NSE

Macro Review

October 08, 2021 | Vol. 3, Issue 20

RBI Monetary Policy: Status quo on rates/stance, liquidity calibration underway

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. Prof. Varma maintained a divergent stance for the second time in a row. While the MPC acknowledged a progressive improvement in aggregate demand, the recovery is uneven, and the output remains below pre-pandemic levels, thereby highlighting the need for continued policy support. The uneven nature of global recovery and potential global financial market volatility poses further downside risks. The GDP growth forecast for FY22, therefore, has been retained at 9.5%—a tad higher than our 9.2% estimate. Recent inflation prints, on the other hand, have surprised on the positive side. The trajectory is expected to soften further, aided by a favourable base and easing food prices, with the MPC revising the FY22 headline inflation downwards from 5.7% to 5.3%. That said, easing supply-side bottlenecks and cost pressures via calibrated reduction in indirect taxes on auto fuels is crucial for easing core inflation trajectory that has persisted at elevated levels for quite some time now.

With average daily surplus liquidity widening further in September, the RBI announced a calibrated increase in 14-day variable rate reverse repo (VRRR) amount from Rs4trn currently to Rs 6trn by December 6th. This may be accompanied with different tenor VRRRs as needed to absorb liquidity on a durable basis, even as the Governor emphasised on keeping system liquidity in adequately surplus position (~Rs2-3trn). Additionally, the RBI also refrained from announcing another round of G-SAP (G-sec Acquisition Programme) but not ruling it out completely, citing no requirement at current juncture in the light of huge surplus liquidity, unchanged borrowing programme and expected increase in government spending. That said, the RBI would continue to undertake regular open market operations (OMOs) and other liquidity management tools including Operation Twist (OT). The increase in VRRR amount may lead to some hardening of money market rates, while the long end may find support from continued G-sec purchases from the secondary market.

The policy stance and commentary were on expected lines, with the RBI continuing its focus on strengthening growth impulses while gradually absorbing excess liquidity. The MPC, however, deferred from providing any further guidance beyond the current growth-inflation trade-off and on its response in terms of rate normalisation. On policy action, the MPC is expected to stay put on the repo rate through FY22. In addition to liquidity management via VRRRs, OMOs and OTs, we expect the RBI to remain focused on addressing sector-specific liquidity requirements and begin reducing the rate corridor via hike in reverse repo rate in the last quarter of FY22.

- **RBI keeps policy rates unchanged; maintains an accommodative stance:** In the fourth 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 for the second time in a row. The MPC acknowledged the expectedly good recovery in economic growth since the last review but see it as uneven, highlighting the need for continued policy support. At the same time, the MPC drew comfort from lower-than-anticipated inflation prints over the last few months, expecting the trajectory to ease further in the second half.

Policy rates unanimously kept unchanged. Accommodative stance retained but with a 5:1 vote for the second time in a row

- **Growth forecasts retained:** The ebbing of the second wave, easing lockdown restrictions, buoyant rural demand, and easier monetary and financial conditions have helped economic activity gain traction over the last few months. Agriculture sector and rural demand is expected to find further support from above-normal *Kharif* sowing and good prospects of the *rabi* season. Substantial acceleration in the pace of vaccinations should provide a fillip to contact intensive sectors, thereby bolstering urban demand. Investment demand is also expected to improve gradually, thanks to a slew of reforms undertaken by the Government including infrastructure development, asset monetisation, and production-linked incentives. As such, the RBI has retained its FY22 GDP growth forecast at 9.5%—a tad higher

than our estimate of 9.2%. The growth forecasts for Q2/Q3FY22 have been revised up to 7.9%/6.8% from 7.3%/6.3% projected in August, while that for Q4FY22 has been retained at 6.1%. For Q1FY23, the real GDP growth forecast is pegged at 17.2%. Persistence of supply-side bottlenecks, elevated input cost pressures, continued COVID uncertainty, uneven global recovery and potential global financial market volatility remain key downside risks to domestic growth outlook.

- **Inflation forecasts curtailed marginally:** Headline CPI inflation has surprised on the downside over the last two months, thanks to easing food prices, partly offset by higher fuel prices and sticky core inflation. The RBI expects inflation to ease further over coming months, aided by a high base, arrivals of *Kharif* harvest, supply-side interventions by the Government, and slower passthrough of rising input costs amidst weak demand conditions. As such, the RBI has lowered its headline CPI inflation forecast for FY22 from 5.7% to 5.3%. That said, easing supply-side bottlenecks and cost pressures via calibrated reduction in indirect taxes on auto fuels is crucial for easing core inflation trajectory that has persisted at elevated levels for quite some time now. On the negative side, continued surge in crude oil and domestic fuel prices, rising metal and other commodity prices, persisting supply shortages of key industrial components and higher logistic costs are likely to put upside pressures on the inflation trajectory going ahead.

FY22 average CPI inflation forecast has been revised lower by 40bps to 5.3%.

- **Liquidity normalisation underway:** With average daily surplus liquidity widening further in September, the RBI announced a calibrated increase in 14-day variable rate reverse repo (VRRR) amount from Rs4trn currently to Rs 6trn by December 6th. This may be accompanied with different tenor VRRRs as needed to absorb liquidity on a durable basis, even as the Governor emphasised on keeping system liquidity in adequately surplus position (~Rs2-3trn). Additionally, the RBI also refrained from announcing another round of G-SAP (G-sec Acquisition Programme) but not ruling it out completely, citing no requirement at current juncture in the light of huge surplus liquidity, unchanged borrowing programme and expected increase in government spending. That said, the RBI would continue to undertake regular open market operations (OMOs) and other liquidity management tools including Operation Twist (OT). The increase in VRRR amount may lead to some hardening of money market rates, while the long end may find support from continued G-sec purchases from the secondary market.

The RBI raised the VRRR amount in a phased manner from Rs4trn currently to Rs6trn by December 6th to absorb some of the excess liquidity from the system.

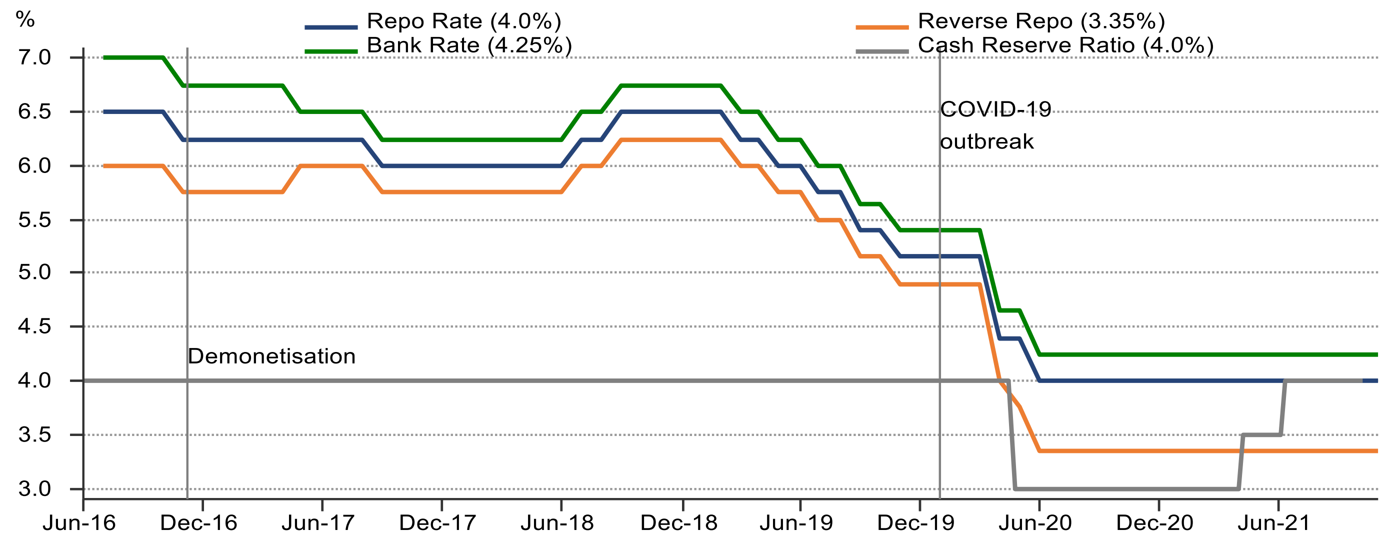
- **Expect pause on the repo rate in FY22:** The policy stance and commentary were on expected lines, with the RBI continuing its focus on strengthening growth impulses while gradually absorbing excess liquidity. The MPC, however, deferred from providing any further guidance beyond the current growth-inflation trade-off and on its response in terms of rate normalisation. On policy action, the MPC is expected to stay put on the repo rate through FY22. In addition to liquidity management via VRRRs, OMOs and OTs, we expect the RBI to remain focused on addressing sector-specific liquidity requirements and begin reducing the rate corridor via hike in reverse repo rate in the last quarter of FY22.

Table 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%

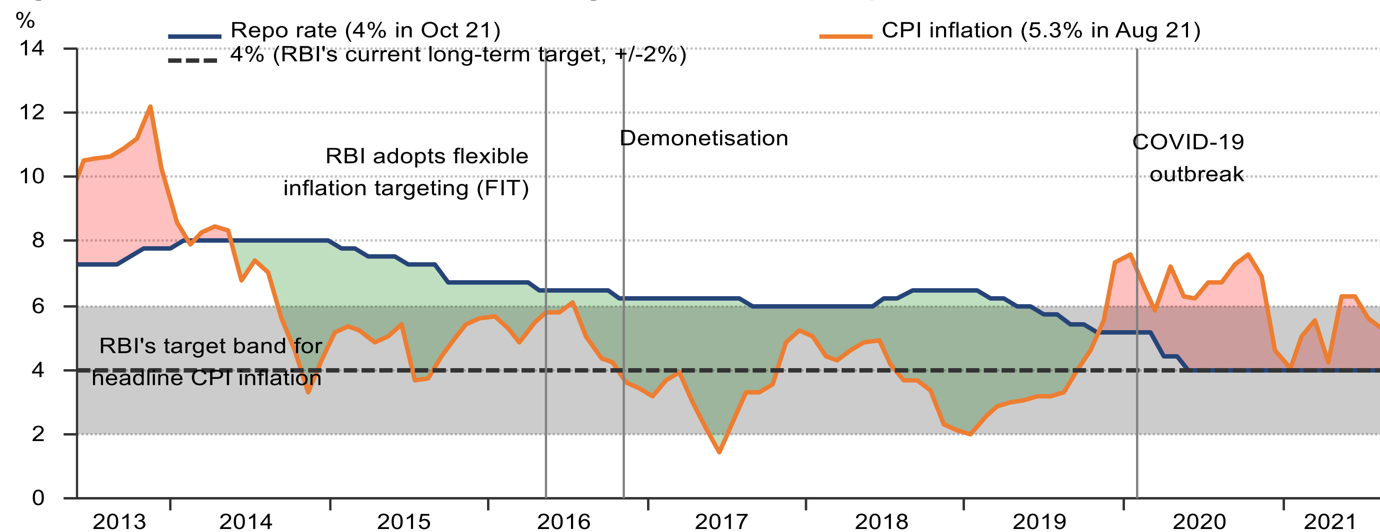
Source: RBI

Figure 1: Policy rates kept unchanged



Source: Refinitiv Datastream.

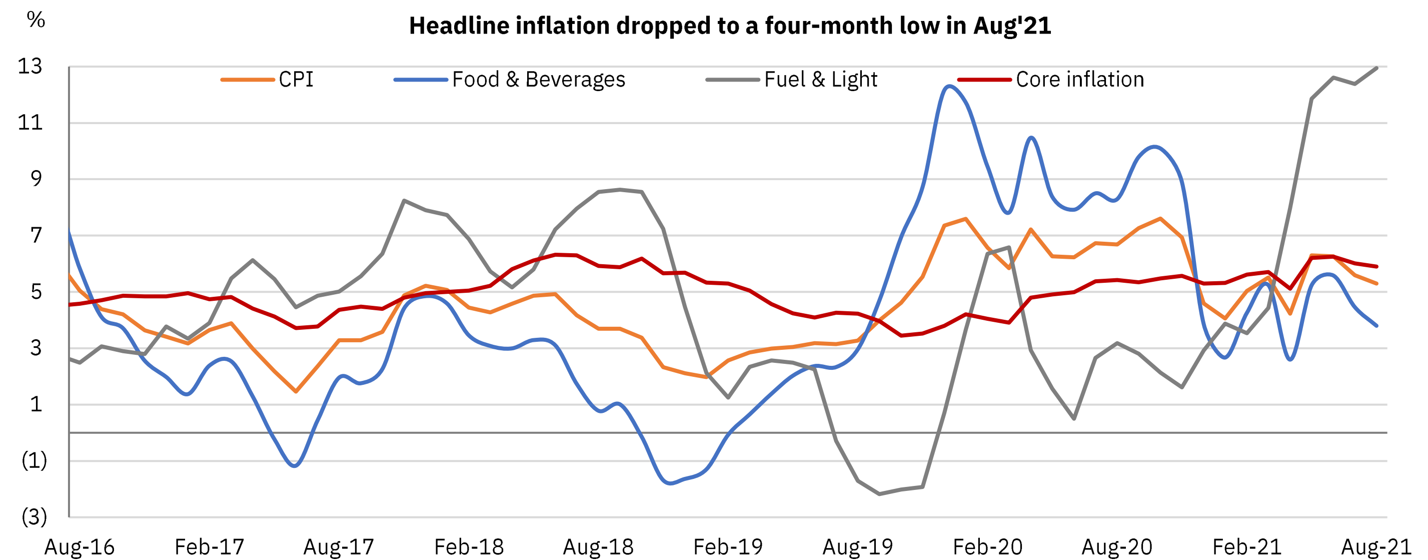
Figure 2: Real interest rates have remained negative for more than a year now



Source: Refinitiv Datastream.

Contribution to inflation in FY22 thus far concentrated to limited sub-groups: Lower-than-anticipated inflation prints over the last two months was primarily on account of moderation in food prices, primarily perishables, which otherwise was a matter of concern during May-June. This was partly offset by a sharp spike in fuel inflation and sticky core inflation. According to the Monetary Policy Report, the contribution of imported components to headline inflation rose from 0.8 percentage points in February to a peak level of 1.9 percentage points in June but moderated slightly to 1.4 percentage points in August. Additionally, spike in inflation during the first five months of FY22 was concentrated to limited sub-groups of the CPI basket. During April-August 2021, eight out of 23 sub-groups in CPI, making up 49.7% of the CPI basket, contributed to ~83% of the CPI inflation. The contribution of these sub-groups in FY21 was much lower at 56%.

Figure 3: Monthly inflation trajectory

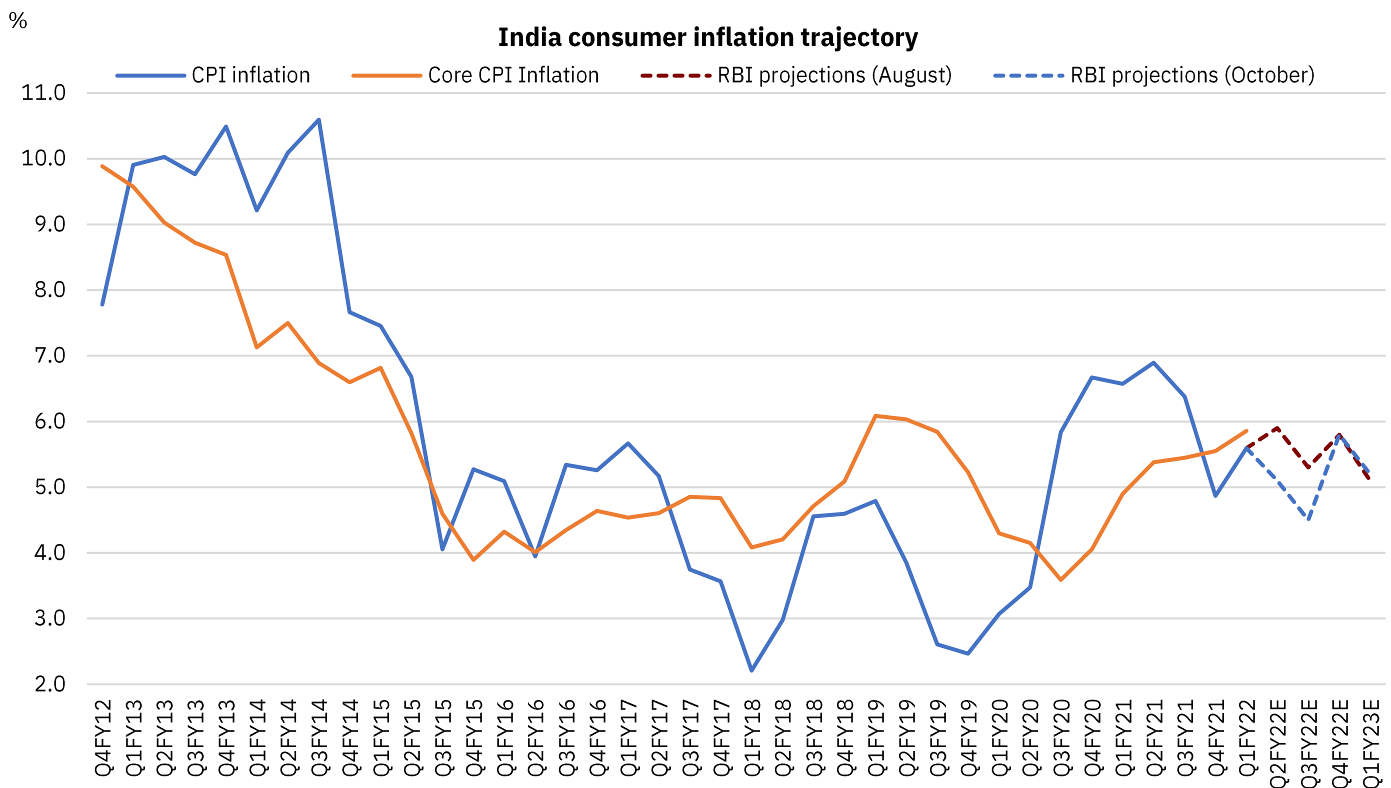


Source: CSO. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

Inflation forecasts curtailed marginally: With inflation trajectory meaningfully undershooting the projected territory over the last couple of months, the RBI has lowered its headline CPI inflation forecast for FY22 from 5.7% to 5.3%. This is primarily coming from a significant drop in inflation forecasts for Q2FY22 and Q3FY22 from 5.9% and 5.3% to 5.1% and 4.5% respectively, even as the forecast for Q4FY22 has been retained at 5.8%. That said, easing supply-side bottlenecks and cost pressures via calibrated reduction in indirect taxes on auto fuels is crucial for easing core inflation trajectory that has persisted at elevated levels for quite some time now. On the negative side, continued surge in crude oil and domestic fuel prices, rising metal and other commodity prices, persisting supply shortages of key industrial components and higher logistic costs are likely to put upside pressures on the inflation trajectory going ahead.

Figure 4: RBI expects headline CPI inflation to average at 5.3% in FY22

The RBI has lowered its inflation forecasts for FY22 by 40bps to 5.3% from 5.7% projected in the previous policy.



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

Growth recovery expected to gain traction in H2FY22: Notwithstanding the deadlier second wave of COVID-19, the economic ramifications were limited, thanks to implementation of targeted and localised lockdowns unlike a stringent nation-wide lockdown implemented during the first wave. Several high-frequency indicators point to a meaningful recovery in economic activity over the last few months, thanks to the ebbing of the second wave, easing lockdown restrictions, buoyant rural demand, and easier monetary and financial conditions. Rural consumption demand, which saw a bit hit during the second wave on account rapid surge in infections in the rural areas, showed signs of recovery in Q2FY22, as reflected in two-wheeler sales, and is expected to find further support from above-normal *Kharif* sowing and good prospects of the *rabi* season. Urban consumption demand has also recovered, supported by accelerating pace of vaccinations and gradual reopening of the economy, particularly the contact intensive sectors.

While rural demand is expected to gain further buoyancy, supported by good *kharif* harvest and robust *rabi* prospects, urban demand should bolster further, particularly for the contact-intensive services, aided by substantial acceleration in the pace of vaccinations should provide a fillip to contact intensive sectors. Investment demand is also expected to improve gradually, thanks to a slew of reforms undertaken by the Government including infrastructure development, asset monetisation, and production-linked incentives. As such, the RBI has retained its FY22 GDP growth forecast at 9.5%—a tad higher than our estimate of 9.2%. The growth forecasts for Q2/Q3FY22 have been revised up to 7.9%/6.8% from 7.3%/6.3% projected in August, while that for Q4FY22 has been retained at 6.1%. For Q1FY23, the real GDP growth forecast is pegged at 17.2%. Persistence of supply-side bottlenecks, elevated input cost pressures, continued COVID

uncertainty, uneven global recovery and potential global financial market volatility remain key downside risks to domestic growth outlook.

Figure 5: Movement in rural and urban consumption indicators

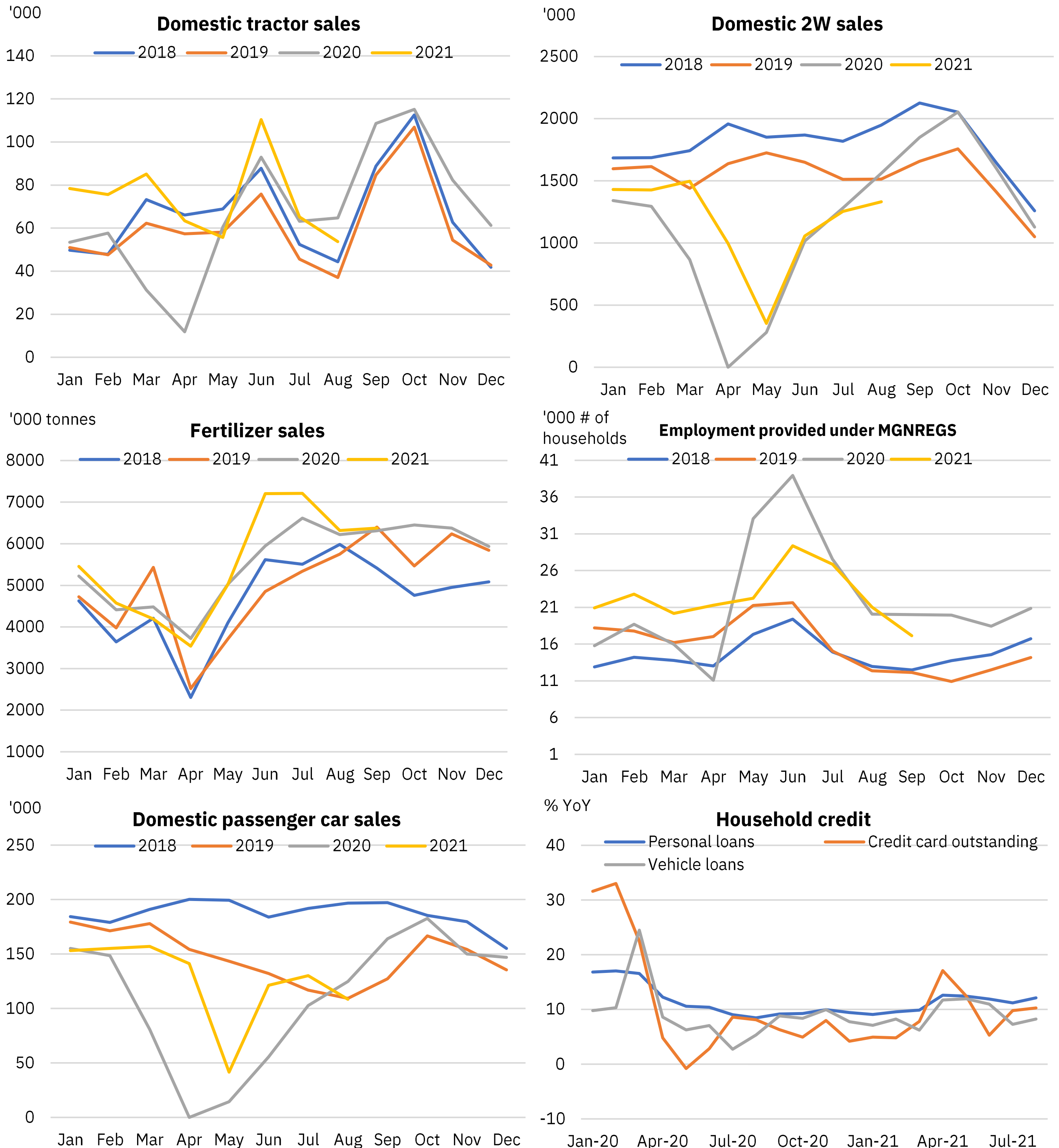
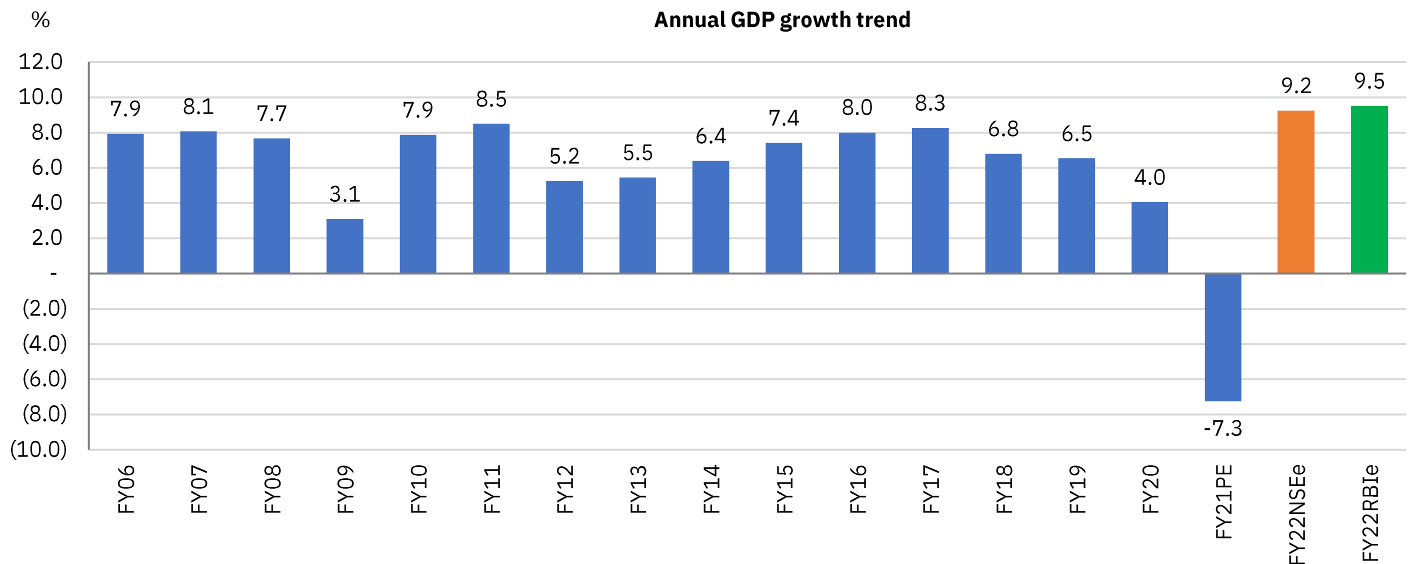


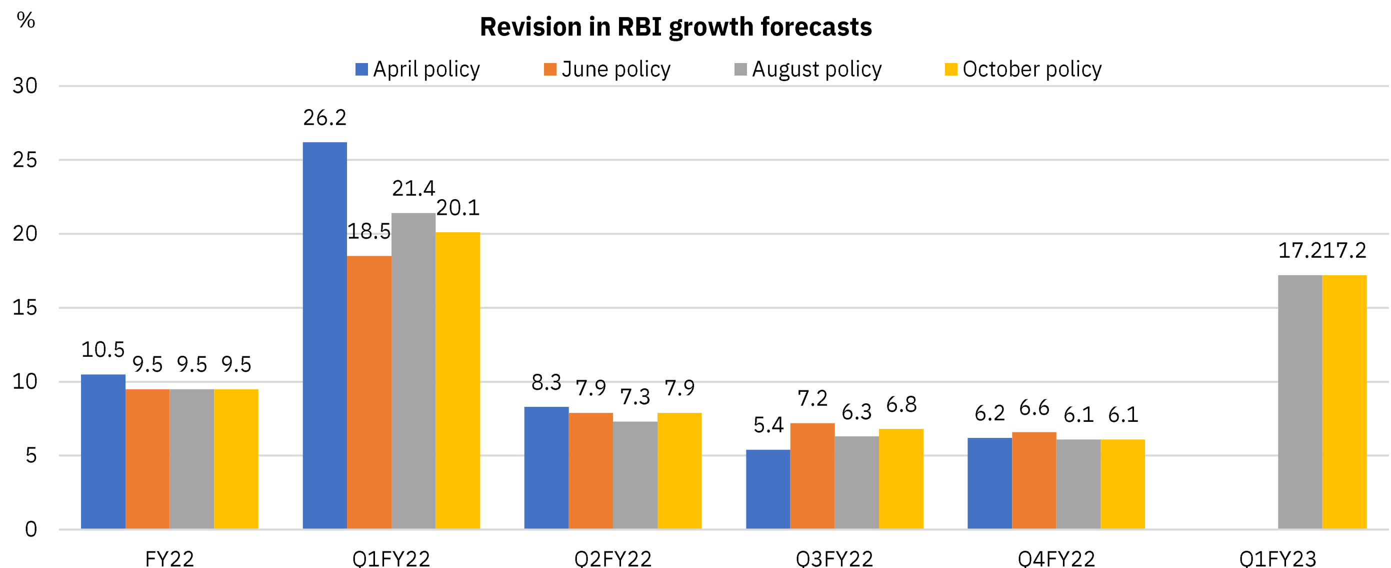
Figure 6: GDP growth trend and estimate for FY22

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 7: Revision in RBI GDP growth forecasts for FY22



Source: RBI. Q1FY22 data for the October policy is actual growth figure.

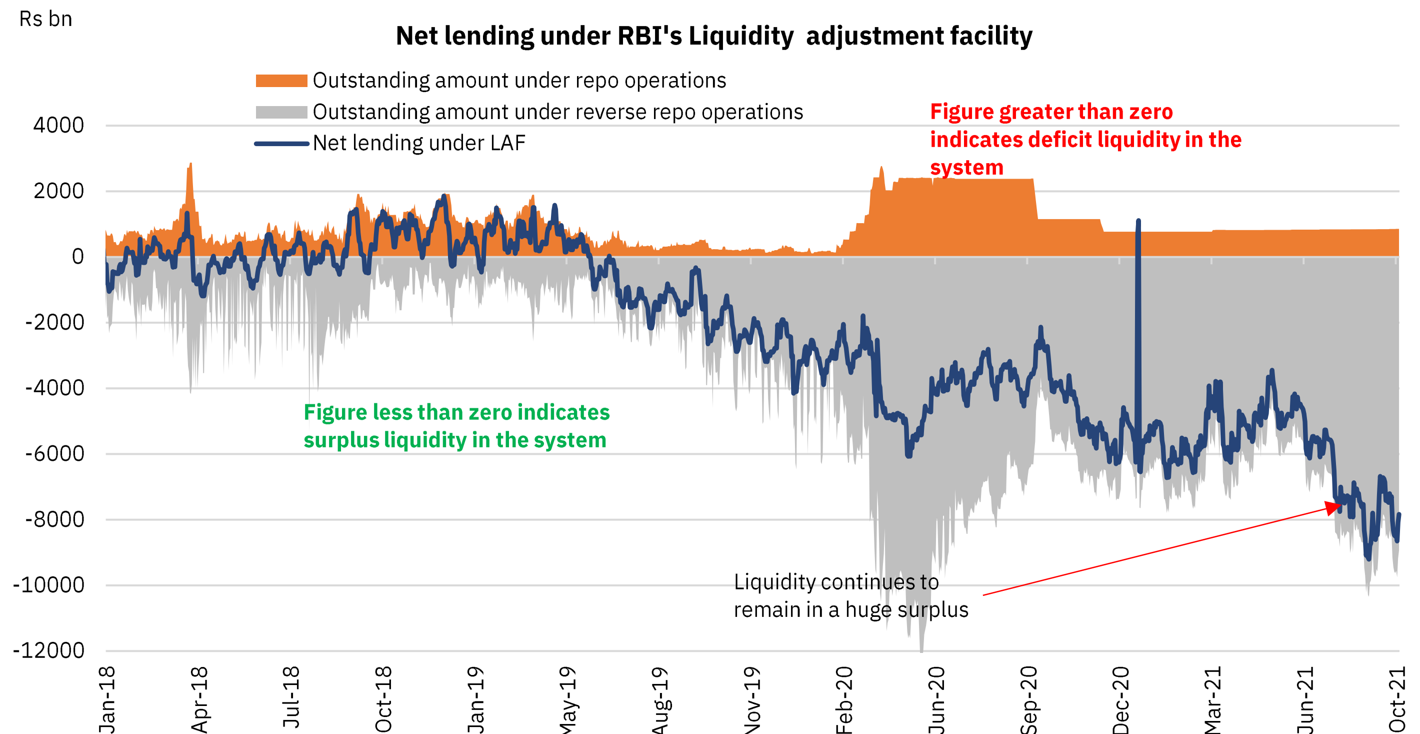
Liquidity calibration underway: Average net daily liquidity widened further from Rs 7.7trn in July-August to Rs 9trn in September to Rs 9.5trn in October thus far. Net liquidity injected by the RBI through OMOs and assured G-sec purchases under G-SAP 1.0 and G-SAP 2.0 during the first half of FY22 stood at Rs2.4trn, which in turn kept interest rates benign across the curve, thereby facilitating monetary transmission.

With the aim to gradually absorb excess liquidity from the system, the RBI announced a calibrated increase in 14-day variable rate reverse repo (VRRR) amount from Rs4trn currently to Rs 6trn by December 6th. This may be accompanied with different tenor VRRRs as needed to absorb liquidity on a durable basis, even as the Governor emphasised on keeping system liquidity in adequately surplus position (~Rs2-3trn). Additionally, the RBI also refrained from announcing another round of G-SAP (G-sec Acquisition

Programme) but not ruling it out completely, citing no requirement at current juncture in the light of huge surplus liquidity, unchanged borrowing programme and expected increase in government spending.

Figure 8: Net lending under RBI's Liquidity Adjustment Facility vs. money market rates

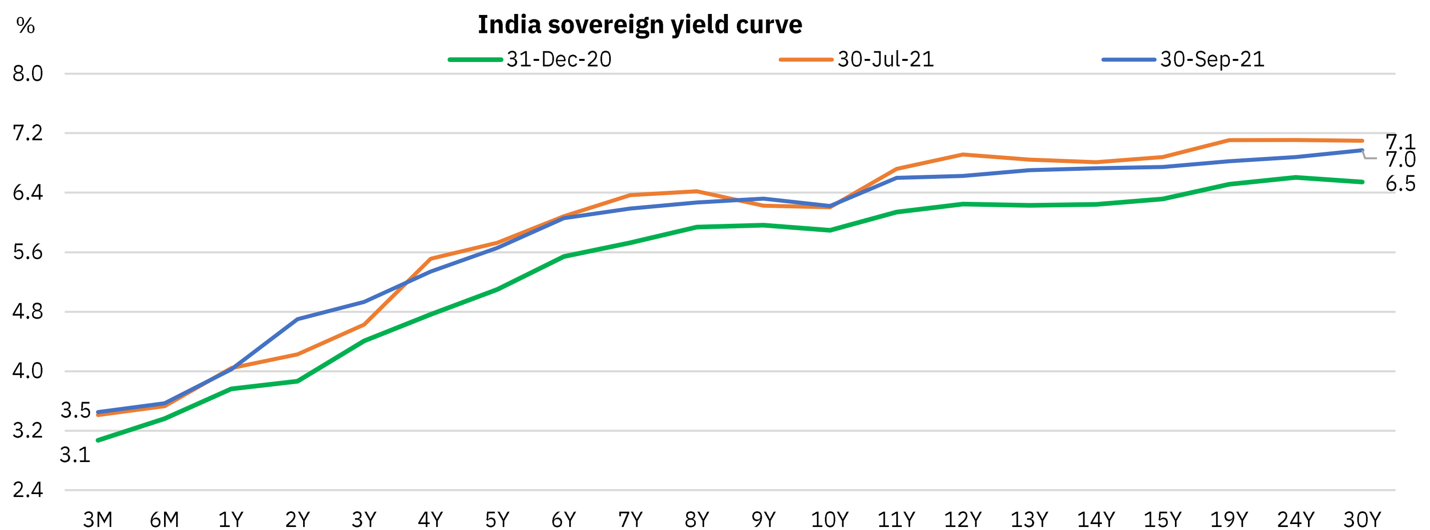
Average net daily liquidity in the system has widened meaningfully from Rs 8trn in August to Rs 9trn in September.



Source: CMIE Economic Outlook, Refinitiv Datastream, NSE

Figure 9: 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 heavy Government borrowing and mounting inflationary pressures.



Source: Refinitiv Datastream, NSE.

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