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Macro Review

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RBI Monetary Policy: Inflation forecast raised; rate and stance maintained

The RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy rates unchanged (repo rate: 4%) and on a 5 to 1 majority to continue with the accommodative stance—the first divergent view on stance since April 2019. The MPC acknowledged the **nascent economic recovery that's underway following the deadlier second** wave, expecting it to gather pace on the back of rising vaccinations, continued policy support, strong exports, and favourable financial conditions. The GDP growth forecast for FY22, therefore, has been retained at 9.5%—a tad higher than our 9.2% estimate. Inflation, on the other hand, has surprised on the upside, breaching the upper tolerance of the target band for the second month in a row in June. The RBI expects inflation to remain elevated until Q2FY22 but ease in the second half, aided by arrivals of *Kharif* harvest, with the forecast for FY22 revised up to 5.7% vs. 5.1% projected in June. Importantly, the RBI views the recent inflationary pressures as transitory in nature, largely led by supply-side bottlenecks, even as demand-side impulses remain sluggish. The communique regarding looking at ***"anchoring inflationary expectations as soon as the prospects for a strong and sustainable growth are assured"*** elu**cidates the MPC's focus on prioritising growth for now**, albeit far more cautiously.

Excess liquidity in the system—evident from the recent sharp surge in amount absorbed through reverse repo—led to the RBI raising the 14-day variable rate reverse repo (VRRR) auction amount in a phased manner from Rs2trn to Rs4trn by Sep-end. This would lead to increase in short-term and money market rates that have been hovering closer to reverse repo rate for quite some time now. While this is a step towards liquidity normalisation, the RBI restated as this being just another tool to manage liquidity and should not be construed as reversal of an accommodative stance. The RBI also reiterated its focus on ensuring an orderly evolution of the yield curve via continued G-SAP (G-sec acquisition programme) auctions and special/regular open market operations on securities across the maturity spectrum.

The policy stance and commentary were on expected lines, with emergence of diverging views among the MPC members, that may intensify over the coming months as COVID-led risks ebb and economic recovery gains further traction. The MPC deferred providing any further guidance beyond the current growth-inflation trade-off and on its response in terms of rate normalisation. It also stopped short of providing clarity on what it deems as strong and sustainable growth. On policy action, the MPC is expected to stay put on the repo rate through the current financial year. Reduction in rate corridor via hike in reverse repo rate and calibrated increase in excess liquidity absorption through VRRRs are measures that the MPC may resort to later this year before changing policy stance.

- RBI keeps policy rates unchanged; maintains an accommodative stance: In the third 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 accommodative stance was also retained but with a 5:1 vote, with Prof. Varma voting against it. This was the first divergent view on the policy stance among MPC members since April 2019. The MPC acknowledged the expectedly good recovery in economic growth following a deadlier second wave and highlighted concerns emanating from hardening inflationary pressures, even as they were perceived as transitory for now. The communique regarding looking at *"anchoring inflationary expectations as soon as the prospects for a strong and sustainable growth are assured"* elucidates the MPC's focus on prioritising growth for now, albeit far more cautiously.

Policy rates unanimously kept unchanged. Stance retained as accommodative but with a 5:1 vote—the first divergent view on stance since April 2019.

- Growth forecasts retained: Phased reopening of the economy, receding caseloads and increasing coverage of vaccinations have facilitated gradual normalisation of economic activity on expected lines. This is reflected in several high-frequency indicators such as GST collections, e-way bills, non-oil imports, auto sales, among others. While rural demand is expected to remain robust amidst expectations of a normal monsoon, urban demand should revive with re-opening of contact-intensive services, release of pent-up demand and upscaling of vaccinations.

The RBI has retained its FY22 GDP growth forecast at 9.5%—a tad higher than our estimate of 9.2%.

Improvement in capacity utilisation, continued policy support and favourable financial conditions provide a conducive environment for an impending revival in investment demand. As such, the RBI has retained its FY22 GDP growth forecast at 9.5%—a tad higher than our estimate of 9.2%. GDP growth in Q1FY22 has been revised up to 21.4% vs. 18.5% expected in the last policy, indicating lower-than-expected negative impact of the second wave on economic activity. Growth forecasts for the subsequent quarters, however, have been marginally lowered, with Q2, Q3 and Q4 GDP growth estimates pegged at 7.3%, 6.3% and 6.1% vs. the previous policy's forecasts of 7.9%, 7.2% and 6.6% respectively.

- Inflationary concerns rising; FY22 CPI forecast pegged at 5.7%: Headline CPI inflation has surprised on the upside, breaching the upper tolerance of the target band for the second month in a row in June. This was led by a broad-based pick-up on the back of supply-side bottlenecks and rising commodity prices. The RBI expects inflation to remain elevated until Q2FY22 but ease in the second half, aided by arrivals of Kharif harvest, with the forecast for FY22 revised up to 5.7% vs. 5.1% projected in June. Importantly, the RBI views the recent inflationary pressures as transitory in nature, largely led by supply-side bottlenecks, even as demand-side impulses remain sluggish as evident from a moderation in core inflation in June and benign inflation in core services such as house rentals. On the negative side, elevated commodity prices, higher fuel prices and rising logistic costs are expected to continue to impart cost-push pressures on manufacturing as well as services sectors, even as weak demand conditions may limit the passthrough.

FY22 average CPI inflation forecast has been revised up by 60bps to 5.7%.

- Liquidity calibration underway: The RBI had reintroduced variable rate reverse repo (VRRR) auctions in Jan'21 following a temporary halt during the pandemic to absorb a part of the excess liquidity from the system. Continued build-up of excess liquidity—evident from the recent sharp surge in amount absorbed through reverse repo (Rs8.5trn in August thus far vs. Rs6.8trn/Rs5.7trn in July/ June)—led to the RBI raising the 14-day variable rate reverse repo (VRRR) auction amount in a phased manner from Rs2trn to Rs4trn by Sep-end. This would result in an increase in short-term and money market rates which have been hovering near reverse repo rate for quite some time now. While this is a step towards liquidity normalisation, the RBI restated as this being just another tool to manage liquidity and should not be construed as reversal of an accommodative stance. The RBI also reiterated its focus on ensuring an orderly evolution of the yield curve via continued G-SAP (G-sec acquisition programme) auctions and special/regular open market operations on securities across the maturity spectrum.

The RBI raised the VRRR amount in a phased manner from Rs2trn to Rs4trn by September-end to absorb some of the excess liquidity from the system.

- Other measures: Some additional measures announced today include a) Extension of on-tap TLTRO (Targeted Long-term Repo Operations) scheme by another three months ending December 31st, 2021 to support the nascent and fragile economic recovery that's underway, b) Extension of relaxation to avail funds under the marginal standing facility (MSF) by dipping into the Statutory Liquidity Ratio (SLR) up to an additional 1% of NDTL (total 3%) by another three months until December 31st, 2021, and 3) Deferral of deadline for meeting sector-specific thresholds in respect of certain financial parameters under the Resolution Framework 1.0 announced in August 2020 from March 31st, 2022 to October 1st, 2022.
- Growth-inflation trade-off worsening; policy normalisation in the offing: The policy stance and commentary were on expected lines, with emergence of diverging views among the MPC members, that may intensify over the coming

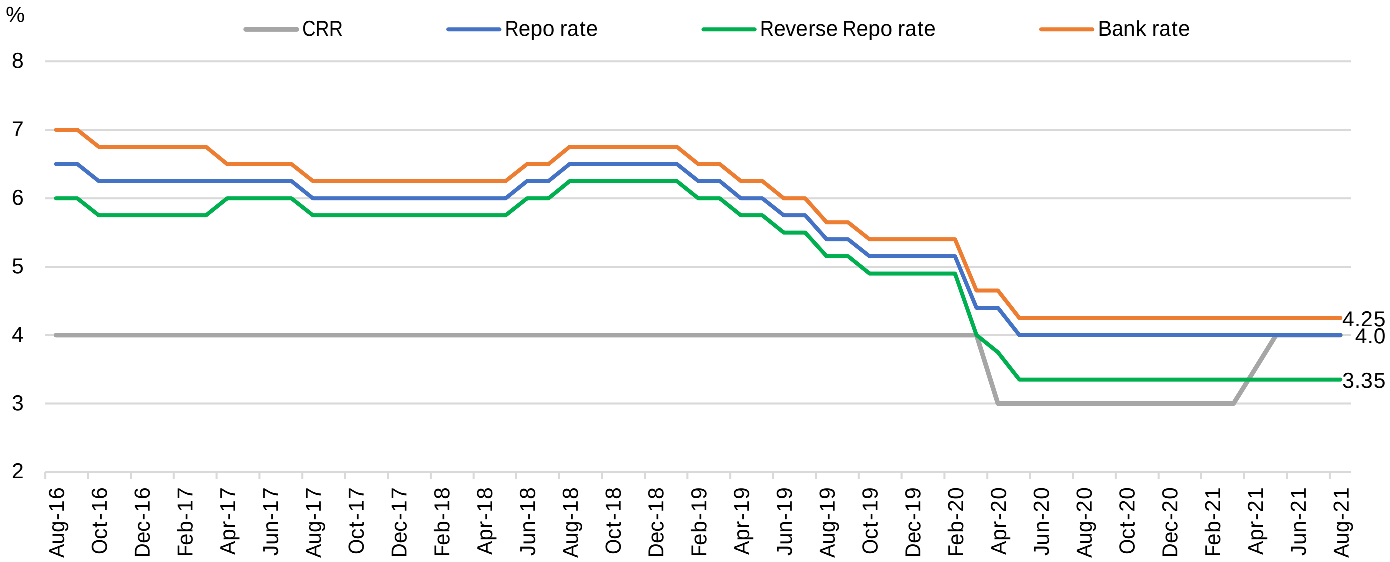
months as COVID-led risks ebb and economic recovery gains further traction. The MPC deferred providing any further guidance beyond the current growth-inflation trade-off and on its response in terms of rate normalisation. It also stopped short of providing clarity on what it deems as strong and sustainable growth. On policy action, the MPC is expected to stay put on the repo rate through the current financial year. Reduction in rate corridor via hike in reverse repo rate and calibrated increase in excess liquidity absorption through VRRRs are measures that the MPC may resort to later this year before changing policy stance.

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)	4.0%
Statutory Liquidity Ratio (SLR)	18.0%

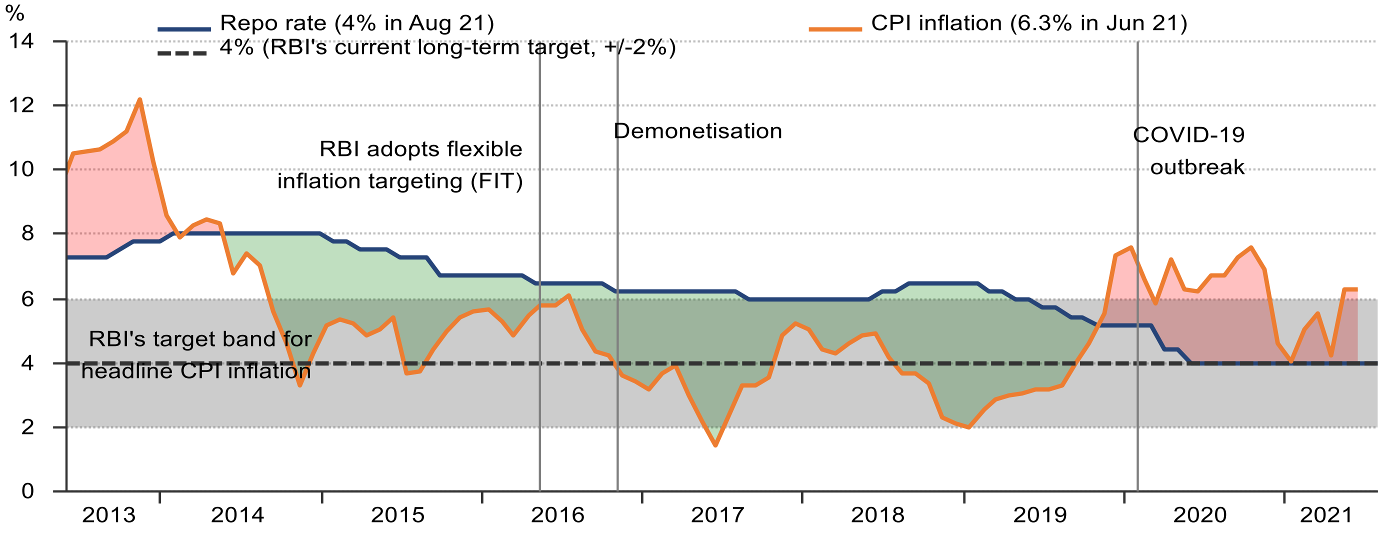
Source: RBI

Figure 2: Policy rates kept unchanged



Source: Refinitiv Datastream.

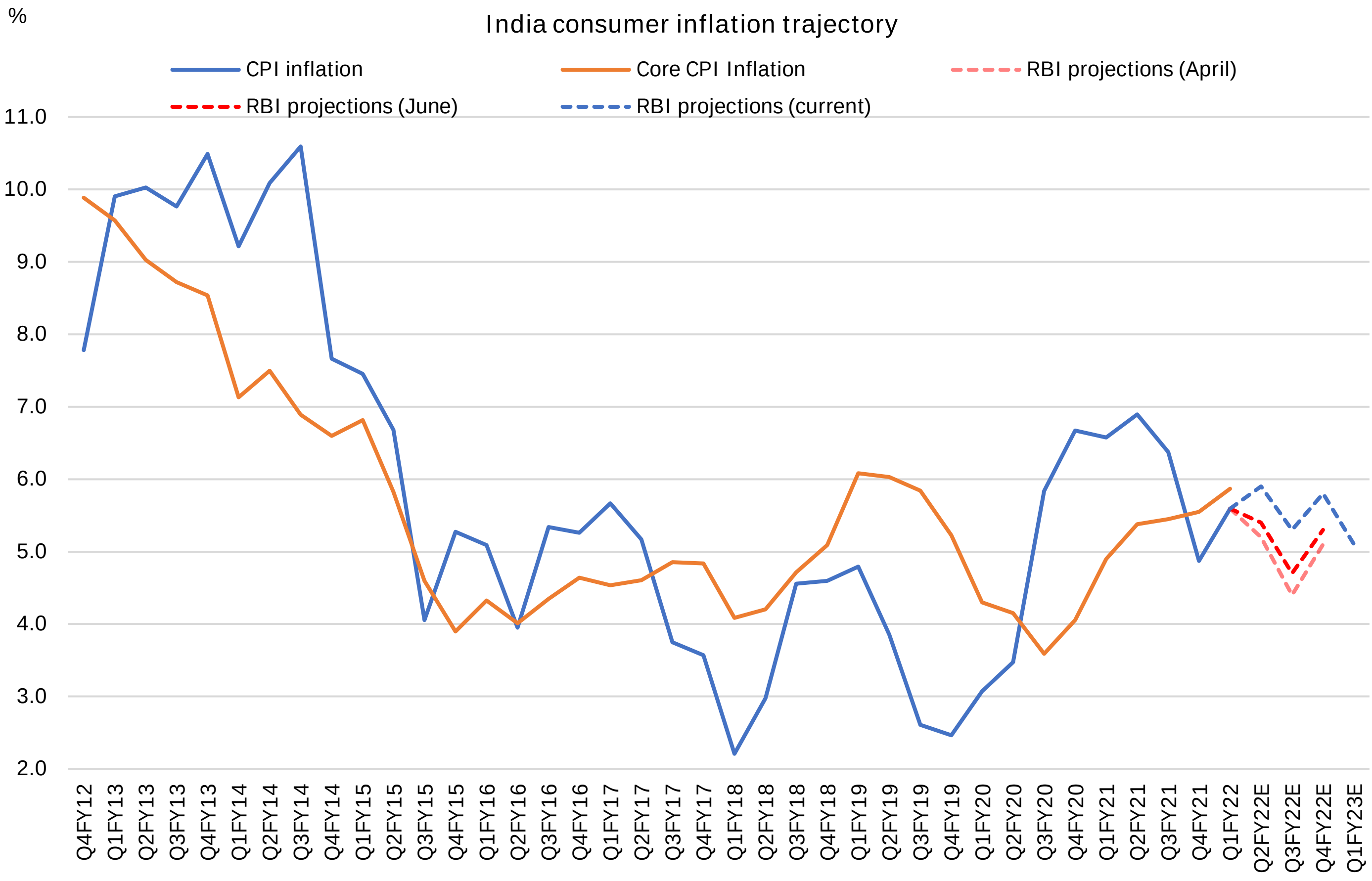
Figure 3: Real interest rates have remained negative for more than a year now



Source: Refinitiv Datastream.

Figure 4: RBI expects headline CPI inflation to average at 5.7% in FY22

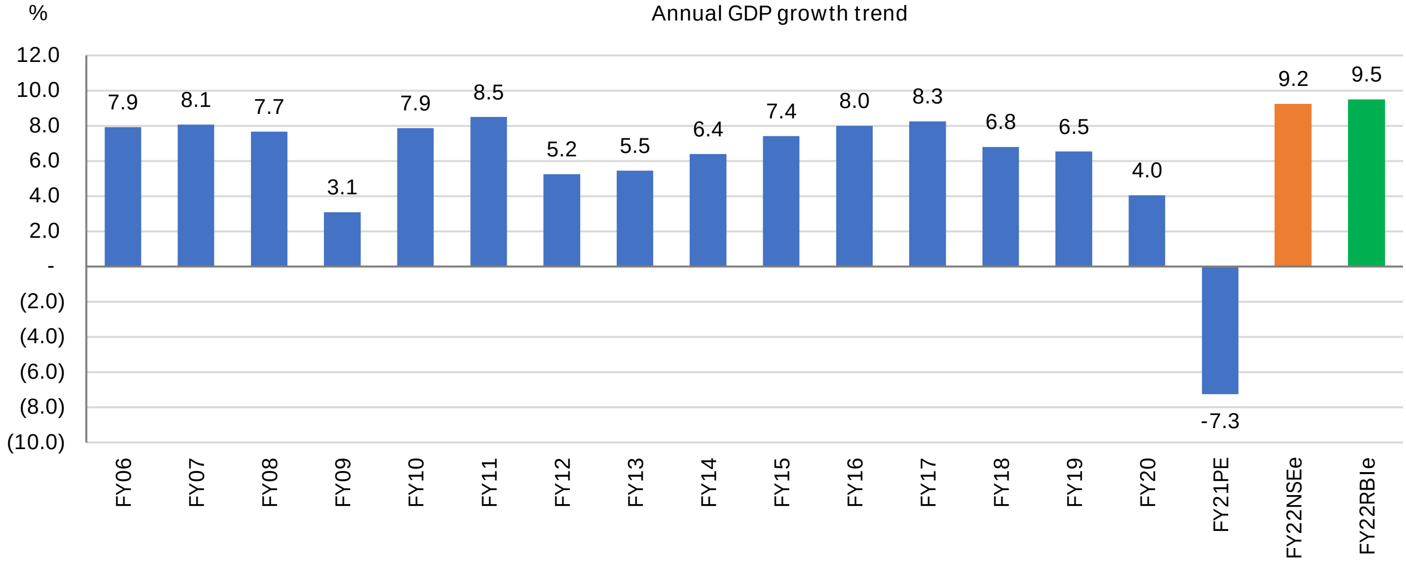
The RBI has increased its inflation forecasts for FY22 by 60bps to 5.7% from 5.1% projected in the previous policy.



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

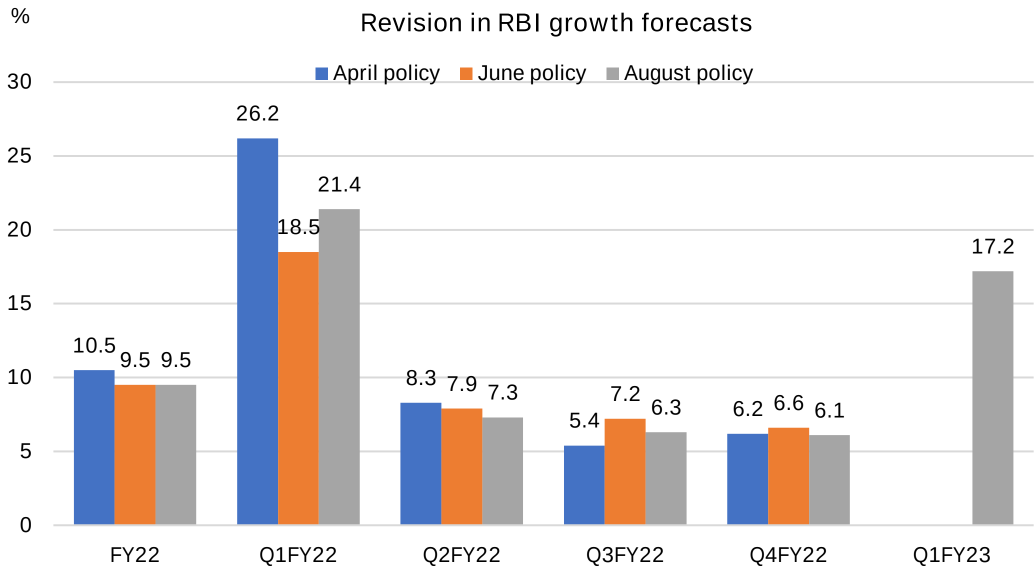
The RBI has retained its FY22 GDP growth forecast at 9.5%—a tad higher than our estimate of 9.2%.



Source: RBI. PE = Provisional estimates.

Figure 6: Revision in RBI GDP growth forecasts for FY22

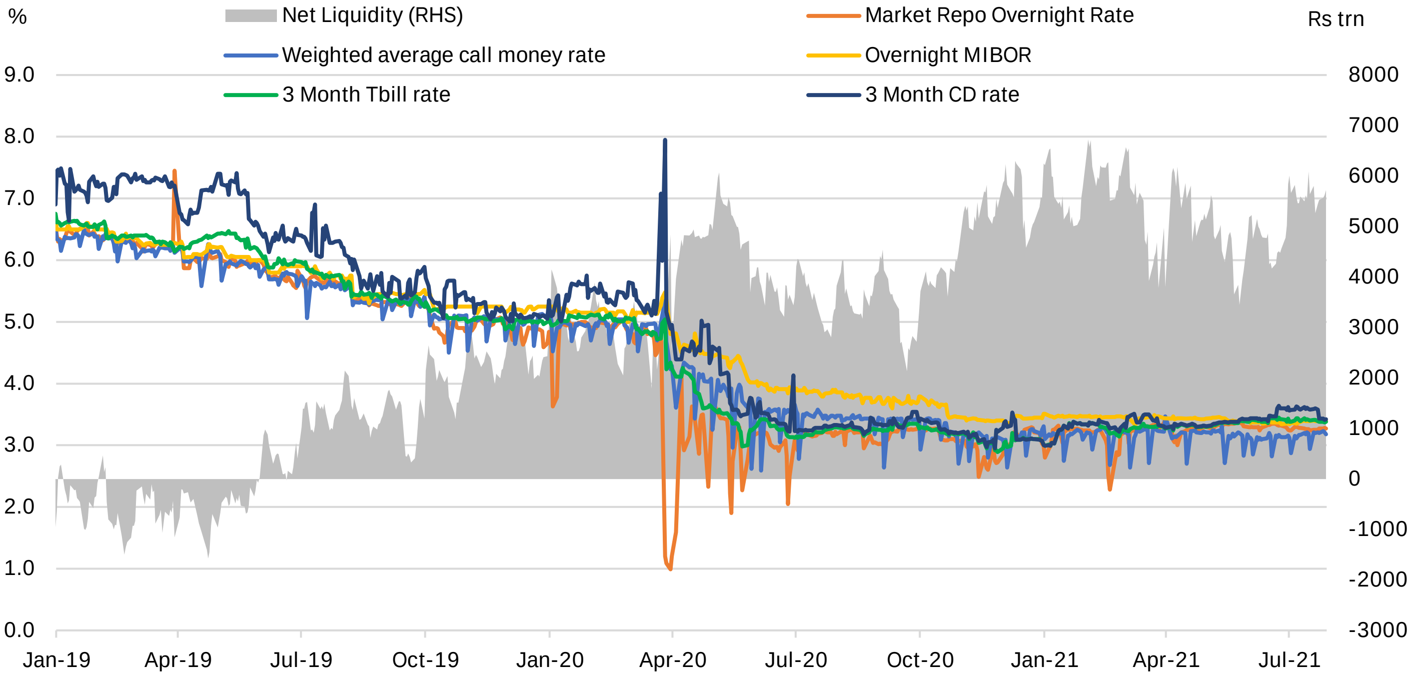
GDP growth in Q1FY22 has been revised up to 21.4% vs. 18.5% expected in the last policy, indicating lower-than-expected negative impact of the second wave on economic activity. Growth forecasts for the subsequent quarters, however, have been marginally lowered, with Q2, Q3 and Q4 GDP growth estimates pegged at 7.3%, 6.3% and 6.1% vs. the previous policy's forecasts of 7.9%, 7.2% and 6.6% respectively.



Source: RBI.

Figure 7: **Net lending under RBI's Liquidity Adjustment Facility** vs. money market rates

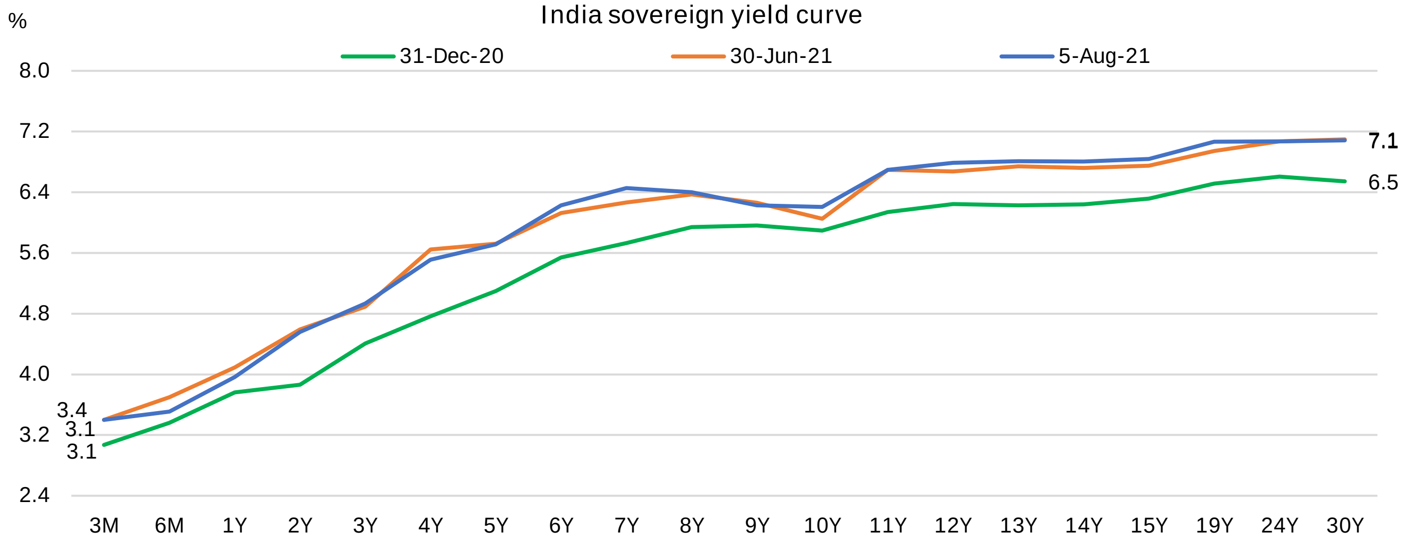
Average daily surplus liquidity in the system has widened meaningfully from Rs4.8trn in June to Rs5.6trn in July. Total absorption through reverse repos surged from a daily average of Rs5.7trn in June to Rs6.8trn in July 2021 and further to Rs8.5trn in August 2021 thus far (As on August 4th).



Source: CMIE Economic Outlook, Refinitiv Datastream, 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 and mounting inflationary pressures.



Source: Refinitiv Datastream, NSE.

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