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RBI Monetary Policy: End of the rate-cut cycle; liquidity support to continue

The RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy rates unchanged and continue with the accommodative stance as long as necessary. While growth outlook has improved significantly, with the recovery turning more broad-based, the RBI underscored the need to continue to support and revive growth on a durable basis particularly amid expectations of a stable near-term inflation trajectory. The RBI now expects GDP growth at 10.5% in FY22—a tad higher than our estimate of 9.5%, with average growth in H1FY22 pegged at 17.3% (26.2%/8.3% in Q1/Q2 vs. 21.9%/6.5% estimated earlier).

The RBI decided to restore CRR (Cash Reserve Ratio) to pre-pandemic levels in two phases beginning March 2021 and utilise the space for injecting additional liquidity. This probably points towards OMO (Open Market Operations) purchases in the offing which was expected amid enhanced Government borrowing requirements. Extension of enhanced HTM (Held to Maturity) limit of 22% for SLR securities bought by banks in FY22 and direct access of retail investors to the Government securities market through RBI would further help in absorbing heavy supply of Government paper. Other key announcements include a) inclusion of NBFCs in TLTRO On Tap scheme[1] for incremental lending to stressed sectors, b) extension of MSF (Marginal Standing Facility) relaxation by six months, c) exemption to banks from including loans to new MSME borrowers in CRR calculation, and d) exemption of FPI investment in defaulted corporate bonds from the short-term limit and minimum residual maturity requirement.

The RBI's upbeat views on the economy along with sustained cost-push pressures on inflation fortifies our stance of no rate cuts in the foreseeable future, notwithstanding sustenance of an accommodative stance. The RBI is likely to focus on gradually normalising ultra-loose policy settings prevailing since March 2020 while maintaining **adequate liquidity in the system to strengthen economic recovery that's currently underway. Amidst a heavy** Government borrowing programme, sustained OMO purchases will be crucial in keeping a check on rising yields.

The RBI expectedly kept policy rates unchanged and maintained an accommodative stance, reiterating the need to support growth.

- RBI keeps policy rates unchanged; maintains an accommodative stance: In the first bi-monthly monetary policy review of the year, the RBI's MPC unanimously voted to keep the policy rates unchanged and maintain an accommodative stance as long as necessary. As such, the repo, reverse repo and bank/Marginal Standing Facility (MSF) rates remain unchanged at 4.0%, 3.35% and 4.25% respectively. While the RBI acknowledged a significant and broad-based improvement in growth outlook since the December policy meeting, it underscored the need for supporting growth and helping the economy return to a higher growth trajectory, deriving comfort from the recent fall in inflation trajectory. The RBI also reiterated on maintaining adequate systemic liquidity, thereby keeping financial conditions easy.

The RBI has revised inflation and growth forecasts upwards.

- Growth outlook turns favourable: The RBI provided an upbeat outlook on growth, citing continued improvement in high-frequency indicators including consumer confidence, power consumption, manufacturing PMI, mobility, and trading activity. The ongoing vaccination drive and fiscal impulse in the Budget should further strengthen the recovery process. Flow of funds to the commercial sector has also improved meaningfully. Accordingly, the RBI now expects GDP growth in FY22 at 10.5%—a tad lower than our estimate of 9.5%, with growth in Q1FY22 and Q2FY22 pegged at 26.2% and 8.3% vs. earlier estimates of 21.9% and 6.5% respectively.
- Inflation forecasts marginally revised upwards: A sharp fall in vegetable prices, thanks to higher arrivals and supply-side policy intervention, had led to a significant moderation in inflation trajectory over the last two months, with a high base effect providing an added support. While vegetable inflation is expected to remain benign, aided by larger winter supplies of vegetables, inflation in other food items may

[1] To provide liquidity to specific sectors that have backward and forward linkages, the RBI announced On tap Targeted Long-term Repo Operation (TLTRO) scheme on October 9th, 2020 (link here). Liquidity availed by banks under this scheme is to be deployed in corporate bonds, commercial papers and non-convertible debentures by entities in the specified sectors or to extend loans to these sectors.

remain elevated. Core inflation faces upside risks on rising cost-push pressures, thanks to record-high fuel prices, increase in input costs and enhanced pricing power on improving demand. While the RBI has lowered its inflation forecast for Q4FY21 from 5.8% to 5.2%, it has marginally raised its inflation forecasts for FY22, expecting it in the range of 5.0-5.2% in H1FY22 (vs. 4.6-5.2% estimated earlier) and 4.3% in Q3FY22. Importantly, the RBI called out for a concerted policy action by the Government to prevent escalation of cost-push pressures on inflation.

- Liquidity support for enhanced Govt. borrowing programme: The RBI reiterated its commitment towards seamlessly managing the Govt.'s borrowing programme and consequently ensuring financial stability and orderly evolution of yield curve. This is reflected in the slew of measures announced today. The RBI decided to restore CRR (Cash Reserve Ratio) to pre-pandemic levels in two phases beginning March 2021 (from 3.0% currently to 3.5% w.e.f. March 27th, 2021 and 4% w.e.f. May 22nd, 2021) and utilise the space for injecting additional liquidity. This probably points towards OMO (Open Market Operations) purchases in the offing which was expected amid enhanced Government borrowing requirements. Extension of enhanced HTM limit of 22% for SLR securities bought by banks in FY22 and direct access of retail investors to the Government securities market (primary as well as secondary) by allowing them to open Gilt accounts with RBI are some of the other measures announced today to facilitate absorption of heavy supply of Government paper in the next fiscal year.

RBI announced measures to ensure seamless completion of Govt.'s borrowing programme:
1. CRR normalisation to create space for further liquidity injection
2. Extension of enhanced HTM limit by a year, and
3. Direct Government securities market access to retail investors

- Additional measures: Other key measures include: a) Inclusion of NBFCs in TLTRO On Tap scheme for incremental lending to sectors specified earlier including 26 stressed sectors identified by the Kamath Committee, b) Extension of MSF relaxation by another six months wherein banks will be allowed to dip into SLR up to 3% of NDTL until September 30th, 2021, c) A one-year exemption to banks from including loans up to Rs2.5mn to new MSME borrowers extended this year until October 1st, 2021 in CRR calculation, d) Exemption of FPI investment in defaulted corporate bonds from the short-term limit and minimum residual maturity requirement, and e) Deferment of the implementation of the last tranche of Capital Conservation Buffer of 0.625% and Net Standing Facility Ratio (NSFR) by another six months to October 1st, 2021.

- Liquidity management to remain in focus: The RBI's upbeat views on the economy along with sustained cost-push pressures on inflation fortifies our stance of no rate cuts in the foreseeable future, notwithstanding sustenance of an accommodative stance. The RBI is likely to focus on gradually normalising ultra-loose policy settings prevailing since March 2020 while maintaining adequate liquidity in the system to strengthen economic recovery that's currently underway. Amidst a heavy Government borrowing programme, sustained OMO purchases will be crucial in keeping a check on rising yields.

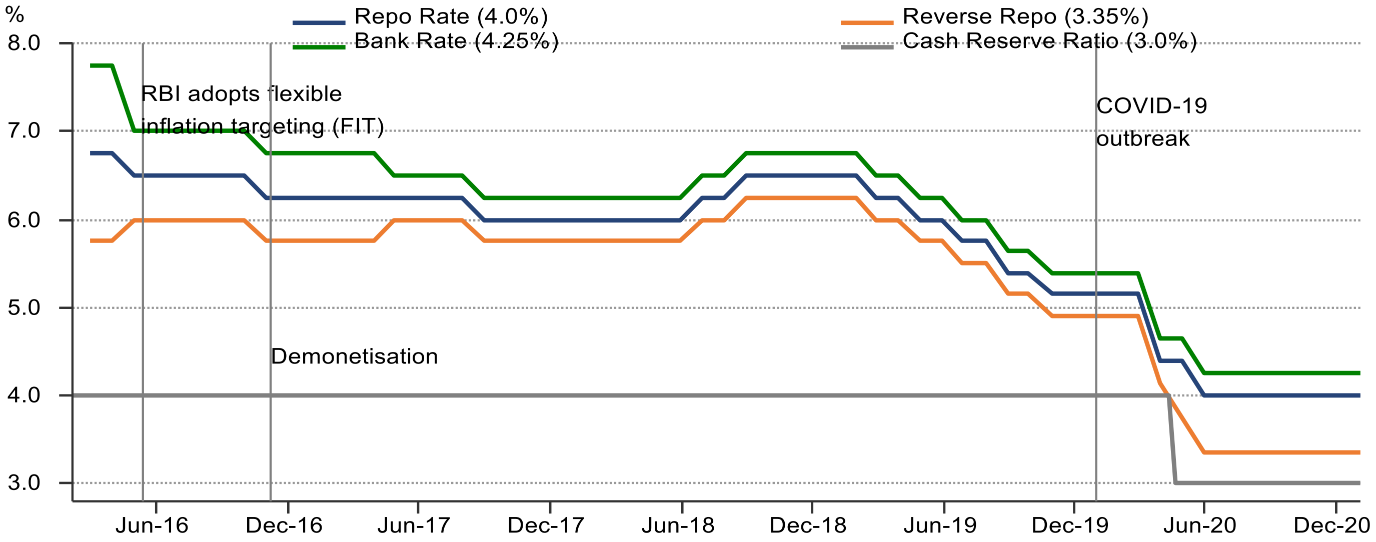
Rate cut cycle has come to an end with the RBI likely to focus on normalising ultra-loose policy settings this year, while maintaining adequate liquidity in the system.

Figure 1: Current policy rates

Key rates	Current value
Repo Rate	4.0%
Reverse Repo Rate	3.35%
Marginal Standing Facility (MSF) Rate	4.25%
Bank Rate	4.25%
Cash Reserve Ratio (CRR)	3.0%
Statutory Liquidity Ratio (SLR)	18.0%

Source: RBI

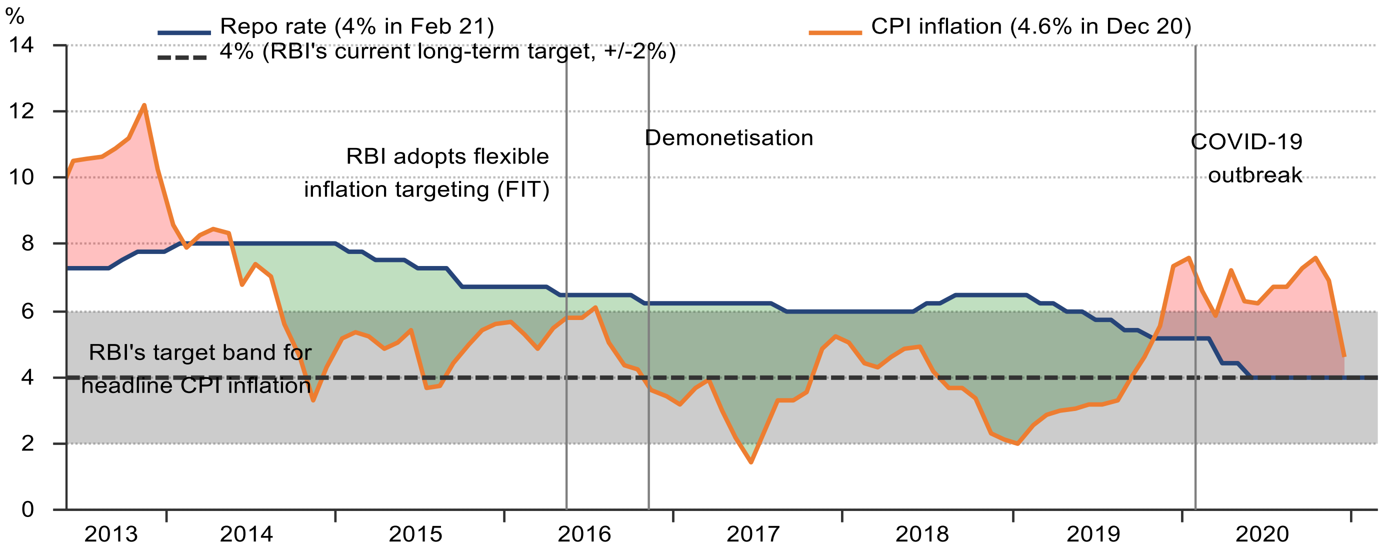
Figure 2: Policy rates kept unchanged



Source: Refinitiv Datastream.

Figure 3: India headline Consumer Price Inflation (CPI) and real interest rates

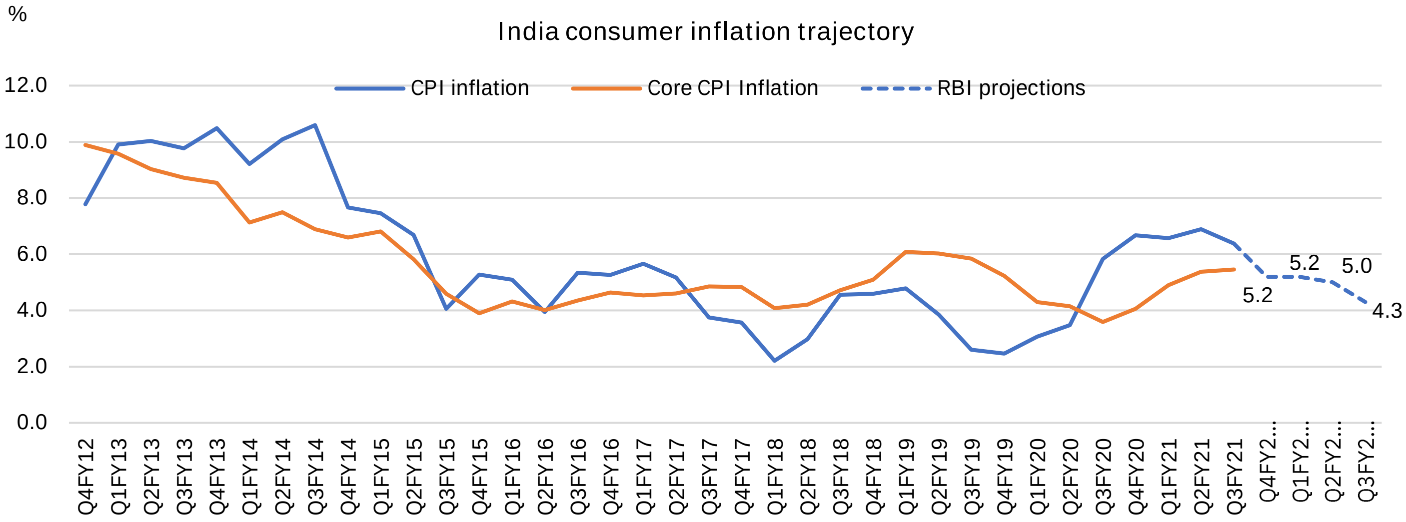
India headline CPI inflation fell below the RBI's 6% upper bound for the first time in the post-pandemic period in December. However, it still remains above the mid-point target of 4%, translating into persistence of negative real interest rates for more than a year now.



Source: Refinitiv Datastream.

Figure 4: RBI expects headline CPI inflation to average at 5.1% in H1FY22

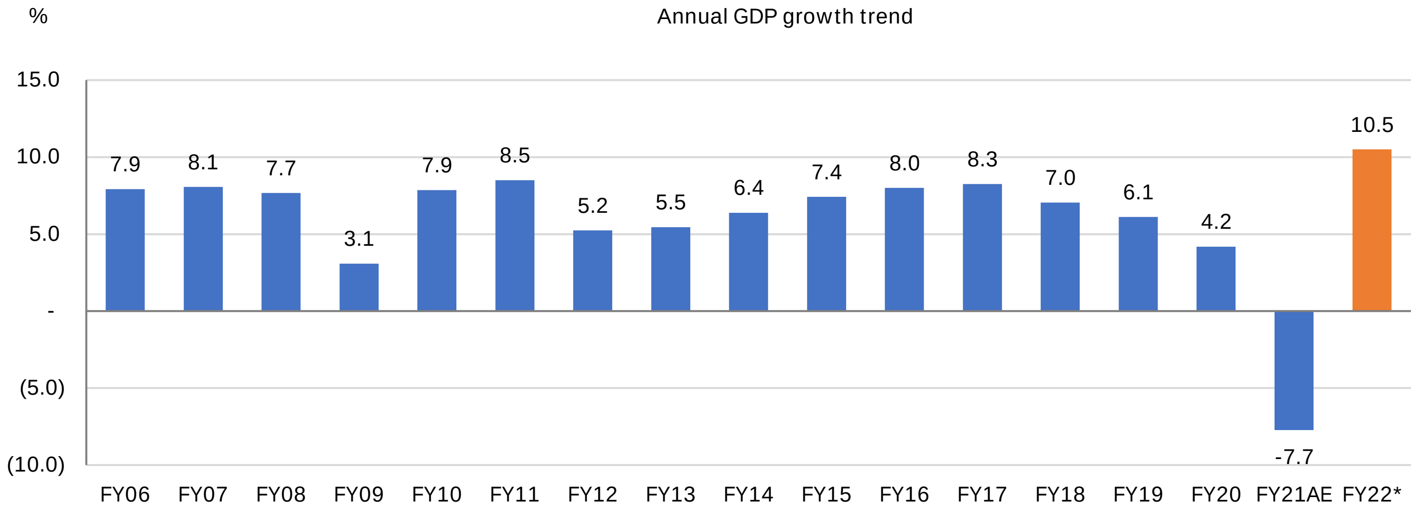
While the RBI has lowered its inflation forecast for Q4FY21 from 5.8% to 5.2%, thanks to continued moderation in vegetable prices, it has marginally raised its inflation forecasts for FY22, expecting it in the range of 5.0-5.2% in H1FY22 (vs. 4.6-5.2% estimated earlier) and 4.3% in Q3FY22.



Source: CSO, RBI. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

Figure 5: GDP growth trend and estimate for FY22

The RBI provided an upbeat outlook on growth, citing continued improvement in high-frequency indicators, with the ongoing vaccination drive and fiscal impulse announced in the Budget further strengthening the recovery process. Accordingly, the RBI now expects GDP growth in FY22 at 10.5%—a tad lower than our estimate of 9.5%, with growth in Q1FY22 and Q2FY22 pegged at 26.2% and 8.3% vs. earlier estimates of 21.9% and 6.5% respectively.

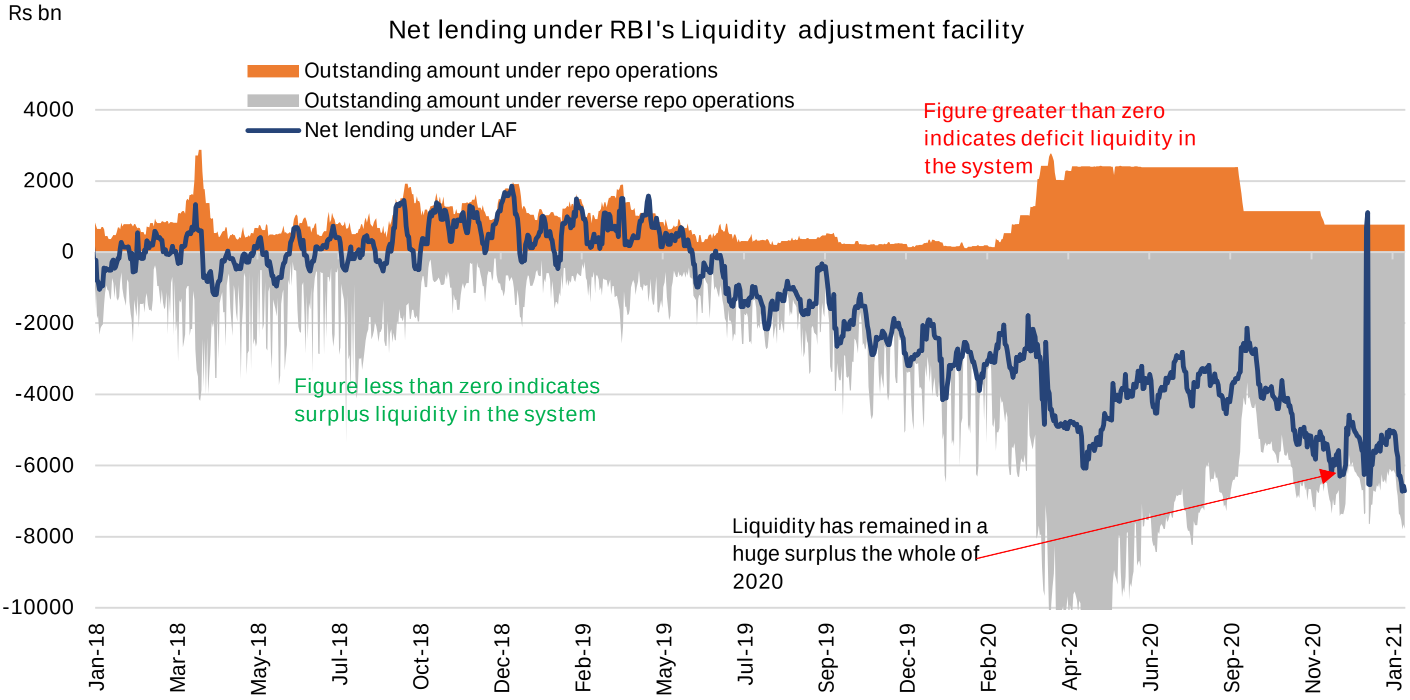


Source: RBI. * FY22 figure is RBI's estimate.

Liquidity management to remain in focus: The RBI's upbeat views on the economy along with sustained cost-push pressures on inflation fortifies our stance of no rate cuts in the foreseeable future, notwithstanding sustenance of an accommodative stance. The RBI is likely to focus on gradually normalising ultra-loose policy settings prevailing since March 2020 while maintaining adequate liquidity in the system to strengthen economic recovery that's currently underway. Amidst a heavy Government borrowing programme, sustained OMO purchases will be crucial in keeping a check on rising yields.

Figure 6: Net lending under **RBI's Liquidity Adjustment Facility**

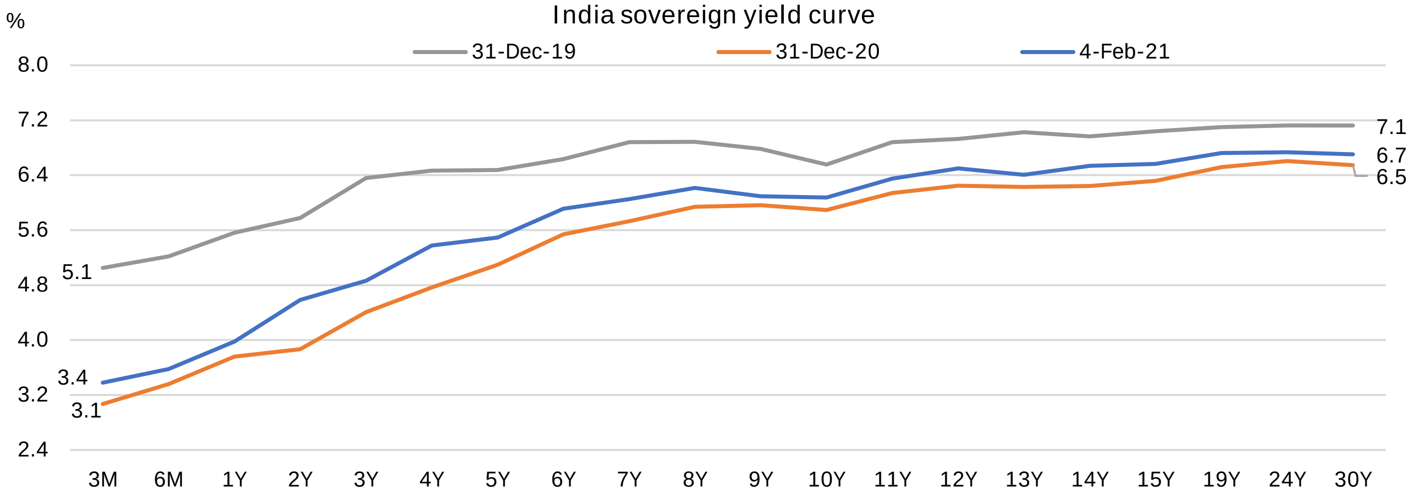
Surplus liquidity in the system has remained north of Rs5trn over the last three months.



Source: CMIE Economic Outlook, NSE

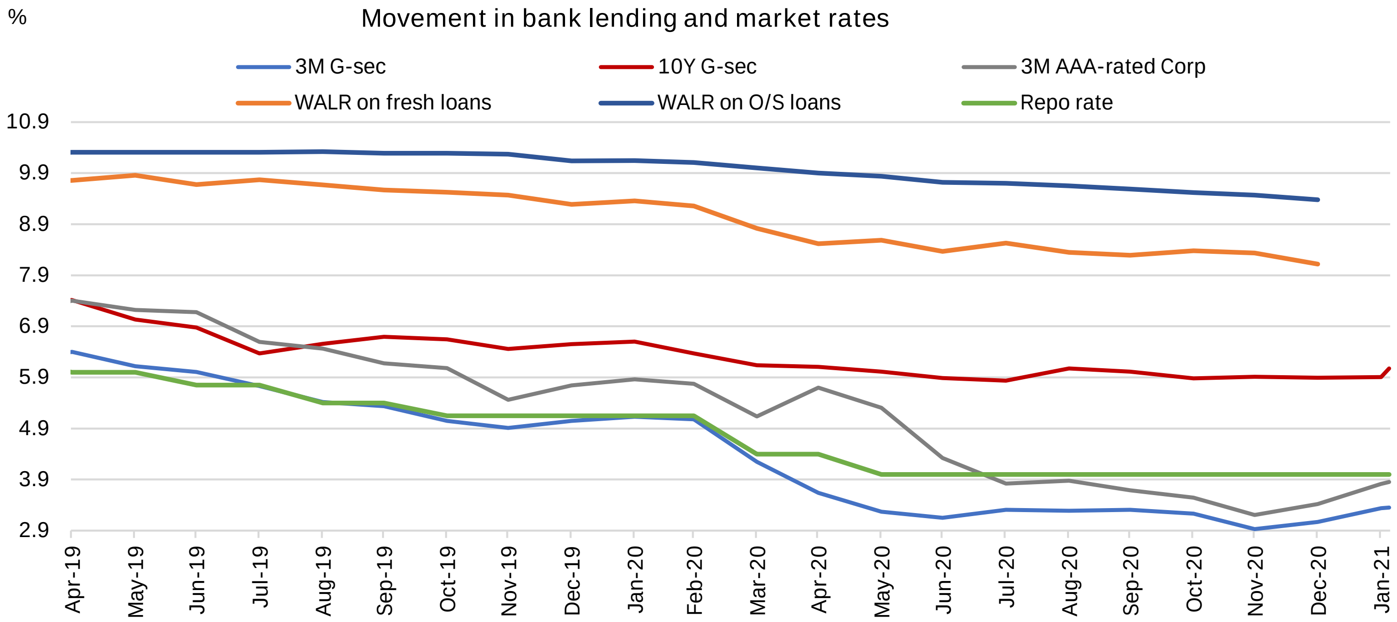
Figure 7: India sovereign yield curve

The India sovereign yield curve has risen across the tenors in the last month or so, and particularly after the budget, thanks to the enhancement in Government's borrowing plan for the current fiscal year by Rs800bn and a much higher-than-expected borrowing figure for the next fiscal year.



Source: Refinitiv Datastream, NSE.

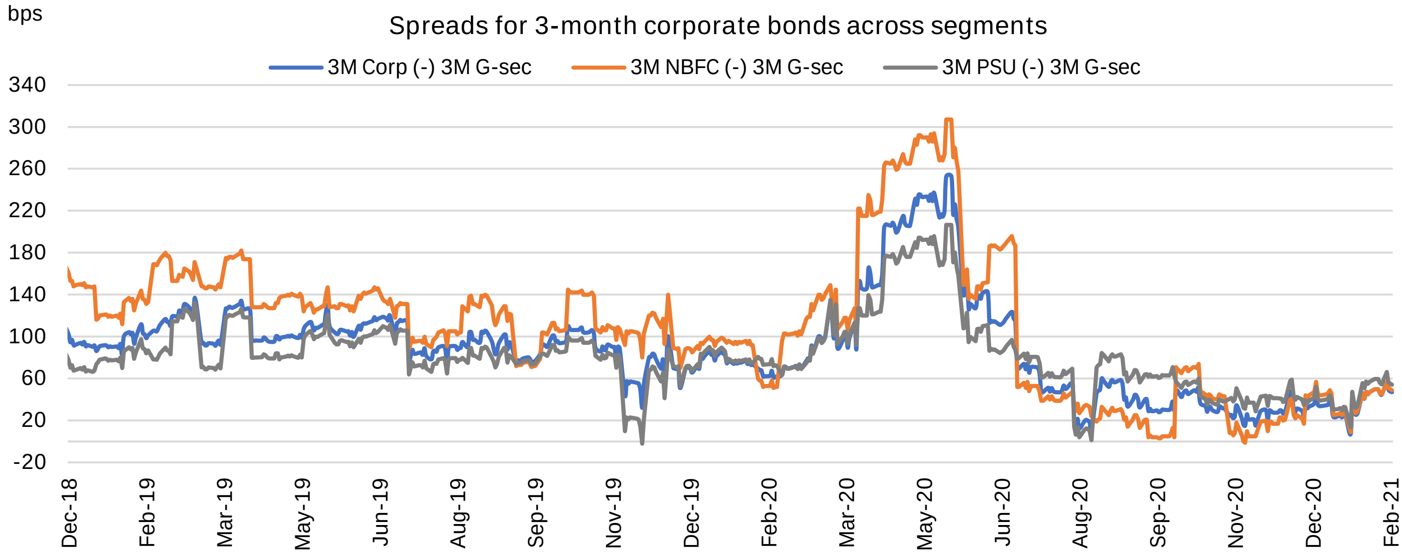
Figure 8: Movement in bank lending rates and market rates vs. policy repo rate



Source: RBI, Refinitiv Datastream, NSE.

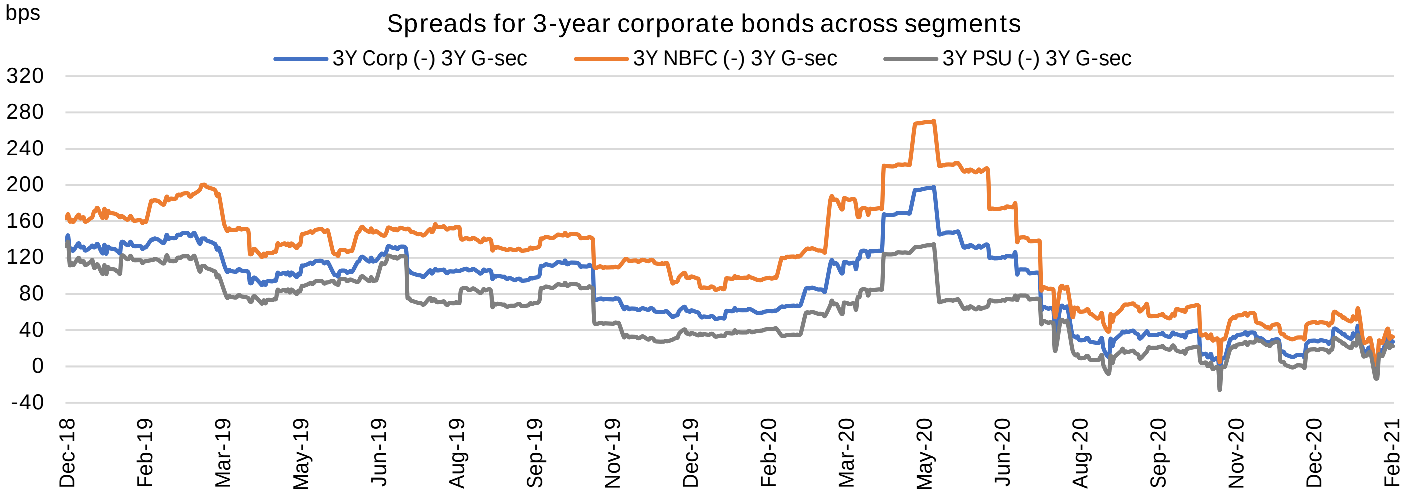
The corporate bond yields have risen at a steeper pace last month in the run-up to the Budget and this week, resulting in widening of spreads with the similar-tenor G-secs.

Figure 9: Spreads for 3-month corporate bonds across segments



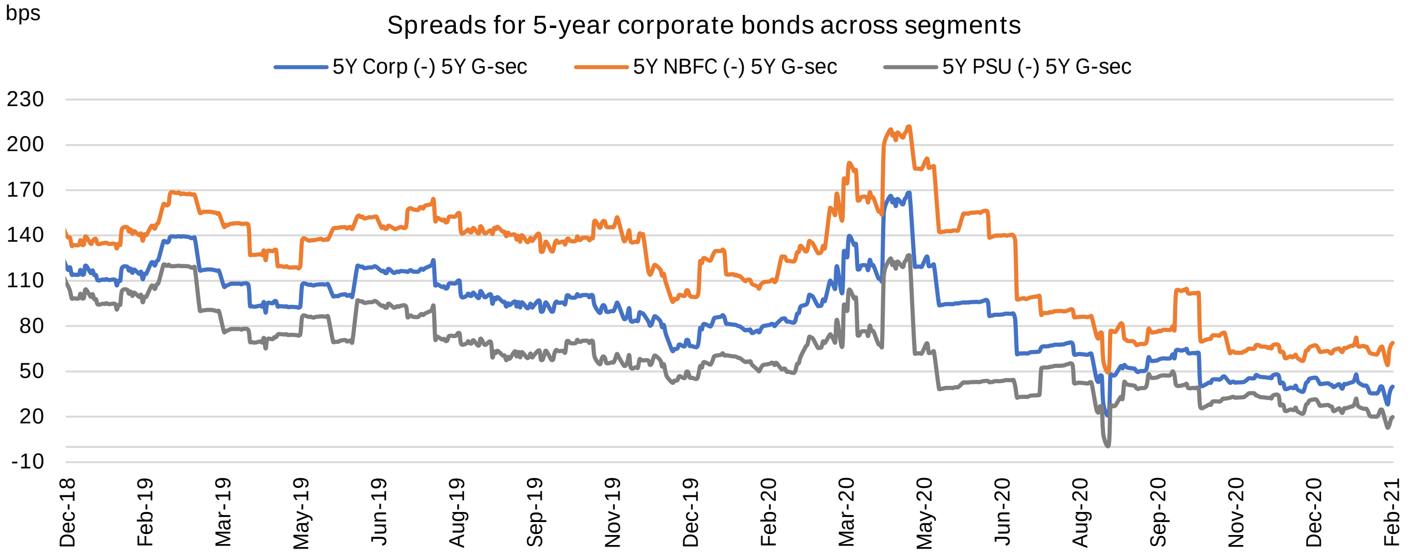
Source: Refinitiv Datastream, Bloomberg, NSE.

Figure 10: Spreads for 3-year corporate bonds across segments.



Source: Refinitiv Datastream, Bloomberg, NSE.

Figure 11: Spreads for 5-year corporate bonds across segments



Source: Refinitiv Datastream, Bloomberg, NSE.

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