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RBI USES "CONSTRAINED DISCRETION" FOR BETTER POLICY IMPACT

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As expected, MPC has decided to keep the Repo rate unchanged at 5.15%. The RBI monetary policy announcement reminds us of Ben Bernanke's (former chair of the US Federal Reserve) comment that "***constrained discretion***" rules always achieve the desired objective of monetary policy making better than a strict rule-based approach. Under a ***strict rules-based approach*** to monetary policy, the policy instruments of the central bank would be set according to some simple and publicly announced formula, with little or no scope for modification or discretionary action on the part of policymakers. This was perhaps the path of RBI prior to December 2018. "***constrained discretion***" is an approach that allows monetary policymakers considerable leeway in responding to economic shocks, financial disturbances, and other unforeseen developments but constrained by a strong commitment to keeping inflation low and stable.

The statement on development and regulatory measures has many measures which are analogous of "*constrained discretion*". The introduction of long-term repo operations (LTRO) for 1yr and 3yr, for total amount of Rs 1,00,000 crore at policy repo rate, will bring down cost of funds for banks without effectively cutting deposit rates. ECB had used this tool back in 2011. This decision is likely to make reverse repo rate as the operative policy rate over a point of time. Interestingly, such a decision will also allow banks the option of using durable liquidity and avoid the substituting of durable with transient liquidity as it used to happen when the RBI was conducting more of daily repo operations. RBI has also announced the revised liquidity framework abolishing the daily fixed rate repo and four 14-day term repos conducted every fortnight with WACR as the single operating target. There is now no need the to specify a one-sided target for liquidity provision of 1% of NDTL. And the RBI has issued a detailed press release detailing that liquidity provision will be adequate, need based and through several competing instruments. Subsequent to the budget announcement, RBI has extended standard accounts of GST registered MSMEs that were in default as on January 1, 2020. This will help around 6-8 lakh MSME units for further formalization.

Now commercial banks will also be allowed to deduct the incremental credit disbursed for automobiles, residential housing and loans to micro, small and medium enterprises (MSMEs), over and above the outstanding level of credit to these segments as at the end of the fortnight ended January 31, 2020 from their NDTL for maintenance of CRR. This will release Rs 4000 crore for 6 months as extra credit for commercial banks.

To boost the real estate sector, RBI has extended 1-year the date of commencement of commercial operations of project loans for commercial real estate, delayed for reasons beyond the control of promoters. It is estimated that around Rs 400 crore loans to commercial real estate would be benefitted.

Meanwhile, the impact of coronavirus on global growth is a developing story. The breakout of the coronavirus will impact tourist arrivals and global trade. In such an uncertain environment RBI has decided to wait and watch, as the economy is expected to grow sub-5.0% in FY20 (with Q3 growth less that 4.5%) and in the range of 5.5%-5.7% in FY21 as per our projections.

We would like the RBI to take cognizance of the following "constrained discretion" in forthcoming policy. **First,** revise the methodology of measuring CPI based on existing food weights as given by CES survey that are out of sync with consumption expenditure patterns. Interestingly, **if we reduce the weightage of food in CPI to 27.6% as per the latest CSO NAS data released on Jan'31, the headline CPI declines to 5.17% from 7.35% for Dec'19**. **Second**, since the banks are currently participating in reverse repo owing to surplus liquidity, it is opportune time to introduce the standing deposit facility (SDF). This will push down the yields further.

RBI MAINTAINS *STATUS QUO*

- As expected, MPC has decided to keep the Repo rate unchanged at 5.15%. All the members voted for *status quo*. MPC also decided to continue with the accommodative stance.
- RBI has retained 5.0% GDP growth target for FY20 and projected 6.0% growth for FY21 (5.5-6.0% in H1 and 6.2% in Q3) on basis of easing global uncertainties, better monetary transmission and consumption boost through better rural income (due to high foodgrains production).
- RBI projected CPI inflation at 6.5% for Q4 FY20, 5.4-5.0% for H1 FY21 (earlier: 4.0-3.8%) and 3.2% for Q3 FY21 (due to favourable base effect).

DEVELOPMENTAL AND REGULATORY POLICY MEASURES

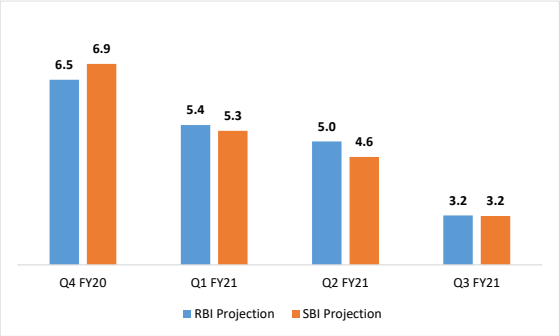
- ***Liquidity Framework:*** RBI has announced the revised liquidity framework which has abolished the daily fixed rate repo and four 14-day term repos conducted every fortnight as WACR is the single operating target, thus there is no need the to specify a one-sided target for liquidity provision of one percent of net demand and time liabilities (NDTL).
- However, we still believe that the call rate is an ineffective representation of target rate because of various reasons. For example, it is often seen that while WACR remains within the RBI corridor, due to restricted participation (only SCBs, Co-operative banks and Standalone PDs), other money market rates can vary wildly. Also, given the small size of call money market compared to TREPS or Market Repo or even CD/ CP markets, WACR is unrepresentative of actual system liquidity. **Thus, we believe a risk spread say between repo rates and CD rates could be also used to understand the tightness in liquidity and clearly distinguish between banking liquidity and market liquidity.**

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	Q3 FY21
Feb'20 (6th Bi-monthly)	5.8*	6.5	5.4	5.0	3.2
Dec'19 (5th Bi-monthly)	5.1	4.7	4.0	3.8	-
Oct'19 (4th Bi-monthly)	3.5	3.7	3.6	-	-
Aug'19 (3rd Bi-monthly)	3.5	3.7	3.6	-	-
Real GDP Growth (%)	**Q3 FY20**	**Q4 FY20**	**Q1 FY21**	**Q2 FY21**	
Feb'20 (6th Bi-monthly)	4.9	5.5	5.5	6.0	6.2
Dec'19 (5th Bi-monthly)	4.9	5.5	5.9	6.3	-
Oct'19 (4th Bi-monthly)	6.8	7.3	7.2	-	-
Aug'19 (3rd Bi-monthly)	7.4	7.6	7.4	-	-

Source: RBI, SBI Research; * Actual

CPI Inflation Projection (%): RBI vs. SBI



Source: SBI Research

- Also, since the banks are currently participating in reverse repo owing to surplus liquidity, it is opportune time to introduce the standing deposit facility (SDF). The SDF has several potential benefits that could introduce operational flexibility in sterilisation by RBI and, hence, the exchange rate. It will serve the three-fold purpose of (a) negating the costs of sterilisation in terms of its non-impact on interest rates and (b) since the SDF comes with the conditionality of no collateral of G-secs, it will free up securities from SLR holdings and, hence, will lead to an increase in demand for bonds and thereby lower the yields (c) this move will also ensure a lower supply of government bonds through less issuance of cash management bills.
- ***Long Term Repo Operations:*** The introduction of long term repo operations for 1yr and 3yr, for total amount of Rs 1,00,000 crore at policy repo rate, will bring down cost of funds for banks who can now borrow up to 3 yr funds at repo rate. This will bring down yields for G-Secs up to 3 years, while pushing up T-Bill rates as banks will now be able to invest this money into up to 3yr bills. 1-year and 3-year G-sec yields already down by around 6 & 19 bps, respectively. It will also lower lending rates to corporates and will improve transmission.
- The LTRO was used by the European Central Bank (ECB) during the European sovereign debt crisis to lend money at very low interest rates to Eurozone banks.
- ***Extension of One-time Restructuring Scheme for MSME advances:*** After the introduction of the external benchmark system to retail loans from starting of Q3, most of the banks have linked their lending rates for housing, personal and micro and small enterprises (MSEs) to the policy repo rate of the RBI. With this, during Q3FY20, the WALRs of banks on fresh loans has declined by 18 bps for housing loans, 87 bps for vehicle loans and 23 bps for loans to MSEs. With a view to further policy transmission, RBI asked banks to link the loans to Medium enterprises to the external benchmark (say Repo rate) with effective from April 1, 2020. However, a number of banks has already linked the loans to medium enterprises at the time of linked to MSE loans.
- Consequent to the budget announcement, RBI has extended standard accounts of GST registered MSMEs that were in default as on January 1, 2020. This will help around 6-8 lakh MSME units for further formalization, which would have positive impact on financial stability .
- ***Commercial Real Estate sector:*** To boost the real estate sector, RBI has extended 1-year the date of commencement of commercial operations of project loans for commercial real estate, delayed for reasons beyond the control of promoters. It is estimated that around Rs 400 crore loans to commercial real estate could be benefitted. This will help banks, developers to overcome the stressed issues in the sector.
- ***Incentivising Bank Credit to Specific Sectors:*** Now commercial banks will be allowed to deduct the incremental credit disbursed for automobiles, residential housing and loans to micro, small and medium enterprises (MSMEs), over and above the outstanding level of credit to these segments as at the end of the fortnight ended January 31, 2020 from their net demand and time liabilities (NDTL) for maintenance of CRR. We estimated and found that due to this measure Rs 4000 crore for 6 months will be available as extra lendable for commercial banks. This will also have an impact on cost of funds.
- ***Inter-operability of Depositories:*** RBI will now modify its Government securities registry (the PDO-NDS system) to include constituent details in the Constituent Subsidiary General Ledger (CSGL) accounts by end July ,to aid retail investor interest in G-Secs. and add the much required depth to this market.
- ***Margin Requirements for Non-Centrally Cleared Derivatives*** is expected to address concerns related to September 2020 implementation of initial margin requirements for any covered entity belonging to a group whose aggregate month-end average notional amount of such derivatives (non-centrally cleared) for June, July and August exceeds Euro 8 billion. Many Indian banks will be covered under this requirement.

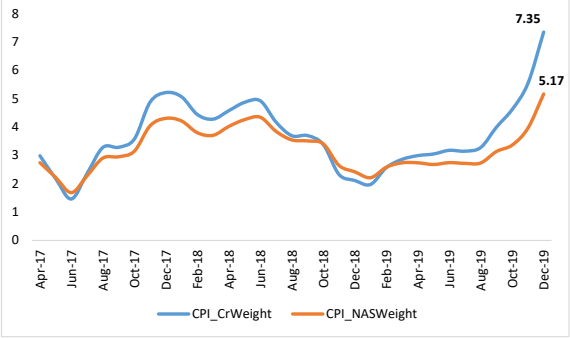
Movement in Key Rates (%)			
	Yesterday	Today (5 pm)	Change in bps
1 Year Gsec	5.58	5.52	-6
3 Year Gsec	6.11	5.92	-19
5 Year Gsec	6.49	6.34	-15
3 Year MIFOR	6.34	6.23	-11
1 Year OIS	5.18	5.13	-5
3 Year OIS	5.21	5.15	-6
1 Year USD INR NDF	74.13	74.00	-13
Memo:			
1-3 Years Deposit rate	6.25-7.10		-
3-5 years Deposit rate	6.25-7.00		-
Source: SBI Research			

- ***Deepening of Rupee Interest Rate Derivative Market:*** Market makers undertaking rupee IRD transactions with non-residents by way of 'back-to-back' arrangements are required to recognise all rupee IRD transactions undertaken by their related entities globally, in their books in India. This has been extended to all market makers, including those not covering back to back. The earlier guidance had created the impression that such transactions are only allowed for those doing back to back transactions and today's announcement removes that distinction. This measure would encourage higher non-resident participation and improve transparency by having better regulatory oversight going forward.
- ***Payment and Settlement System:*** (i) The introduction of "Digital Payments Index" (DPI) is an excellent step and this will dispel the confusion regarding the benefits of demonetisation in promoting India a less-cash economy. (ii) A pan-India Cheque Truncation System (CTS) will expedite the cheque clearing though already 99.82% of paper clearing in volume terms done through CTS. (iii) Self-Regulatory Organisation (SRO) for Digital Payment System will foster best practices on security, customer protection and pricing of payment products.

IS CPI CORRECTLY MEASURED BY CSO?

- If we look at the weight matrix, there is a significant difference between the share of food and beverages (27.6%) in the Private Final Consumption Expenditure (PFCE), published by the National Account Statistics (NAS), and the weights derived from the CES (45.86%) used in CPI. Subsequently, the episodic spikes in CPI inflation, which is largely contributed by rise in food and vegetable prices (as in the current situation), makes the RBI decision difficult. Interestingly, **if we reduce the weightage of food in CPI to 27.6%, the headline CPI declines to 5.17% from 7.35% for Dec'19**.
- The NAS and CES estimates have difference in coverage, estimation methods and databases, and, therefore, the inflation derived from weights under both the methodology, would be different. **However, the present policy decisions are based on the headline CPI inflation where the weights matrix plays an important role that derived from the consumption pattern of eight years back data, so the level of true inflation in the economy remain a matter to investigate.**

CPI based on NAS and CES data (%)



Source: SBI Research

GLOBAL ECONOMY

- Since the last assessment, the global economic activity indicates a lacklustre performance with growth getting differentiated across geographies. Among the key advanced economies (AEs), the US economy grew by 2.1 per cent in Q4:2019; the Chinese economy slowed down to a 29-year low of 6.1 per cent in 2019, caused by sluggish domestic demand and prolonged trade tensions.
- The fall in consumer spending is common theme across countries such as the US, the UK, Japan, China, France and Brazil. The economic performance in France was impacted by disruptions due to 29-day worker strike over pension reforms.
- The impact of coronavirus on global growth is a developing story. The breakout of the coronavirus will impact tourist arrivals and global trade. The commodities notably oil and metals have turned bearish. Even Indian commodity exports such as castor oil, cotton and ground nuts may face some temporary slowdown.
- The virus has already surpassed the count of infection from previous outbreak of SARS-Coronavirus. The total number of recoveries now surpass total fatality, but the number of new infections continue to rise thus keeping the spread of virus. Since there is no known treatment of this novel coronavirus, the current medical response is to undertake quarantine operation of suspected cases.
- Compared with the last outbreak, the quarantine strategy had worked well till a vaccine was developed. The process of vaccine development has already started for novel coronavirus and given advances in technology the time for vaccine launch may be shorter than a decade back. In the mean time Drug Controller General of India has approved the "restricted use" of a combination of drugs used widely for controlling HIV infection in public health emergency for treating those affected by novel coronavirus.

Comparison between 2003 SARS Corona Virus & Novel Corona Virus

	2003 SARS Corona Virus	2019 Novel Corona Virus
Number Affected	8,096.0	28,289.0
Fatality	774.0	565.0
No of Countries affected	29.0	28.0
Fatality rate	9.6	2.0
Total progression time	6 months	32 days
Total cost ($ Billion)	40.0	NA

Source: CDC, WHO, Johns Hopkins University

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