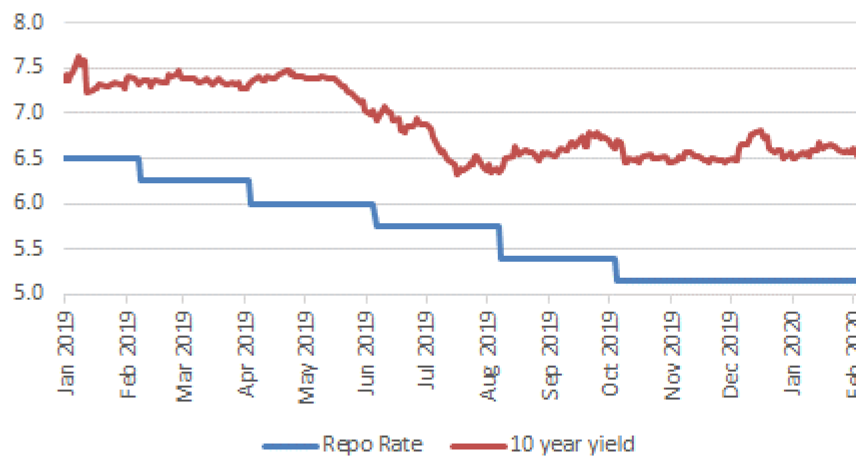
RBI maintains status quo on rates, and announces measures for greater monetary transmission

- **Sampath Reddy, Chief Investment Officer, Bajaj Allianz Life Insurance**

As expected, the RBI Monetary Policy Committee (MPC) voted to keep the key policy rate (repo rate) unchanged at 5.15%. All MPC members unanimously voted for the decision, while continuing with the 'accommodative' stance.

RBI Repo Rate Vs 10 year yield



Source: Bloomberg

The RBI has revised upwards CPI headline inflation projection to 6.5% for Q4 FY20, 5.0-5.4% for H1 FY21 (vs 3.8-4.0% earlier). But CPI inflation is projected to fall sharply to 3.2% in Q3 FY21. Risks are broadly balanced. RBI said that going forward inflation will be influenced by the following factors:

- Food inflation is likely to soften from the high levels of December 2019, and the decline is expected to become more pronounced during Q4 FY20.
- However recent pick-up in prices of milk and pulses are likely to sustain and this could impart some upward bias on food prices.
- Crude prices are likely to remain volatile due to geo-political tensions and uncertain global economic outlook.
- There has been an increase in input costs for services, in recent months. The increase in customs duties on items of retail consumption in the budget may result in a marginal one-time uptick in inflation.
- Base effect for inflation would turn favourable during Q3 FY21 (thus explaining the sharp downward revision).

On the economic front, RBI projects GDP growth to recover from 5%YoY in FY20 to 6%YoY in FY21.

Some other measures were also announced as follows:

- The RBI has incentivized credit flow to certain stressed sectors like auto, housing and MSMEs, by exempting commercial banks from CRR (Cash Reserve Ratio) on incremental credit to these sectors till July 2020.

- The liquidity framework has been tweaked to some extent to allow long term borrowing through repo (1 year and 3 years) up to Rs. 1 trillion. This will provide banks with more durable liquidity at a lower cost.

Outlook:

The various measures announced by RBI will help to further improve/aid liquidity conditions and monetary policy transmission, going forward. Transmission of rate cuts has been higher for the bond/money markets, than for the credit markets—with the RBI mentioning that the 1-year median marginal cost of funds-based lending rate (MCLR) has declined by 55 bps compared to 135 bps cut in the policy rate (repo rate). The measures should also help to revive credit growth, which has slowed down particularly due to stress in some sectors, and is therefore beneficial for the banking and NBFC sectors.

The RBI also seems to be comfortable with the additional market borrowing numbers announced in the Union Budget. It mentioned that the higher fiscal deficit for FY20 has not resulted in increase in market borrowings, and gross market borrowing is budgeted to increase by Rs. 70,000 crore in FY21.

Overall, the policy has been positive for the bond markets with bond yields easing (especially at the shorter end). The RBI recognized that there is monetary policy space for future action, but it will be data–dependent. The yield curve could steepen a bit, with short term yields easing more than long term yields. From an investment perspective, we continue to prefer the shorter to medium term part of the yield curve.

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