CIO Memo

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India: RBI announces liquidity-boosting measures

Key take aways

- The Reserve Bank of India (RBI) held rates at its meeting today, but conveyed a dovish tone with several liquidity boosting measures.
- Markets welcomed these measures, with both fixed income and equity markets closing positively.
- RBI transmission measures should help lowering borrowing costs. Open Market Operations (OMO) will be particularly important for state government borrowings.

1. What happened?

As inflation continues to come in higher than its tolerance band, the Reserve Bank of India (with its newly-constituted Monetary Policy Committee) held rates for a second consecutive policy meeting. This accommodative stance will continue for at least another six months, with a priority focus on reviving the economy.

A number of liquidity measures were announced:

- An INR1 trn (USD13.7 bn) on-tap targeted long-term refinancing operations (TLTRO) for banks until March 2021 for various lending programs.
- Extending hold-to maturity (HTM) limits for statutory liquidity ratio (SLR) securities to March 2022.
- Open Market Operations (OMO) for State Development Loans (SDL), or bonds issued by States.

The RBI also took steps to boost credit growth for mortgages by rationalising risk weightages for banks, and by increasing threshold limits for small business loans.

For the first time since the pandemic started, RBI issued guidance on macro-economic numbers. GDP for FY 2020-21 is expected to contract by -9.5%, while CPI inflation is expected to be 5.4-4.5% for the second half of the current financial year (ending March 2021), down from 6.8% in Q2.

2. How did markets react?

Bond markets reacted positively to the liquidity-boosting measures, with the India government 10-year bond yield falling by 8 bps to 5.94%. In equities, the Nifty Bank Index rose sharply by nearly 3%, while the broader market was up 0.7%.

3. What does it mean for investors?

The RBI Governor, Shaktikanta Das, painted a broadly positive picture for the recovering economy, saying that GDP contraction could be less than expected. With agriculture registering solid growth, rural economy demand is projected to be better than urban. High-frequency indicators have also pointed to a sharper than expected economic recovery. A second wave of infections was the only risk cited. The assumption therefore is that the worst is now past for the Indian economy, and monetary policy ‘will do all it can’ for ‘as long as needed’ to boost the recovery in demand.

As we have said in the previous two Memos, rate cut transmission is more important than the rate cuts themselves. The RBI has acted to administer several measures (mentioned above) which should accelerate this process in the economy. OMO for state government borrowings are especially important. Since state government finances have been hit harder than the centre’s by the lockdowns, their borrowing is expected to increase substantially in the Jan-Mar final quarter of this financial year. These OMO purchases will increase appetite for the bonds and may also provide a good yield pick-up for investors. Similarly, the extension of HTM limits until 2022 should help ensure enough takers for the enhanced borrowing program of the central government in the current fiscal year.

Another important signal for investors is the RBI statement on higher inflation numbers, which have mainly been attributed to supply side shocks from food components. This suggests no reversal in policy direction or stance.

Overall, the RBI has strongly indicated its intent to keep rates low, and address transmission issues by deploying new and innovative additional policy measures. We expect compression of the term premiums, and for yields to remain subdued. Investors may want to remain in sovereign and highest-rated bonds until the Indian economy is out of the woods.

Glossary

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The NIFTY Bank Index is comprised of the most liquid and large capitalised Indian Banking stocks.

Open market operations (OMO) refers to central banks' sale and purchase of securities in the open market to implement monetary policy.

The Reserve Bank of India (RBI) is the central bank of India.

State Development Loans (SDLs) are dated securities issued by states for meeting their market borrowings requirements.

The Statutory Liquidity Ratio (SLR) refers to the proportion of deposits the commercial bank is required to maintain with them in the form of liquid assets in addition to the cash reserve ratio.

Targeted long-term refinancing operations (TLTROs) are used by the ECB to provide financing to Eurozone banks.

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