Governor's Statement – August 6, 2020

The Monetary Policy Committee met on 4th, 5th and 6th August for its second meeting of 2020-21, the 24th under its aegis, completing four years of its operation under the new monetary policy framework. The MPC sifted through domestic and global conditions and evaluated their unfolding impact on overall outlook for India and the world. At the end of its deliberations, the MPC voted unanimously to leave the policy repo rate unchanged at 4 per cent and continue with the accommodative stance of monetary policy as long as necessary to revive growth, mitigate the impact of COVID-19, while ensuring that inflation remains within the target going forward. The Marginal Standing Facility (MSF) rate and the Bank rate remain unchanged at 4.25 per cent. The reverse repo rate stands unchanged at 3.35 per cent. I thank the MPC members for their valuable contributions to the policy decision taken today.

2. The Reserve Bank of India (RBI) is perhaps the only central bank in the world to have set up a special quarantine facility with its officers, staff and service providers, numbering about 200, for critical operations to ensure business continuity in banking and financial market operations and payment systems. Other teams in the RBI have ensured availability of digital banking channels, ATMs, internet/ mobile banking, cyber security, redress of customer grievances, and carried out sustained campaigns about safe use of digital transactions through RBI *Kehta Hai.* Our teams have also provided logistical support, and engaged in analysis and research to back the conduct of financial and monetary policies. I am proud of all of them for their tireless commitment to public service. I would also like to applaud all employees of banks and other financial entities for ensuring uninterrupted operations in these trying times. Our gratitude also

goes out **to** all COVID warriors – medical and health personnel, police and other law enforcement agencies, authorities at various levels and others.

Assessment

3. In the MPC's assessment, global economic activity has remained fragile and in retrenchment in the first half of 2020. A renewed surge in COVID-19 infections in major economies in July has subdued some early signs of revival that had appeared in May and June. Global financial markets, however, have been buoyant, with the return of risk-off sentiment inserting a disconnect from the underlying state of the real economy. Portfolio flows to emerging markets have resumed and their currencies have appreciated.

4. The global manufacturing purchasing managers' index (PMI) and the global services PMI rose to 50.3 and 50.5, respectively in July, moving back to the expansion zone. The World Trade Organisation (WTO) has estimated that the volume of merchandise trade shrank by 3.0 per cent year-on-year in Q1 and early estimates suggest a fall of 18.5 per cent in Q2. CPI inflation remains largely subdued across major AEs, primarily due to benign fuel prices and soft aggregate demand since March. In most EMEs, however, CPI inflation, after easing in April-May, rose in June amidst cost-push pressures. Domestic food inflation remains elevated across most economies since the onset of the pandemic.

5. The MPC noted that in India too, economic activity had started to recover from the lows of April-May; however, surges of fresh infections have forced re-clamping of lockdowns in several cities and states. Consequently, several high frequency indicators have levelled off. The agriculture sector's prospects are strengthened by the progress of the south-west monsoon and expansion in the total area sown

under *kharif* crops by 13.9 per cent up to July 31 over last year. Industrial production remained in contraction *albeit* at a moderated pace in May. The manufacturing purchasing managers' index (PMI) shrank in July for the fourth consecutive month. The PMI services remained in contractionary zone in July, although the downturn eased, relative to the June reading.

6. Headline CPI inflation, which was at 5.8 per cent in March 2020, was placed at 6.1 per cent in the provisional estimates for June 2020. Inflation pressures were evident across all sub-groups. Households' one year ahead inflation expectations were lower than their three months ahead expectations in the July 2020 round of the Reserve Bank's survey, indicating their anticipation of lower inflation over the longer horizon. Producers' sentiments on input prices remained muted as their salary outgoes fell. Their selling prices contracted in Q1 in the April-June round of the Reserve Bank's industrial outlook survey.

7. India's merchandise exports contracted for the fourth successive month in June 2020, although the pace of fall moderated. Imports fell sharply in June in a broad-based manner, reflecting weak domestic demand and low international crude oil prices. The merchandise trade balance recorded a surplus in June (US$ 0.8 billion), after a gap of over 18 years.

8. On the financing side, net foreign direct investment moderated to US$ 4.4 billion in April-May 2020 from US$ 7.2 billion a year ago. In 2020-21 (April-July), net foreign portfolio investment (FPI) in equities at US$ 5.3 billion was higher than US$ 1.2 billion a year ago. In the debt segment, however, there were outflows of US$ 4.4 billion during the same period as against inflows of US$ 2.0 billion a year ago. Net investment under the voluntary retention route increased by US$ 0.9 billion during the same

period. India's foreign exchange reserves have increased by US$ 56.8 billion in 2020-21 so far (April-July) to US$ 534.6 billion (as on July 31, 2020) – equivalent to 13.4 months of imports. The ratio of foreign exchange reserves to external debt has gone up from 76.0 per cent at the March 2019 to 85.5 per cent at the end of March 2020.

Outlook

9. Against this backdrop, the MPC was of the view that supply chain disruptions on account of COVID-19 persist, with implications for both food and non-food prices. A more favourable food inflation outlook may emerge as the bumper *rabi* harvest eases prices of cereals, especially if open market sales and public distribution offtake are expanded on the back of significantly higher procurement. Nonetheless, upside risks to food prices remain. The abatement of price pressure in key vegetables is delayed and remains contingent upon normalisation of supplies. Protein-based food items could also emerge as a pressure point. Higher domestic taxes on petroleum products have resulted in elevated domestic pump prices and will impart broad-based cost push pressures going forward. Taking into consideration all these factors, the MPC expects headline inflation to remain elevated in Q2:2020-21, but likely to ease in H2:2020-21, aided by favourable base effects.

10. As regards the outlook for growth, the MPC noted that the recovery of the rural economy is expected to be robust, buoyed by the progress in *kharif* sowing. Manufacturing firms expect domestic demand to recover gradually from Q2 and to sustain through Q1:2021-22. On the other hand, consumer confidence turned more pessimistic in July relative to the preceding round of the Reserve Bank's survey. External demand is expected to remain anaemic under the weight of the global recession and

contraction in global trade. Taking into consideration the above factors, real GDP growth in the first half of the year is estimated to remain in the contraction zone. For the year 2020-21 as a whole, real GDP growth is also estimated to be negative. An early containment of the COVID-19 pandemic may impart an upside to the outlook. A more protracted spread of the pandemic, deviations from the forecast of a normal monsoon and global financial market volatility are the key downside risks.

11. The MPC noted that in an environment of unprecedented stress, supporting recovery of the economy assumes primacy in the conduct of monetary policy. While space for further monetary policy action is available, it is important to use it judiciously to maximise the beneficial effects for underlying economic activity. At the same time, the MPC is conscious of its medium term inflation target. The headline inflation prints of April-May 2020 are obscured by (a) the spike in food prices and (b) cost-push pressures. Meanwhile, the cumulative reduction of 250 basis points is working its way through the economy, lowering interest rates in money, bond and credit markets, and narrowing down spreads. Given the uncertainty surrounding the inflation outlook and extremely weak state of the economy in the midst of an unprecedented shock from the ongoing pandemic, the MPC decided to keep the policy rate on hold, while remaining watchful for a durable reduction in inflation to use available space to support the revival of the economy.

12. Living with the pandemic has improved the way we manage it – working from home; virtual meetings; and “contactless” transactions. Throughout this traumatic period, one thing has stood out – the indomitable spirit of humanity, the inner conviction that whatever be the challenge, we have the innate resilience to combat them, overcome them and emerge victorious. I continue to be an eternal optimist; Mahatma Gandhi should

inspire us: "If our resolve is firm and our conviction clear, it would mean half the battle won…."[1]

Impact of the Monetary and Liquidity Measures taken by the RBI

13. Against this backdrop, let me turn to the impact of the monetary and liquidity measures so far taken by the RBI to mitigate the negative fallout of COVID-19.

14. It may be noted that transmission of the rate cuts by the MPC would not have been possible to the extent achieved so far without creating comfortable liquidity conditions. The overriding objective was to prevent financial markets from freezing up; ensure normal functioning of financial intermediaries; ease the stress faced by households and businesses; and keep the life blood of finance flowing. This is achieved by infusing large amounts of liquidity in and out of the system through injections and absorptions through the LAF. In the process, the easing of financial conditions has actually enhanced monetary transmission and, thereby, the effectiveness of the MPC's accommodative stance and actions. What is more, the injections of liquidity, including through open market operations, special operations and forex interventions, are being fully sterilised by absorptions through the reverse repo, while preventing a seizure of money markets under extreme risk aversion and uncertainty.

15. Another aspect that needs to be recognised is that RBI's open market purchases are aimed at reducing funding costs for private sector entities that issue instruments in the market which are usually priced off the G-sec yield as the benchmark. In fact, it is worthwhile to see who is benefiting from RBI's actions. Borrowing costs in financial markets have dropped to their lowest in a decade on the back of abundant liquidity. Interest rates on

[1] Mahatma Gandhi, Harijan, July 21, 1940.

instruments like the 3-month Treasury bill, commercial paper (CP) and certificates of deposit have fully priced in the reduction in the policy rate and are, in fact, trading below it in the secondary market. CPs of NBFCs have softened to 3.80 per cent on July 31, 2020. Rates have fallen to 3.40 per cent on July 31, 2020 for non-NBFC borrowers.

16. With illiquidity premia dissipating under the impact of Operation Twist and TLTRO 1.0, spreads of 3-year AAA-rated corporate bonds over similar tenor government securities have also declined from 276 basis points on March 26, 2020 to 50 basis points on July 31, 2020. Spreads on AA+ rated bonds softened from 307 basis points to 104 basis points; spreads on AA bonds narrowed from 344 basis points to 142 basis points over the same period. Even for the lowest investment grade bonds (BBB-), spreads have come down by 125 basis points as on July 31, 2020.

17. Lower borrowing costs have led to record primary issuance of corporate bonds of ₹2.09 lakh crore in the first quarter of (April-June) 2020-21. In particular, market financing conditions for NBFCs, which had become challenging, have largely stabilised in the wake of targeted policy measures. For AA+ rated 3-year NBFC bonds, spreads over similar tenor G-secs have narrowed from 360 basis points on March 26 to 139 basis points on July 31, 2020.

18. Abundant liquidity has supported other segments of financial markets too. In particular, MFs have stabilised since the Franklin Templeton episode. Assets under management of Debt MFs, which fell to ₹12.20 lakh crore as on April 29, 2020, recovered and improved to ₹13.89 lakh crore as on July 31, 2020.

19. At the same time, financial conditions have improved in specific sectors. Although non-food bank credit has slowed to 5.6 per cent (As on

July 17), credit to NBFCs is growing at 25.7 per cent in June, loans to services at 10.7 per cent, and to housing at 12.5 per cent. Monetary transmission has also improved considerably. The weighted average lending rate (WALR) on fresh rupee loans sanctioned by banks declined by 162 basis points during February 2019-June 2020, of which 91 basis points transmission was witnessed during March-June 2020.

Additional Measures

20. With COVID-19 infections rising unabated under fragile macroeconomic and financial conditions, we propose to undertake additional developmental and regulatory policy measures to (i) enhance liquidity support for financial markets and other stakeholders; (ii) further ease financial stress caused by COVID-19 disruptions while strengthening credit discipline; (iii) improve the flow of credit; (iv) deepen digital payment systems; (v) augment customer safety in cheque payments; and (vi) facilitate innovations across the financial sector by leveraging on technology.

21. In the worst peacetime health and economic crisis of the last 100 years that we face today, the regulatory response has to be dynamic, proactive and balanced. While designing the major announcements that I am making today, we have ensured that necessary safeguards are in place for preserving financial stability. We are fully mindful of RBI's responsibility to maintain stability of the financial sector. While I am outlining the main measures, the Statement on Developmental and Regulatory Measures addresses them in greater detail.

(i) Additional Special Liquidity Facility (ASLF)

22. Additional special liquidity facility of ₹10,000 crore will be provided at the policy repo rate consisting of : ₹5,000 crore to the National Housing

Bank (NHB) to shield the housing sector from liquidity disruptions and augment the flow of finance to the sector through housing finance companies (HFCs); and ₹5,000 crore to the National Bank for Agriculture and Rural Development (NABARD) to ameliorate the stress being faced by smaller non-bank finance companies (NBFCs) and micro-finance institutions in obtaining access to liquidity.

(ii) Resolution Framework for COVID-19-related Stress

23. The "Prudential Framework on Resolution of Stressed Assets" dated June 7, 2019 provides a principle-based resolution framework for addressing borrower defaults. Any resolution plan implemented under the Prudential Framework, which involves granting of any concessions on account of financial difficulty of the borrower, entails an asset classification downgrade except when accompanied by a change in ownership, subject to prescribed conditions.

24. The disruptions caused by COVID-19 have led to heightened financial stress for borrowers across the board. A large number of firms that otherwise maintain a good track record under existing promoters face the challenge of their debt burden becoming disproportionate, relative to their cash flow generation abilities. This can potentially impact their long-term viability and pose significant financial stability risks if it becomes wide-spread. Accordingly, it has been decided to provide a window under the June 7th Prudential Framework to enable lenders to implement a resolution plan in respect of eligible corporate exposures - without change in ownership - as well as personal loans, while classifying such exposures as standard assets, subject to specified conditions.

25. In the light of past experience with regard to use of regulatory forbearance, necessary safeguards have been incorporated, including prudent entry norms, clearly defined boundary conditions, specific binding

covenants, independent validation and strict post-implementation performance monitoring. The underlying theme of this resolution window is preservation of the soundness of the Indian banking sector.

26. The Reserve Bank is constituting an Expert Committee (Chairman: Shri K.V. Kamath) which shall make recommendations to the RBI on the required financial parameters, along with the sector specific benchmark ranges for such parameters, to be factored into resolution plans. The Expert Committee shall also undertake a process validation of resolution plans for borrowal accounts above a specified threshold. The details of the resolution framework are spelt out in Part 'B' of the MPC resolution and the circular, both of which will be issued immediately after this press statement.

(iii) Restructuring of MSME debt

27. A restructuring framework for MSMEs that were in default but 'standard' as on January 1, 2020 is already in place. The scheme has provided relief to a large number of MSMEs. With COVID-19 continuing to disrupt normal functioning and cash flows, the stress in the MSME sector has got accentuated, warranting further support. Accordingly, it has been decided that stressed MSME borrowers will be made eligible for restructuring their debt under the existing framework, provided their accounts with the concerned lender were classified as standard as on March 1, 2020. This restructuring will have to be implemented by March 31, 2021.

(iv) Advances against Gold Ornaments and Jewellery

28. As per extant guidelines, loans sanctioned by banks against pledge of gold ornaments and jewellery for non-agricultural purposes should not exceed 75 per cent of the value of gold ornaments and jewellery. With a view to mitigating the impact of COVID-19 on households, it has been

decided to increase the permissible loan to value ratio (LTV) for such loans to 90 per cent. This relaxation shall be available till March 31, 2021.

(v) Banks' Investment in Debt Mutual Funds and Debt Exchange Traded funds – Capital Charge for Market risk

29. As per RBI's extant Basel III guidelines, if a bank holds a debt instrument directly, it would have to allocate lower capital, as compared to holding the same debt instrument through a Mutual Fund (MF)/Exchange Traded Fund (ETF). It has been decided to harmonise the differential treatment existing currently. This will result in substantial capital savings for banks and is expected to give a boost to the corporate bond market.

(vi) Review of Priority Sector Lending Guidelines

30. With a view to aligning the guidelines with emerging national priorities and bring sharper focus on inclusive development, the Priority Sector Lending (PSL) guidelines have been reviewed. An incentive framework is now being put in place for banks to address the regional disparities in the flow of priority sector credit. While higher weightage will be assigned for incremental priority sector credit in the identified districts having lower credit flow, a lower weightage would be assigned in identified districts where the credit flow is comparatively higher. PSL status is also being given to start-ups; and the limits for renewable energy, including solar power and compressed bio-gas plants, are being increased.

***(vii)* Other measures that are being announced today include:**

31. (a) Introduction of an automated mechanism in e-Kuber system to provide banks more flexibility/discretion in managing their liquidity and maintenance of cash reserve requirements.

(b) While permitting lenders to provide relief to the borrowers through various measures, it is also considered necessary to take appropriate measures for strengthening credit discipline. In view of the concerns emanating from use of multiple operating accounts by borrowers, both current accounts as well as cash credit (CC)/overdraft (OD) accounts, it has been decided to put in place certain safeguards for opening of such accounts for borrowers availing credit facilities from multiple banks.

(c) The Reserve Bank has constantly endeavoured to encourage responsible innovation by entities in the financial services sector. In order to further promote and facilitate an environment that can accelerate innovation across the financial sector, Reserve Bank will set up an Innovation Hub in India. Further details about the Innovation Hub would be announced in due course.

(d) To enhance safety of cheque payments, it has been decided to introduce a mechanism of Positive Pay for all cheques of value ₹50,000 and above. This will cover approximately 20 per cent and 80 per cent of total cheques by volume and value, respectively. Operational guidelines in this regard will be issued separately.

(e) A scheme of retail payments in offline mode using cards and mobile devices, and a system of on online dispute resolution (ODR) mechanism for digital payments will also be introduced.

Concluding Remarks

32. At this juncture, the war against COVID-19 is most intense, and the world is bracing up for a second wave as it cautiously opens up. The pandemic poses a challenge of epic proportions, but our collective efforts, intrepid choices, innovations and true grit will eventually take us to victory. As Mahatma Gandhi had said, “Patience and perseverance, if we have

them, overcome mountains of difficulties"[2]. The challenges of today will only strengthen our resilience and self-belief. We shall remain alert and watchful and collectively do whatever is necessary to revive the economy and preserve financial stability. Courage and conviction will conquer Covid-19.

Thank you.

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[2] *Mind of Mahatma Gandhi* (Eds: Prabhu and Rao), 3rd Edition, 1968 pp. 365