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RBI ramps up monetary and regulatory support

In yet another unscheduled policy meet, the RBI announced a series of steps to mitigate the economic and financial fallout from the spread of COVID-19 in India (for previous announcements, see - *COVID-19 Policy Response: All guns blazing*, Mar 27, 2020 and *RBI extends the financial safety net*, Apr 17, 2020). Key highlights:

Monetary policy easing

• **The Monetary Policy Committee reduced repo rate by 40 bps, taking the benchmark repo rate to an all-time low of 4.00%**. Accordingly, the MSF rate and the reverse repo rate now stands reduced to 4.25% and 3.35% respectively.
• **While the decision to cut the monetary policy rate was unanimous, it was backed by a 5-1 vote, with one member opting for a 25 bps cut**.
• Overall, the MPC decided to continue with its accommodative policy 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.

Improve functioning of markets

• In order to provide greater flexibility to SIDBI in its operations, special refinancing facility amounting to INR 150 bn provided earlier for a period of 90 days will now be extended for another period of 90 days.
• To smoothen the disruptions faced by FPIs in adhering to the condition of investing at least 75% of the allotted limits under Voluntary Retention Route (VRR) within three months, the RBI has now extended the period for another three months to fulfil this requirement.

Support external trade

• Recognizing the challenges faced by the exporters, the RBI increased the maximum permissible period of pre-shipment and post-shipment export credit sanctioned by the bank from the existing one year to 15 months, for disbursements made up to Jul 31, 2020.
• In order to ease challenges faced by EXIM Bank in raising funds in international debt capital markets, the RBI has decided to extend INR 150 bn line of credit for a period of 90 days from the date of commencement with rollover up to a maximum period of one year so as to avail a USD swap facility to meet its foreign exchange earnings.
• To provide greater flexibility to importers in managing their operating cycles amidst COVID-19 pandemic, the RBI decided to extend the time period for completion of remittances against normal imports into India from six months to twelve months from the date of shipment for such imports made on or before Jul 31,2020.

Ease financial stress

• The RBI has decided to permit lending institutions to extend the moratorium on term loan instalment by another three months, i.e. from Jun 1, 2020 to Aug 31, 2020.

• In respect of working capital facilities sanctioned in the form of cash credit/overdraft, banks are being permitted to allow a deferment of another three months, from Jun 1, 2020 to Aug 31, 2020. Additionally, banks are also permitted to convert the accumulated interest on working capital facilities over the deferment period (up to Aug 31, 2020) into funded interest term loan which shall be repayable by the end of FY21.

• Asset classification guidelines have been introduced as follows: (i) the moratorium will not be treated as changes in terms and conditions of loan agreements and will not result in asset classification downgrade, (ii) the rescheduling of payments on account of moratorium will not qualify as a default for the purposes of supervisory reporting and reporting to credit information companies by lending institutions, (iii) the 90-day NPA norm shall also exclude the extended moratorium impact. Consequently, there would be an asset classification standstill for all such accounts during the moratorium period from Mar 1 - Aug 31,2020.

• In order to ease working capital financing the RBI has permitted lending institutions to (i) recalculate the 'drawing power' by reducing the margins till the extended period, i.e. Aug 31, 2020 and (ii) reassess the working capital cycle of a borrowing entity up to an extended period till Mar 31, 2020.

• Given the continuing challenges to resolution of stressed assets, lending institutions are permitted to exclude the entire moratorium period from Mar 1, 2020 to Aug 31, 2020 from the calculation of 30-day Review Period or 180-day Resolution Period.

• With a view to facilitate the flow of resources to corporates, the RBI has decided to increase a bank's exposure to a group of connected counterparties from 25% to 30% of the eligible capital base of the bank which will be applicable up to Jun 30, 2021.

Debt management

• Realizing the stress on State Government finances, the RBI has decided to relax the rules governing withdrawal from the Consolidated Sinking Fund (CSF) which the state governments maintain as a buffer for repayment of their liabilities. These relaxations will release an additional amount of about INR 133 bn to states. Together with the normally permissible withdrawal, this measure will enable the states to meet about 45% of their redemptions due in FY21 through withdrawal from CSF. This change in withdrawal norms will come into force with immediate effect and will remain valid till March 31, 2021.

Our take

As per the MPC, the economic and financial impact of COVID-19 is turning out to be more severe than initially anticipated. **While the RBI once again refrained from sharing its FY21 GDP growth forecast, the Governor hinted at the possibility of a contraction in economic activity for the year as a whole**. Indeed, the rapid spread of COVID-19 and the administrative response in the form of nationwide lockdown is creating supply chain disruptions across sectors, dislocation in labor market, while creating the likelihood of a cut back in discretionary consumption in the near term.

In this somber backdrop, inflation appears to provide comfort. The recent spike in food inflation could be short lived with gradual relaxation in the lockdown stringency. Further, prospects of a normal monsoon bodes well for the food inflation trajectory. The combination of soft global commodity prices (esp. oil) and subdued pricing power could further impart disinflationary pressures. **We continue to expect CPI inflation to moderate towards 4.0% in FY21 from 4.8% in FY20**.

Going forward, with likelihood of growth concerns mounting and financial markets remaining susceptible to volatility, **we expect further support from the central bank in the form of another 50 bps cut in the repo rate amidst widening of negative output**

gap and assertion of disinflationary pressures. In addition, we also expect the RBI to come up with large scale bond purchase program (via OMOs) covering both g-secs and SDLs to lower elevated term premium and credit spreads in the economy (see Chart 1)**.**

With repo rate already at a record low, any aggressive monetary easing beyond the anticipated 50 bps move appears less likely. **The real monetary policy rate (current repo rate deflated by expected annual inflation) for India currently stands at 0% (it could go down to -0.5% if RBI frontloads another 50 bps cut). Among key EM countries, barring Turkey, India already has the lowest real monetary policy rate (see Chart 2). Any aggressive direct monetary easing would make it further negative, thereby creating disincentives for domestic savings while creating pressure for the currency from an external perspective. Hence, focus on financial stability and rekindling of risk appetite should be continued via various forms of liquidity and credit easing, targeted relaxation of macro-prudential measures, along with time bound regulatory forbearance wherever required.**

Chart 1: Despite repo rate cut, the 10Y term premium increased

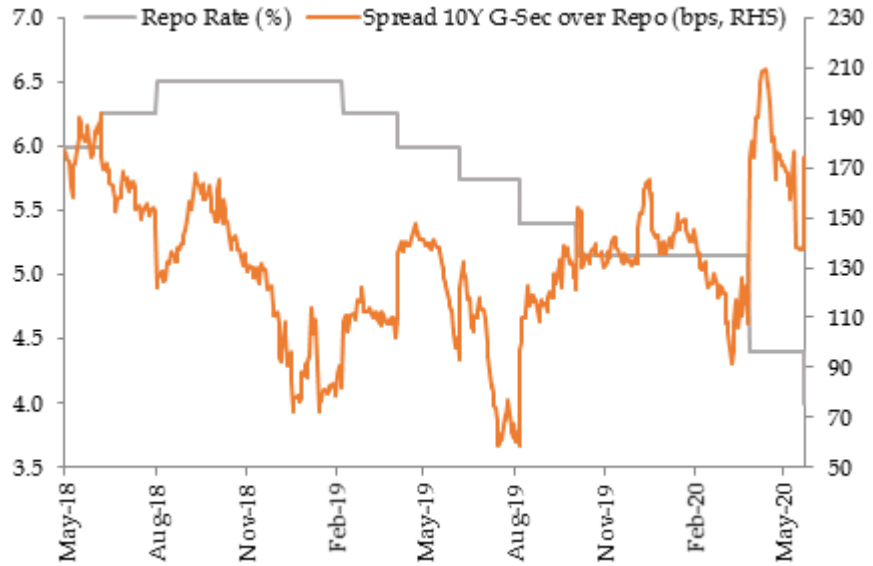
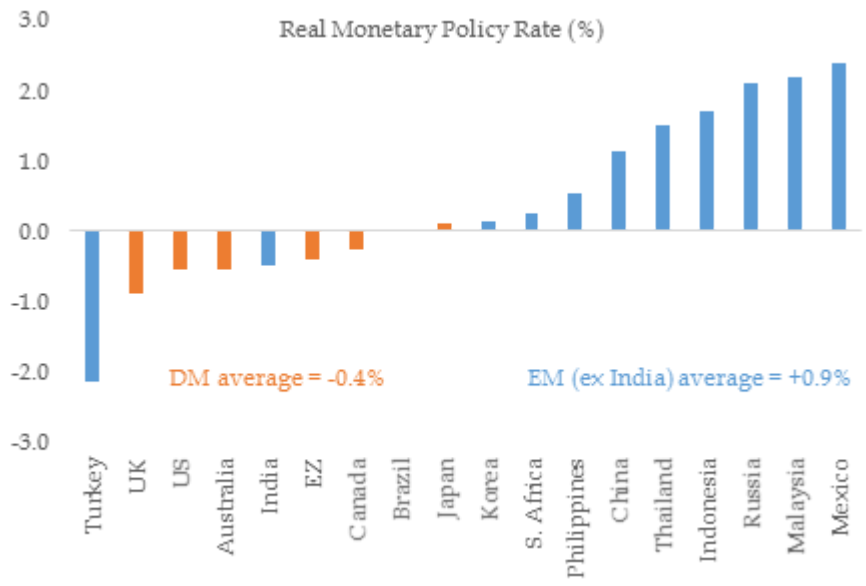


Chart 2: India has the one of the lowest real monetary policy rate among key EMs



Data Source: CEIC, Bloomberg, YES BANK Limited