor

In view of persistent excess liquidity, it has been decided to widen the existing policy rate corridor from 50 bps to 65 bps. Under the new corridor, the reverse repo rate under the liquidity adjustment facility (LAF) would be 40 bps lower than the policy repo rate. The marginal standing facility (MSF) rate would continue to be 25 bps above the policy repo rate.

II. Regulation and Supervision

Alongside liquidity measures, it is important that efforts are undertaken to mitigate the burden of debt servicing brought about by disruptions on account of the fall-out of the COVID-19 pandemic. Such efforts, in turn, will prevent the transmission of financial stress to the real economy, and will ensure the continuity of viable businesses and provide relief to borrowers in these extraordinarily troubled times.

5. Moratorium on Term Loans

All commercial banks (including regional rural banks, small finance banks and local area banks), co-operative banks, all-India Financial Institutions, and NBFCs (including housing finance companies and micro-finance institutions) ("lending institutions") are being permitted to allow a moratorium of three months on payment of instalments in respect of all term loans outstanding as on March 1, 2020. Accordingly, the repayment schedule and all subsequent due dates, as also the tenor for such loans, may be shifted across the board by three months.

6. Deferment of Interest on Working Capital Facilities

In respect of working capital facilities sanctioned in the form of cash credit/overdraft, lending institutions are being permitted to allow a deferment of three months on payment of interest in respect of all such facilities outstanding as on March 1, 2020. The accumulated interest for the period will be paid after the expiry of the deferment period.

In respect of paragraphs 5 and 6 above, the moratorium/ deferment is being provided specifically to enable the borrowers to tide over the economic fallout from COVID-19. Hence, the same will not be treated as change in terms and conditions of loan agreements due to financial difficulty of the borrowers and, consequently, will not result in asset classification downgrade. The lending institutions may accordingly put in place a Board approved policy in this regard.

7. Easing of Working Capital Financing

In respect of working capital facilities sanctioned in the form of cash credit/overdraft, lending institutions may recalculate drawing power by reducing margins and/or by reassessing the working capital cycle for the borrowers. Such changes in credit terms permitted to the borrowers to specifically tide over the economic fallout from COVID-19 will not be treated as concessions granted due to financial difficulties of the borrower, and consequently, will not result in asset classification downgrade.

In respect of paragraphs 5, 6 and 7, the rescheduling of payments will not qualify as a default for the purposes of supervisory reporting and reporting to credit information companies (CICs) by the lending institutions. CICs shall ensure that the actions taken by lending institutions pursuant to the above announcements do not adversely impact the credit history of the beneficiaries.

8. Deferment of Implementation of Net Stable Funding Ratio (NSFR)

As part of reforms undertaken in the years following the global financial crisis, the Basel Committee on Banking Supervision (BCBS) had introduced the Net Stable Funding Ratio (NSFR) which reduces funding risk by requiring banks to fund their activities with sufficiently stable sources of funding over a time horizon of a year in order to mitigate the risk of future funding stress. As per the prescribed timeline, banks in India were required to maintain NSFR of 100 per cent from April 1, 2020. It has now been decided to defer the implementation of NSFR by six months from April 1, 2020 to October 1, 2020.

9. Deferment of Last Tranche of Capital Conservation Buffer

The capital conservation buffer (CCB) is designed to ensure that banks build up capital buffers during normal times (i.e., outside periods of stress) which can be drawn down as losses are incurred during a stressed period. As per Basel standards, the CCB was to be implemented in tranches of 0.625 per cent and the transition to full CCB of 2.5 per cent was set to be completed by March 31, 2019. It was subsequently decided to defer the implementation of the last tranche of 0.625 per cent of the CCB from March 31, 2019 to March 31, 2020. Considering the potential stress on account of COVID-19, it has been decided to further defer the implementation of the last tranche of 0.625 per cent of the CCB from March 31, 2020 to September 30, 2020. Consequently, the pre-specified trigger for loss absorption through conversion/write-down of Additional Tier 1 instruments (PNCPS and PDI) shall remain at 5.5 per cent of risk-weighted assets (RWAs) and will rise to 6.125 per cent of RWAs on September 30, 2020.

III. Financial Markets

The decision in respect of financial markets is essentially of a developmental nature, intended to improve depth and price discovery in the forex market segments by reducing arbitrage between onshore and offshore markets. This measure assumes greater importance in the context of the increased volatility of the rupee caused by the impact of COVID-19 on currency markets.

10. Permitting Banks to Deal in Offshore Non-Deliverable Rupee Derivative Markets (Offshore NDF Rupee Market)

The offshore Indian Rupee (INR) derivative market - the Non-Deliverable Forward (NDF) market - has been growing rapidly in recent times. At present, Indian banks are not permitted to participate in this market, although the benefits of their participation in the NDF market have been widely recognised. All aspects of the issue have been examined in detail and a consensus has emerged in RBI that the time is apposite to remove segmentation between the onshore and offshore markets and improve efficiency of price discovery. Accordingly, it has been decided, in consultation with the Government, to permit banks in India which operate International Financial Services Centre (IFSC) Banking Units (IBUs) to participate in the NDF market with effect from June 1, 2020. Banks may participate through their branches in India, their foreign branches or through their IBUs. Final directions are being issued today.