Announcement of liquidity boosting measures to accelerate rate transmission, but absence of demand side boost will constrain the impact of supply side measures

Brickwork Ratings, 07 February 2020, Mumbai: The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) has maintained the policy repo rate at 5.15%, also maintaining an accommodative stance with a view to revive growth and ensure inflation remains within target. The unchanged rate and stance are both in line with BWR expectations.

The MPC has projected real GDP growth for 2020-21 at 6%, with growth in the first half of the fiscal year expected to be at 5.5-6.0%. The projections are almost in line with our expectation of 5.5-6% for the full fiscal.

The MPC, no doubt, faces a serious dilemma with the slump in real GDP, upturn in headline inflation, higher-than-budgeted fiscal deficit and subdued global economic activity. The MPC managed a delicate balance between inflation management and the revival in growth by maintaining a pause on the rates and accommodative stance despite inflation crossing the upper band, particularly on account of an increase in vegetable prices. The Committee’s views on the policy space for a future rate action that reflect a dovish trajectory going forward despite insufficient room for its accommodative stance are reassuring and expected to improve sentiment.

The accompanying ‘Statement on Developmental and Regulatory Policies’ announced substantive measures for improving credit flows to certain sectors and reinforcing monetary transmission. The measures include a revised liquidity management framework, long-term repo operations, incentivising bank credit to specific sectors, the external benchmarking of new floating rate loans to medium enterprises, and an extension in one-time restructuring for MSMEs.

- Under the revised liquidity framework, the RBI withdrew the daily fixed rate repo and four 14-day term repos being conducted every fortnight so far. With the weighted average call rate (WACR) continuing to be the single operating target, the need for specifying a one-sided target for a liquidity provision of 1% of Net Demand and Time Liabilities (NDTL) does not arise. The RBI will conduct the longer-term variable rate repo/reverse repo operations of more than 14 days only when required. The Reserve Bank-assured adequate provision/absorption of liquidity as warranted by underlying and evolving market conditions - unrestricted by quantitative ceilings - at or around the policy rate, would be provided.

- The RBI introduced longer tenor repos maturing in 1- and 3-year brackets amounting to Rs 1 trillion. The move was aimed at ensuring adequate liquidity by providing an additional source of funding to lower the cost of funds of the banks that utilise the LAF window on a regular basis.
Incentivising banks by providing a leeway in CRR (Cash Reserve Ratio) on incremental lending on credit disbursements to certain productive sectors such as auto, housing and MSMEs will have multiplier effects on various sectors and the economy as a whole. It will improve banks’ liquidity and ALM and reduce their cost of funds (as 4% CRR that currently has no earnings and will reduce their overall cost of funds from 20-25 bps on the portion of funds used for such lending, given their present average cost at 5-6%). The measures are expected to facilitate additional transmission of rate to the extent of 50 bps, improve market liquidity and asset quality in banks and boost credit growth, ultimately resulting in higher consumption, economic growth and stability.

Linking the pricing of loans by scheduled commercial banks for medium enterprises to an external benchmark effective 1 April 2020 in addition to the external benchmarking of new floating rate loans by banks to medium enterprises may lead to a better flow of credit to MSEs stressed by the non-availability of cheaper funds currently.

The extension of the one-time restructuring scheme for MSME advances will help create an enabling environment for the sector towards formalisation and a positive impact on financial stability, which is still underway. Earlier, a one-time restructuring of loans to MSMEs that were in default, but were ‘standard’ as on 1 January 2019 were permitted without an asset classification downgrade. The restructuring of the borrower account was to be implemented by 31 March 2020. The scheme has provided relief to a large number of MSMEs. The extension of these measures will also help manage their NPAs.

Detailed instructions are awaited; in a positive move, forbearance to commercial real estate projects’ commencement of commercial operations date delayed for reasons beyond the control of promoters by another year has been extended without downgrading the asset classification. This will be in line with the treatment accorded to other project loans to the non-infra sector. It is a great support extended to the sector read together with the government initiatives.

Other reforms in digitisation through RRBs (regional rural banks), the deepening of the Rupee derivative market, margin requirements for OTC derivatives and expanding cheque truncation to a pan-India level will help streamline operations and accelerate the payment system.

All these measures will incentivise banks in the further monetary transmission of rates, ensuring adequate medium-term liquidity in the market, improving the asset quality of banks in MSME and real estate, stabilising and softening yield and boosting economic growth. Improved sentiment for lending and reduction in banks’ funding cost will lead to better transmission of rates, thereby increasing the flow of funds to these sectors. The government and RBI have announced a series of measures to address supply side concerns, but demand side constraints remain unaddressed. We believe that while the easing of supply side constraints are a positive, unless these measures are accompanied by a revival in demand, the impact of the measures on achieving a quick turnaround will be muted.
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