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RBI Event Note @ Dalal & Broacha

RBI POLICY UPDATE:

- **RBI's Monetary Policy Committee (MPC) on Friday decided to cut its benchmark repo rate by 40 bps to 4%, amid rising concerns over the impact of coronavirus outbreak on the domestic as well as the global economy.**
- 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.
- While all members of the MPC unanimously voted to reduce the policy repo rate and to maintain the accommodative stance of monetary policy, one MPC member (Chetan Ghate) voted to reduce the policy repo rate by 25 bps instead of 40 bps.
- Committee held its policy meeting on May 20, 21 and 22 ahead of the scheduled date in view of the current economic outlook.

Key Policy rates:

Policy Tools	Post policy	Pre policy	Status
Repo	4.00%	4.40%	Changed by 40 bps
Reverse Repo	3.35%	3.75%	Changed by 40 bps
Marginal Standing Facility (MSF)	4.25%	4.65%	Changed by 40 bps
Bank Rate	4.25%	4.65%	Changed by 40 bps
CRR	3.00%	3.00%	Unchanged

Going Beyond Rate Cuts; Growth & Inflation Outlook:

- Painting a gloomy picture of the economy, **RBI said the impact of COVID-19 is more severe than anticipated and the GDP growth during 2020-21 is likely to remain in the negative territory**. Even though the lockdown may be lifted by end-May with some restrictions, economic activity in Q2 may remain subdued due to social distancing measures and the temporary shortage of labour. Recovery in economic activity is expected to begin in Q3 and gain momentum in Q4 as supply lines are gradually restored to normalcy and demand gradually revives.
- **The only silver lining** was provided by agriculture, with summer sowing of rice, pulses & oilseeds in the country progressing well, with **total area sown under current kharif season up by 43.5% so far, & rabi harvest promising to be a bumper as reflected in record procurement.**
- **MPC is of the view that inflation in first half of 2020 will be intact but, by 3rd and 4th quarter it may fall below the target of 4%.** Retail inflation, is beginning to gain momentum once again in April, as supply disruptions took a toll and reversed the softening of food inflation, which surged to 8.6% from 7.8% in March, 2020. The price of vegetables, pulses, oil seeds and milk emerged as pressure points.

Pro-active liquidity management

- **RBI remained in pro-active liquidity management mode**, expanding its array of measures, both conventional and unconventional, to augment system-level liquidity as also to channel liquidity to specific sectors facing funding constraints.
- **Systemic liquidity remained in abundance, with average daily net absorptions under the liquidity adjustment facility (LAF) increasing to Rs 5.66 trillion in May 2020 (up to May 20) from Rs 4.75 trillion in April.** During FY21 (up to May 20), Rs 1.20 trillion was injected through open market operation (OMO) purchases and Rs 0.88 trillion through three TLTRO auctions and one TLTRO 2.0 auction.
- RBI has provided Rs 0.22 trillion as refinance to NABARD, SIDBI and NHB so far (as on May 21, 2020) and Rs 24.30 Bn to mutual funds through a special liquidity facility (SLF) with a view to easing liquidity constraints and de-stress financial markets.
- **Since February 6, 2020 the Reserve Bank of India has announced liquidity augmenting measures of Rs 9.42 trillion (4.6% of GDP).**

Other key takeaways:

- **In 2020-21 so far (till May 18), net FPI in equities increased to $ 1.2 Bn from $ 0.8 Bn a year ago.** In the debt segment, however, there were portfolio outflows of US$ 3.8 billion during the same period as compared with outflows of US$ 1.4 billion a year ago.
- **India's foreign exchange reserves have increased by $ 9.2 Bn in FY21 so far (up to May 15) to $ 487 Bn** - equivalent to 12 months of imports.
- Monetary policy transmission has improved, with passing on a lower rate to borrowers across various business segments. The one-year median MCLR declined by 90 bps between February 2019 and May 15, 2020. WALR on fresh rupee loans has cumulatively declined by 114 bps since February 2019, of which 43 bps decline occurred in March 2020 alone.

Other policy measures

Measures to Improve the Functioning of Markets

- In view of the tightening of financial conditions, **RBI had announced a special refinance facility of Rs 150 Bn to SIDBI for on-lending/refinancing**. Advances under this facility were provided at RBI's policy repo rate at the time of availment for a period of 90 days.
- **RBI gave FPIs another three months to fulfil the requirement of meeting at least 75% of the allotted limits under Voluntary Retention Route (VRR).** Since its introduction, the VRR scheme has evinced strong investor participation, with investments exceeding 90% of limits allotted under the scheme.

Measures to Support Exports and Imports

- Knowing the challenges faced by the exporters, the **central bank has 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, **RBI has decided to extend Rs 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 requirements.
- To provide better flexibility to importers in managing their operating cycles amidst COVID-19 pandemic, **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.

Measures to Ease Financial Stress

- **The central bank 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:**
    - The moratorium will not be treated as changes in terms and conditions of loan agreements and will not result in asset classification downgrade.
    - 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
    - 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 central bank has permitted lending institutions to recalculate the 'drawing power' by reducing the margins till the extended period, i.e. Aug 31, 2020 and 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 central bank 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 central bank 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 Rs 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.

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Our take

Once again, RBI has to answer the call to the frontline in defence of the economy. This is a difficult time, with the country's GDP will likely to shrink in FY21, which means everything will shrink – from incomes, to consumption to output. With this as the headline worry, **the central bank has changed its stance from a hard inflation targeting to a directional approach, focusing more on getting growth back.** The rate cut announced today will have limited impact in the short term, but it is helpful to revive growth over the longer term. It is the second sharp cut in the key policy rate in two months.

Monetary policy transmission has improved, with passing on a lower rate to borrowers across various business segments. The one-year median MCLR declined by 90 bps between February 2019 and May 15, 2020. Lowering the cost of capital is some relief in these times.

India would need more measures on a continuous basis on both fiscal & monetary front to revive the economy from the current crisis. 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 labour market, while creating the likelihood of a cut back in discretionary consumption in the near term.

The unequivocal statement by the MPC that monetary policy will continue to be accommodative till growth revives sends positive signals. We expect additional scope for 25-40 bps of rate cut with any further easing and extension of measures depending on the nature of the spread of COVID-19. However, **the rising food inflation rate could be a challenge to the central bank**. Food inflation which had eased from January 2020 peak in February and March has now surged to 8.6% in April 2020. We believe 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 (especially oil) and subdued pricing power could further ease inflationary pressures.

The extension of the moratorium would bring in some relief to the borrowers, but it can put pressure on the bank's balance sheet. The steps to ease working capital pain, reduce liquidity costs and provide moratorium on term loans will alleviate stress across various sectors. While credit costs can go up, one need needs to be monitored cash as well as ALM position for financial institutions as interest income cash flow will fall significantly at least till August. Furthermore, Collection efficiency can drop if more customers decide to go in for moratorium. One need to understand moratorium is not a bad concept. These measures are designed to help businesses stay afloat till the time the situation improves. Many good borrowers have opted for moratorium to conserve cash and will pay up once moratorium ends. Besides, businesses can use these three months to get back on track.

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Contact	Email ID	Contact No.	Sector
Mr. Kunal Bhatia	kunal.bhatia@dalal-broacha.com	022 67141442	Auto, Auto Ancillary, FMCG
Ms.Charulata Gaidhani	charulata.gaidhani@dalal-broacha.com	022 67141446	Pharma /Healthcare
Ms. Abhilasha Satale	abhilasha.satale@dalal-broacha.com	022 67141439	Midcaps
Mr. Mayank Babla	mayank.babladalal-broacha.com	022 67141412	I.T/Telecom/Media
Mr. Avinash Tanawade	avinash.tanawade@dalal-broacha.com	022 67141449	BFSI
Mr. Akshay Ashok	akshay.ashok@dalal-broacha.com	022 67141486	BFSI
Mr. Suraj Nandu	suraj.nandu@dalal-broacha.com	022 67141438	Associate
Mr. Tanush Mehta	tanush.mehta@dalal-broacha.com	022 67141432	Associate

Address: - 508, Maker Chambers V, 221 Nariman Point, Mumbai 400 021
Tel: 91-22- 2282 2992, 2287 6173, (D) 6630 8667 Fax: 91-22-2287 0092
E-mail: research@dalalbroachaindia.com, equity.research@dalal-broacha.com