Central Bank Watch: As good as it gets

Today's monetary policy was as aggressively accommodative as possible without cutting the policy rate (unchanged at 4%). The decision to remain accommodative for an extended period and to look through "transient humps" in inflation reveals an appreciation for the basic principles of economics –that a GDP contraction of 95 per cent is simply not compatible with demand side inflation pressures.

If inflation has remained over the RBI's target limit, it has been driven by persistent supply side problems. Persistence itself cannot transform a supply driven problem to a demand side concern amenable to monetary policy driven containment. Given the stance, there is a significant probability of a rate cut (of close to 50bps) in February, if not in December itself as inflation, as we expect, moderates.

Inflation and Growth estimates: *It was a relief to finally receive the RBI's assessment on growth and inflation over the coming quarters, something it has abstained to do since the beginning of the pandemic. The RBI expects GDP to contract by 9.5% in FY21 with a return to positive growth expected in Q4 FY21. On inflation, the central banks estimates inflation to average at 6.8% in Q2, 5.4-4.5% in H2 FY21 and 4.3% in Q1 FY22. Given the recent signs of recovery balanced with the continuing risks, we expect GDP growth to contract between 8-10% in the current fiscal. On inflation, we expect CPI to remain above 6.5% in September and above 6% in October, before moderating to 4.5%-5% by December 2020. In Q4, we expect inflation prints to cool off further and average close to 4%.*

Yield management: *The highlight of today's policy was the RBI's signal that it would "do whatever it takes" (a phrase immortalized by former European Central Bank Governor Mario Draghi) to align risk-free government bond yields with the fundamentals of the economy. This involved key changes such as an increase in the size of Open Market Operations (to INR 20,000 crore), extension of the increase in HTM limits till March 2022 to incentivise banks' to utilise the higher limits, and innovations like OMOs in State Government Bonds. Were these measures to succeed, as we expect them to, the upward pressure on yields that have built up on the back of heavy anticipated supply of central and state government bonds, is likely to moderate.*

Liquidity support to continue: *In a continued effort to support liquidity needs in the system, the RBI also announced an on-tap TLTRO with tenors upto three year for an amount of INR 1 lakh crores. The liquidity availed under this scheme will have to be deployed by banks in corporate bonds, commercial papers and non-convertible debentures. Banks are also permitted to use this scheme to extend loans and advances to certain sectors and have the option of reversing previous borrowings under TLTRO and TLTRO2.0 before maturity to benefit from current reduced rates. We expect this measure to improve transmission and reduce corporate bond yields.*

Bond View: *10-Y bond yield fell by 7.7 bps to 5.938% (at the time of writing) as compared to yesterday's closing level of 6.02% after the RBI said it will double the purchase size under its OMO to the tune of INR 20,000 cr and also conduct OMOs in State Development Loans (SDLs). Looking at the shorter tenure bonds, 3-Y and 5-Y slumped 8 bps and 6 bps, respectively as compared to Thursday's closing level.* ***We now expect the 10-year yield to trade in the range of 5.75%-6% in the near-term as the RBI aggressively intervenes to keep borrowing costs low.***

On the FX front, the USD/INR touched an intra-day low of 73.026 and is currently trading at 73.20 levels. We expect the USD/INR to trade in the range of 73.0-74.0 in the coming week.

The Specifics:

Inflation Outlook: In todays' policy the RBI signalled that it views the current spike in inflation as transient. The RBI noted that COVID related supply disruptions, including labour shortages and high transportation costs, has weighed on the headline inflation and could continue to impose cost-push pressures in the near-term. Going forward, it expects these supply bottlenecks to dissipate aided by easing of lockdowns and removal of restrictions on inter-state movements.

<u>**The RBI expects CPI inflation to average at 4.5-5.4% in H2 FY21 and 4.3% in Q1 FY22, with risks broadly balanced**</u>.

- We expect the headline inflation to remain elevated in the near term (remaining higher than ~6% in Oct-20) and ease only gradually, moving towards 4.5%- 5.0% in Dec-20 and 4% in Mar-21 aided by a favourable base and correction in food prices as supply disruptions fade.

Growth Outlook: On the growth front, the RBI expects the recovery in rural demand to strengthen further, while recovery in urban demand is likely to lag behind amid social distancing norms and high rate of COVID-19 infections. The RBI expects the recovery to gain some traction from Q4 FY21 onwards. Looking at the internals, the RBI reckons that the service sector will take time to return to pre-COVID levels while manufacturing firms capacity utilization to recover in Q3 FY21. On the other hand, private investments and exports, are likely to remain subdued. **For FY21, the RBI expects the GDP growth to contract by 9.5%, with downside risks.**

- <u>We expect the GDP growth to contract by 8-10% in FY21, with a sharper contraction in Q2 and some recovery (to the tune of 1.5-2%) in Q4 FY21.</u>

RBI Quarterly growth forecast (% YoY)

Q2 FY21	Q3FY21	Q4 FY21
-9.8	-5.6	0.5

Other Key Announcements:

1. **Liquidity Measures:**
   - **Open Market Operations (OMOs) in State Development Loans (SDLs) to be conducted as a special case during this financial year in order to improve liquidity and facilitate efficient pricing.** The OMOs would be conducted for a basket of SDLs comprising securities issued by states. In addition, the RBI announced special OMOs worth INR 20,000 cr, to be conducted next week.

   - **To conduct on tap TLTRO with tenors of up to 3 years for a total amount of up to INR 1 trn at a floating rate linked to the policy repo rate.**

- *The liquidity availed by banks under the scheme has to be deployed in corporate bonds, commercial papers, and non-convertible debentures. The liquidity availed under the scheme can also be used to extend bank loans and advances to these sectors.*
- *Investments made by banks under this facility will be classified as held to maturity (HTM) even in excess of 25 percent of total investment permitted to be included in the HTM portfolio.*
- *Banks that had availed of funds earlier under targeted long-term repo operations (TLTRO and TLTRO 2.0) have the option of reversing these transactions before maturity.*

- **Extending the Held to Maturity (HTM) limits of 22 percent up to March 31, 2022** for securities acquired between September 1, 2020 and March 31, 2021. The HTM limits would be restored from 22 per cent to 19.5 percent in a phased manner starting from the quarter Q1 FY22.

Update on State borrowings and OMOs done by RBI so far:

State borrowings pressure continues to mount:

During first half of ongoing fiscal year state governments borrowed INR 3.3 tn, with INR 1.55 tn in Q1 and INR 1.71 tn in Q2. This marks a 45% increase in states borrowing compared to the last year. Furthermore, several states including Maharashtra, Gujarat & Jharkhand undertook additional borrowing, indicating stress in fiscal accounts. As per the indicative borrowing calendar released by the RBI, state governments are expected to raise INR 2.02 tn in Q3. For the full year, we estimate overall states borrowings in the range of INR 6.8-8.7 tn.

	FY21 (in INR, Tn)
State Govt Borrowings	
Done so far (till 25th Sep)	3.3
HDFC FY21 Estimate	6.8-8.7
Remaining for year- HDFC Estimate	3.5-5.4

Source: CEIC, HDFC Bank Estimates

Open Market Operations: Outright and Special Twists

Since Mar-20, the RBI conducted open market purchases worth INR 1.8 tn through plain vanilla bonds and INR 700 bn as special purchases under operation twist. In his post policy media address Governor Das, announced to conduct plain vanilla g-sec purchases worth INR 200 bn on October 15th. With this, open market purchases by the RBI would stand at INR 2 tn under the plain vanilla option.

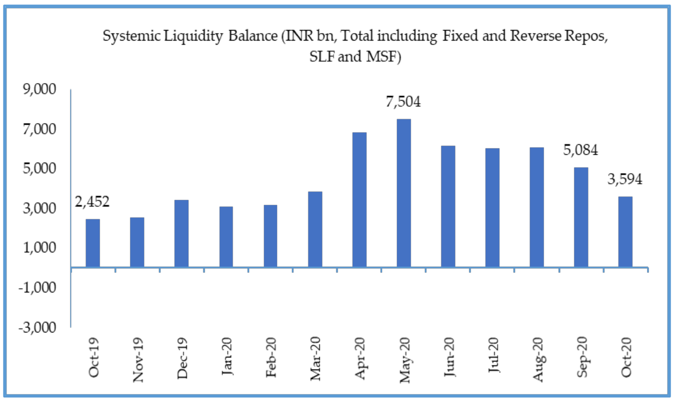
2. **Key regulatory measures announced:**
   - **Regulatory Retail Portfolio - revision of limit for Risk weight**: The threshold limit increased to INR 7.5 cr (from INR 5 cr) in respect to all fresh as well as incremental qualifying exposures in order to reduce the cost of credit for individuals and small businesses (with turnover of up to INR 50 cr). This measure is expected to increase credit flow to the small business segment.
   - **Individual Housing Loans:** Rationalising the risk weights by linking them only with loan to value (LTV) ratios for all new housing loans sanctioned up to March 31, 2022.

3. **Other measures** include round the clock availability of Real Time Gross Settlement System (RTGS), extending the scheme for co-lending to all NBFCs (including Housing Finance Companies).

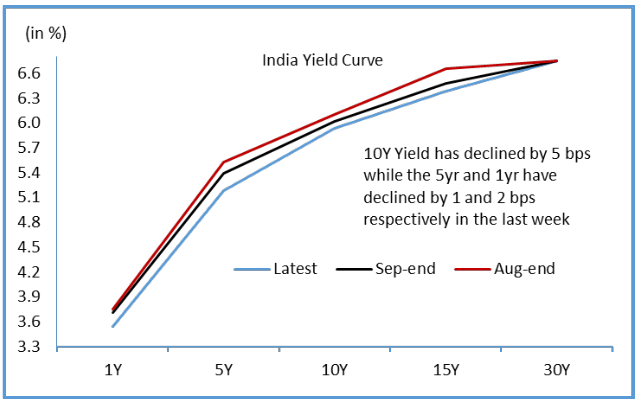
Transmission of previous policy rate cuts: Rates have come down more at the short-end of the curve

	Pre COVID-19	Post COVID-19
(in bps)	Transmission b/w Feb 19 & Jan-20	Transmission b/w Feb-20 & latest
Repo Rate	-135	-115
Reverse Repo	-135	-155
CRR	0	-100
WACR	-149	-163
TREP	-181	-187
T-Bill 3M	-128	-180
T-Bill 6M	-123	-176
CPs (average of low, high)	4	-330
WALR	-45	-91
Term Deposit (1Y)	-63	-100
10Y G-Sec	-99	-43
5Y G-Sec	-69	-68
10Y AAA	-70	-71
10Y AA	-29	-63

Systemic Liquidity moderated in Oct-20



Yields declined today supported by liquidity measures announced by the RBI



Source: CEIC, RBI, Reuters, HDFC Bank

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