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RBI Monetary Policy: Dovish pause; liquidity support strengthened and widened

The RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy rates unchanged (repo rate: 4%) and continue with the accommodative stance as long as necessary for a sustainable growth revival. The MPC acknowledged the ramifications of the more virulent second wave and attendant restrictions, albeit less stringent than the first wave, on the recovery that was underway, partly offset by a favourable global demand environment, and has consequently reduced its FY22 GDP growth forecast from 10.5% to 9.5%. This is a tad higher than our GDP growth estimate of 9.2% (See our detailed report here). Inflation, on the other hand, is expected to remain within **the RBI's target band and average at around 5.1% in FY22 vs. 5% estimated in April, supported by favourable base** effects and expectations of a normal monsoon. That said, active supply-side intervention is crucial to minimise disruptions that may occur in the wake of persistence of the second wave and attendant mobility restrictions.

Following the success of the two tranches of G-SAP 1.0[1] worth Rs600bn conducted in Q1FY22 thus far in ensuring an orderly evolution of the sovereign yield curve, the RBI included SDL purchases amounting to Rs100bn in the last tranche of Q1FY22 for the balance amount of Rs400bn, and announced an enhanced G-SAP 2.0 of Rs1.2trn in Q2FY22. This highlights **the RBI's focus towards keeping yields** low and range-bound particularly amidst negative externalities emanating from a higher borrowing programme and inflation pressures. The RBI is also increasingly focusing on ensuring an equitable distribution of liquidity to all stakeholders given the widespread damage caused by the second wave. Towards this, several measures were announced including a) On-tap liquidity window worth Rs150bn for contact-intensive sectors until March 31st, 2022. Banks would earn 40bps higher than the reverse repo rate on surplus liquidity parked with the RBI equivalent to such loans, b) Special liquidity facility of Rs160bn to SIDBI for on-lending/financing to liquidity-starved MSMEs, and c) Increase in coverage of the Resolution Framework 2.0—announced on May 5th, 2021 for MSMEs, small businesses and individuals hit by COVID-19.

Continuation of a dovish stance, along with enhancement in liquidity support to sectors that have been hit hard by **the second wave, fortifies RBI's focus on** minimising disruptions and reviving growth on a durable basis. Increase in G-SAP amount—while lower than expected given possible inclusion of SDLs—and cancellations/devolvement of recent G-**sec auctions echo RBI's efforts towards keeping bond yields** low, with a clear expectation from markets to respond favourably. This should ease SDL yields which otherwise have been under pressure amidst increasing strain on state finances. Overall, while we maintain expectations of a pause on rates, targeted but ample liquidity **support and yield management are likely to remain RBI's focus areas** in FY22. Reviving growth while maintaining macroprudential stability over the next two years, however, is likely to remain a challenging task for the MPC.

- RBI keeps policy rates unchanged; maintains an accommodative stance: In the second bi-monthly monetary policy review of FY22, the RBI's MPC unanimously voted to keep the policy rates unchanged. As such, the repo, reverse repo and bank/Marginal Standing Facility (MSF) rates remain unchanged at 4.0%, 3.35% and 4.25% respectively. The MPC acknowledged the slowdown in economic growth caused by the more virulent second wave and consequent containment measures taken by several states but expect the impact to be contained given targeted restrictions and adaption of businesses to pandemic working conditions. The MPC therefore remained committed to maintaining an accommodative stance as long as necessary to support growth on a sustainable basis and mitigate the impact of COVID-19, while ensuring inflation remains within the target band of 4% +/- 2%.

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

- Growth forecasts slashed: The second wave of COVID-19 has turned out be more virulent, having transmitted across urban and rural areas. The consequent restrictions imposed by states to curb the spread has resulted in a slowdown in urban as well as rural consumption. The MPC, however, acknowledged that the impact of these restrictions, being localised and targeted, is expected to be not as

The RBI has reduced its FY22 GDP growth forecast from 10.5% to 9.5% and expect inflation to average at ~5.1%.

[1] G-SAP 1.0 is the Government Security Acquisition Programme announced in the April monetary policy wherein the RBI would commit upfront to a specific amount of open market purchases of Government securities from the secondary market.

severe as seen during the first wave. Alongside, supportive monetary and financial conditions, coupled with an expected pick-up in the vaccination pace, should limit the downside. On the positive side, improvement in external demand should support India's export sector, while normal monsoon may revive rural demand faster, even as increasing COVID spread to rural areas poses downside risks. Accordingly, the RBI reduced its FY22 GDP growth forecast from 10.5% estimated in Feb'21 to 9.5%, estimating Q1, Q2, Q3 and Q4 GDP growth at 18.5%, 7.9%, 7.2% and 6.6% respectively. This is a tad lower than our GDP growth estimate of 9.2%.

- Inflation expected to average at 5.1% in FY22: Favourable base effects should continue to lend support to the headline inflation trajectory over the next few months, partly offset by higher commodity and fuel prices as well as logistics costs. Persistence of the second wave and attendant lockdown restrictions may lead to supply-side bottlenecks. Active intervention towards this by the Centre as well as states is crucial for keeping prices of essential food items contained. Progress of the Southwest monsoon is also likely to have a bearing on the inflation trajectory over the next few months. Considering this, the RBI expects inflation the headline CPI Inflation to average at a tad higher 5.1% in FY22 (5.0% estimated earlier), projecting a print of 5.2% in Q1, 5.4% in Q2, 4.7% in Q3 and 5.3% in Q4. While Q1 inflation print is in line with the earlier estimate, Q2, Q3 and Q4 inflation projections have been revised upwards by 20bps, 30bps and 20bps respectively.

- Focus on yield curve management continues through enhanced G-SAP 2.0: Following the success of the two tranches of G-SAP 1.0 worth Rs600bn conducted in Q1FY22 thus far in ensuring an orderly evolution of the sovereign yield curve, the RBI included SDL (state development loans) purchases amounting to Rs100bn in the last tranche of Q1FY22 for the balance amount of Rs400bn. Further, on expected lines, the RBI announced G-SAP 2.0 for an enhanced amount of Rs1.2trn in Q2FY22. Possible inclusion of SDLs, however, may limit the upside gain for G-secs. Enhancement in G-sec purchases via G-SAPs, along with continued purchases through regular and special OMOs (open market operations), highlights the RBI's focus towards keeping yields low and stable particularly amidst negative externalities emanating from a higher borrowing programme to compensate states for GST shortfall, rising global bond yields and inflation pressures.

RBI's enhanced G-SAP purchases and SDL inclusion should provide further comfort to bond markets by ensuring orderly evolution of yield curve.

- Liquidity support strengthened and widened: The RBI is increasingly focusing on ensuring an equitable distribution of liquidity to all stakeholders given the widespread damage caused by the second wave. Towards this, several measures were announced to enhance liquidity support to sectors that have been hit hard by the second wave. On-tap liquidity window worth Rs150bn with tenors of up to three years at the repo rate until March 31st, 2022 was announced for contact-intensive sectors. Liquidity availed by banks through this window can be used to extend fresh loans to hotels & restaurants, tourism-related services, aviation ancillary services, and other services such as private bus operators, car repair and rental service providers, event/conference organizers, and beauty services. Increase in rate on surplus liquidity parked by banks with the RBI under the reverse repo window equivalent to the size of loan book created under this scheme by 40bps to 3.75% is expected to incentivise banks to extend credit to such sectors.

  Additionally, the RBI decided to provide a special liquidity facility worth Rs160bn for a period of one-year at the repo rate to SIDBI for on-lending/financing to liquidity-starved MSMEs. To alleviate the debt servicing pressures faced by MSMEs,

RBI's focus is increasing shifting towards ensuring an equitable distribution of liquidity via one-tap liquidity windows for COVID-impacted sectors and MSMEs as well as easier resolution norms.

small businesses and individuals, the coverage of the Resolution Framework 2.0[2]—announced on May 5th, 2021—was increased by enhancing the maximum aggregate exposure from Rs250m to Rs500m

- Financial market measures: The RBI's decision to permit authorized dealer banks to place margins on behalf of their FPI clients for transactions in central and state government securities would ease operational constraints faced by FPIs, thereby encouraging FPI investments in the Indian debt market. The RBI also permitted Regional Rural Banks (RRBs) to issue Certificate of Deposits (CDs), with buy-back flexibility before maturity, thereby facilitating liquidity management by RRBs.
- Liquidity and yield curve management to remain in focus: Continuation of a dovish stance, along with enhancement in liquidity support to sectors that have been hit hard by the second wave, fortifies RBI's focus on minimising disruptions and reviving growth on a durable basis. Increase in G-SAP amount—while lower than expected given possible inclusion of SDLs—and cancellations/ devolvement of recent G-sec auctions echo RBI's efforts towards keeping bond yields low, with a clear expectation from markets to respond favourably. This should ease SDL yields which otherwise have been under pressure amidst rising strain on state finances. Overall, while we maintain expectations of a pause on policy rates, targeted yet ample liquidity support and yield management are likely to remain RBI's focus areas this year. Reviving growth while maintaining macroprudential stability over the next two years, however, is likely to remain a challenging task for the MPC

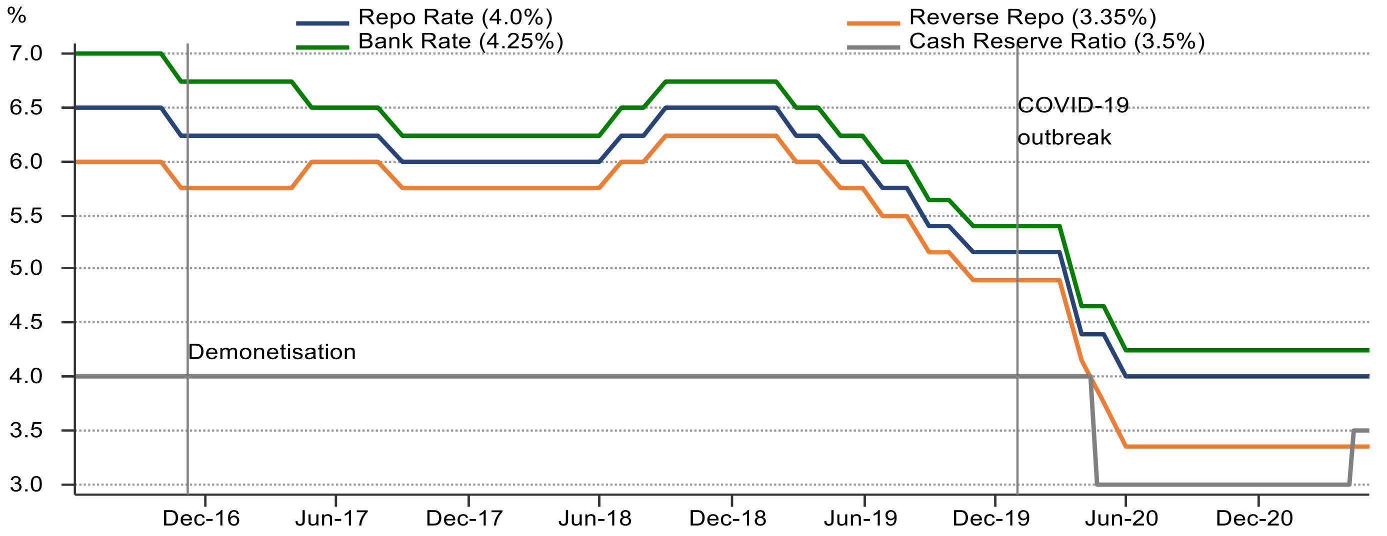
Liquidity and yield curve management to remain the RBI's focus areas in FY22.

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

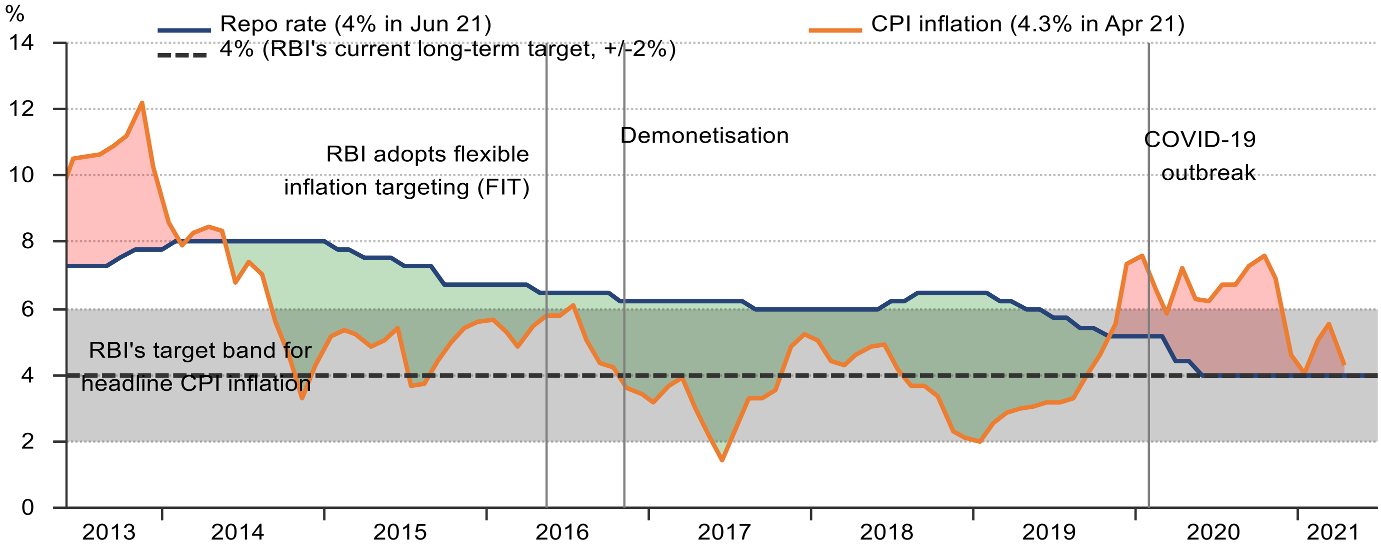
Figure 2: Policy rates kept unchanged



Source: Refinitiv Datastream.

[2] With an aim to ease debt serviceability burden on MSMEs, the RBI introduced Resolution Framework 2.0 in the April policy wherein borrowers with aggregate exposure of up to Rs250m and who have not availed restructuring in the past and who were classified as 'Standard' as on March 31st, 2021 will be eligible to avail restructuring.

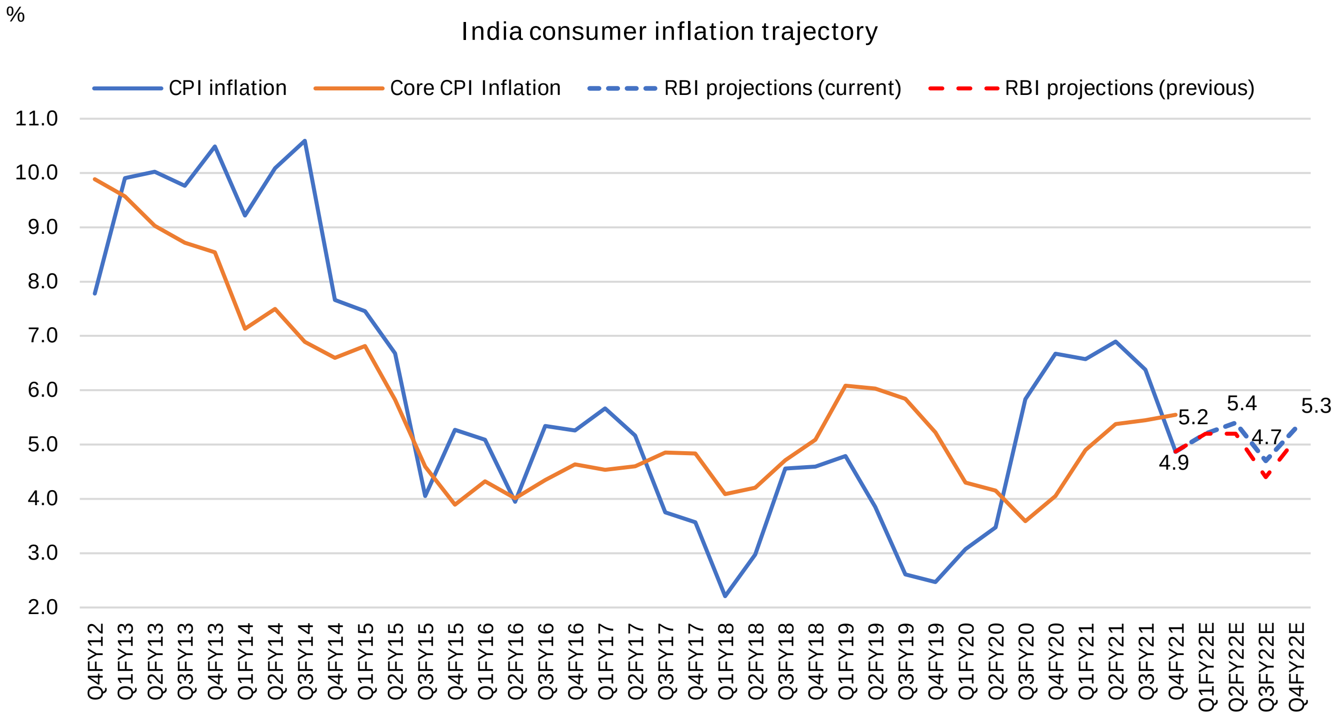
Figure 3: Real interest rates have remained negative for more than a year now



Source: Refinitiv Datastream.

Figure 4: RBI expects headline CPI inflation to average at 5.1% in FY22

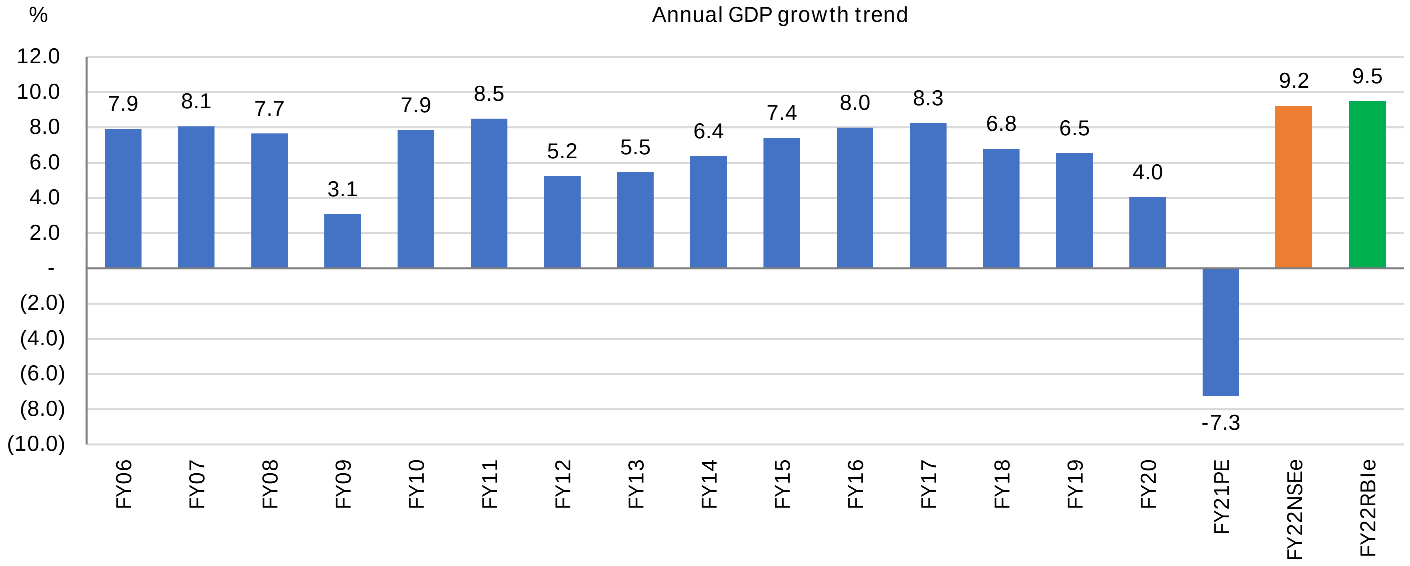
The RBI has increased its inflation forecasts for the next three quarters by 20-30 bps, even as the average headline inflation for the full year is expected at a 10bps higher of 5.1%.



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

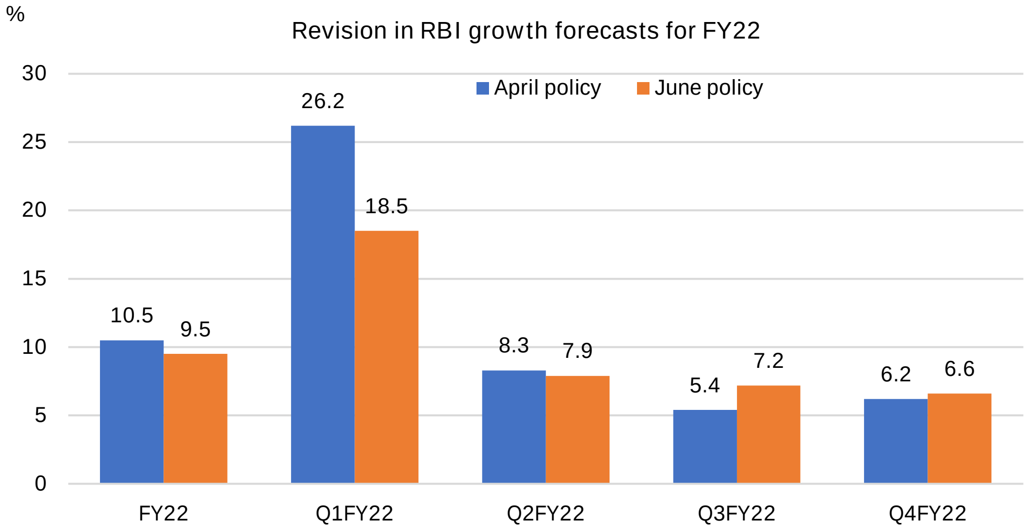
Figure 5: GDP growth trend and estimate for FY22

The RBI has reduced its FY22 GDP growth forecast from 10.5% estimated in Feb'21 to 9.5%, estimating Q1, Q2, Q3 and Q4 GDP growth at 18.5%, 7.9%, 7.2% and 6.6% respectively. This is a tad lower than our GDP growth estimate of 9.2%, with the RBI expecting recovery to gather pace in the second half of the fiscal.



Source: RBI. PE = Provisional estimates.

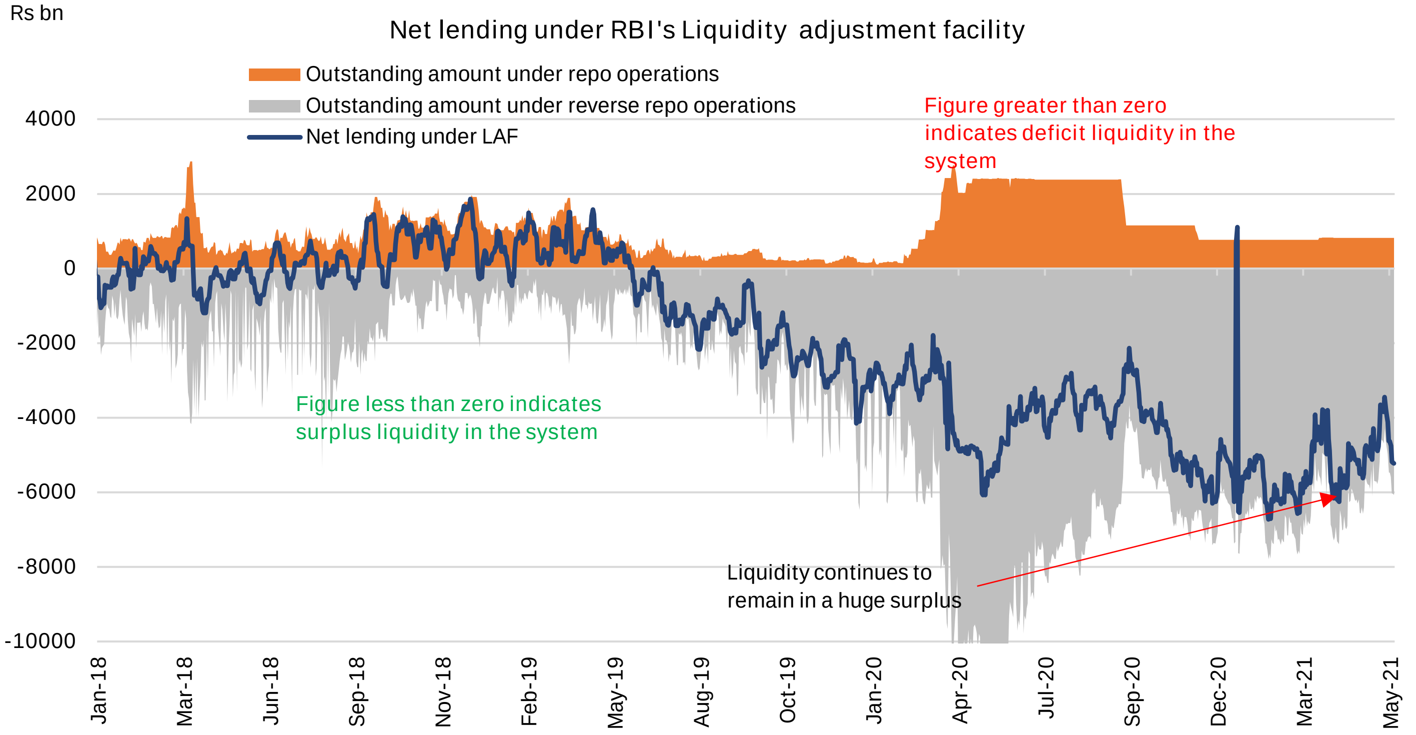
Figure 6: Revision in RBI GDP growth forecasts for FY22



Source: RBI.

Figure 7: **Net lending under RBI's Liquidity Adjustment Facility**

Surplus liquidity in the system has remained north of Rs5trn in FY22 thus far.



Source: CMIE Economic Outlook, NSE

Figure 8: India sovereign yield curve

The RBI's G-SAP purchases and continued liquidity injection via regular and special OMOs have kept yield curve broadly stable over the last few months despite worsening negative externalities in the form of enhanced Government borrowings, mounting inflationary pressures and rising US bond yields.

Source: Refinitiv Datastream, NSE.

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