

RBI Monetary Policy: Liquidity normalisation over policy tightening for now

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 view on retaining the policy stance for the third time in a row. The MPC acknowledged further improvement in aggregate demand, aided by a sustained drop in infections, strong pace of vaccinations and continued normalisation. That said, a sustained recovery remains contingent on a pick-up in private investment cycle. Moreover, strengthening global headwinds and emergence of Omicron variant may widen the slack in the economy, thereby underscoring the need for a continued policy support. The GDP growth forecast for FY22, therefore, has been retained at 9.5%. On the positive side, supply-side measures taken by the Government and recent cut in excise duties on auto fuels are likely to alleviate domestic cost push build-up, even as price pressures may persist in the near-term owing to unfavourable base effect and persistent global supply-side bottlenecks. The RBI expects headline inflation to peak in Q4 FY22 and soften thereafter, with estimate for FY22 retained at 5.3%, moderating to 5% in H1FY23.

Striving for a credible, broad-based economic recovery, while ensuring monetary and financial stability, continues to remain the Central Bank's priority for now. The RBI intends to achieve this through a systematic and calibrated normalisation of liquidity and financial market conditions, while maintaining strong buffers to ensure economic resilience during these uncertain times. With this backdrop, the RBI further enhanced the 14-day variable rate reverse repo (VRRR) amount from Rs6trn currently to Rs6.5trn on December 17th and Rs 7.5trn on December 31st, with liquidity management shifting to the auction route from January 2022. This will be complemented by longer-term VRRRs, regular open market operations (OMOs) and Operation Twists (OTs) as and when required. Enhanced VRRRs will lead to further hardening of money market rates closer to the repo rate. As an additional measure to rebalance financial conditions, the RBI announced return to the normal dispensation of 2% of net demand and time liabilities (NDTL) under the Marginal Standing Facility (MSF) beginning January 1st, 2022.

The policy action, stance and commentary were on expected lines, with the RBI reiterating its focus on nurturing and supporting a durable economic recovery. Unlike market expectations of initiation of a staggered reduction in policy rate corridor via reverse repo hikes, the RBI refrained from providing any guidance beyond the current growth-inflation trade-off. On the contrary, the tone was quite dovish with the RBI expressing caution on the growth front, highlighting downside risks and fresh challenges posed by policy tightening by important global central banks on domestic macro-financial stability. On policy action, we expect the MPC to stay put on the repo rate through FY22 while actively rebalancing liquidity conditions via VRRRs, OMOs and OTs. The RBI may also resort to a reverse repo hike of 15-20bps later this year provided Omicron concerns don't materialise.

- **RBI keeps policy rates unchanged; maintains an accommodative stance:** In the fifth 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 third time in a row. The MPC acknowledged an expectedly progressive improvement in aggregate demand accompanied with a steady recovery in contact-intensive sectors, but still see it quite nascent at the current juncture. Additionally, strengthening global headwinds and emergence of Omicron variant pose fresh challenges to recovering growth impulses, underscoring the need for continued policy support. At the same time, the MPC drew comfort from supply-side intervention by the Government in controlling surge in food prices as well as recent cut in excise duties on petrol and diesel, even as an unfavourable base and persistent supply-chain bottlenecks may keep the trajectory elevated in the immediate term.
- **Growth forecasts retained:** A sustained drop in infections, expanding vaccination coverage and continued normalisation of mobility have facilitated a broad-based

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recovery in domestic economic activity. While rural demand is expected to remain resilient, increase in contact-intensive activities and pent-up consumption bode well for urban demand. Even as private investment cycle remains muted at the current juncture, recent measures undertaken by the Government including the infrastructure push, performance-linked incentive (PLI) scheme, asset monetisation, among others as well as easy financial conditions provide a conducive environment for a gradual recovery ahead. As such, the RBI has retained its FY22 GDP growth forecast at 9.5% (+6.3% in H2FY22), with estimate for H1FY23 GDP growth pegged at 12.2%. Volatile commodity prices, persistent supply-side disruptions, emergence of new strains of SARS-CoV2 and potential global financial market volatility amidst policy tightening by important central banks remain key downside risks to domestic growth outlook.

- **Inflation to remain elevated in the near-term:** Headline CPI inflation edged up in October on higher vegetable prices due to erratic rainfall and higher fuel inflation. Arrival of winter harvest and supply-side intervention by the Government in edible oils, however, should help ease food prices over the coming months. Recent fall in crude oil prices and cut in excise duties on auto fuels back home are also expected to provide some respite. That said, cost-push pressures emanating from higher material prices, logistic and transportation costs and persistent supply chain bottlenecks are likely to continue to impart upside pressure to core inflation, partly offset by economic slack limiting the pass-through to final consumer prices. As such, the RBI expect headline CPI inflation to remain elevated in the near-term, further weighed down by an unfavourable base, averaging at 5.3% in FY22, the same as that projected in the previous policy, but is expected to moderate in FY23, with average estimate for H1 FY23 pegged at 5%.
- **Liquidity normalisation continues:** Striving for a credible, broad-based economic recovery, while ensuring monetary and financial stability, continues to remain the Central Bank's priority for now. The RBI intends to achieve this through a systematic and calibrated normalisation of liquidity and financial market conditions, while maintaining strong buffers to ensure economic resilience during these uncertain times. With this backdrop, the RBI further enhanced the 14-day variable rate reverse repo (VRRR) amount from Rs6trn currently to Rs6.5trn on December 17th and Rs 7.5trn on December 31st, with liquidity management shifting to the auction route from January 2022. This will be complemented by longer-term VRRRs, regular OMOs and OTs as and when required. Enhanced VRRRs will lead to further hardening of money market rates closer to the repo rate. As an additional measure to rebalance financial conditions, the RBI announced return to the normal dispensation of 2% of NDTL under the MSF beginning January 1st, 2022.
- **Growth remains a priority for now:** The policy action, stance and commentary were on expected lines, with the RBI reiterating its focus on nurturing and supporting a durable economic recovery. Unlike market expectations of initiation of a staggered hike in reverse repo rate, the RBI refrained from providing any guidance beyond the current growth-inflation trade-off. On the contrary, the tone was quite dovish with the RBI expressing caution on the growth front, highlighting downside risks and fresh challenges posed by policy tightening by important global central banks on domestic macro-financial stability. On policy action, we expect the MPC to stay put on the repo rate through FY22 while actively rebalancing liquidity conditions via VRRRs, OMOs and OTs. The RBI may also resort to a reverse repo hike of 15-20bps later this year provided Omicron concerns don't materialise.

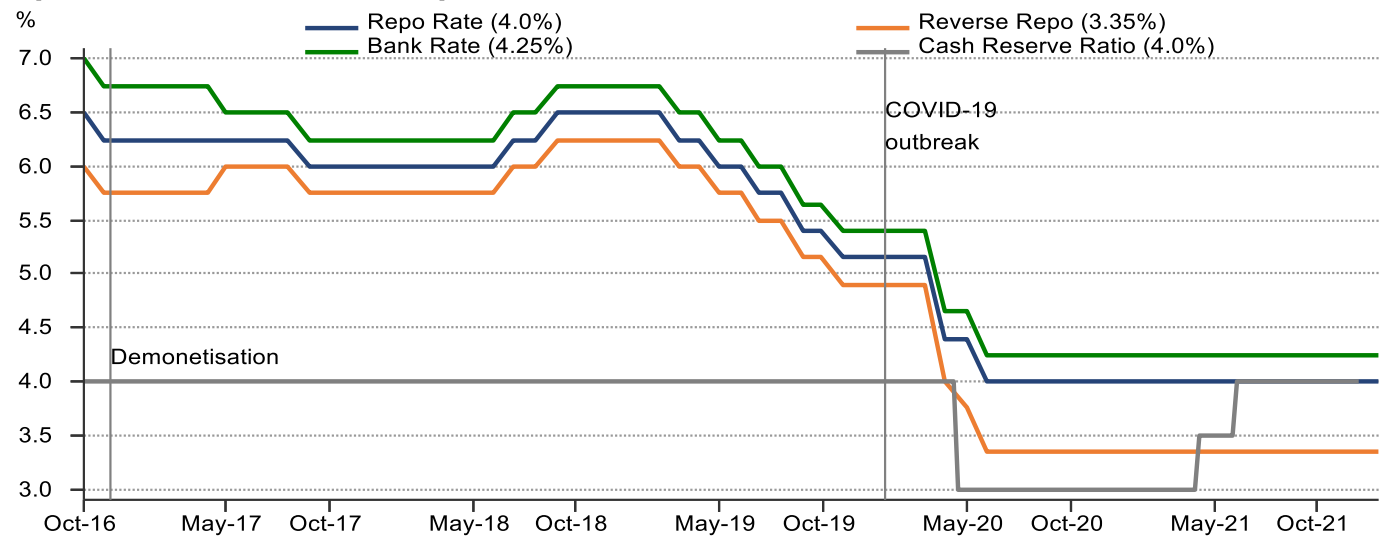
FY22 GDP and average CPI inflation forecasts have been retained at 9.5% and 5.3% respectively.

The RBI further enhanced the VRRR amount from Rs6trn currently to Rs6.5trn by December 17th and to Rs7.5trn by December 31st.

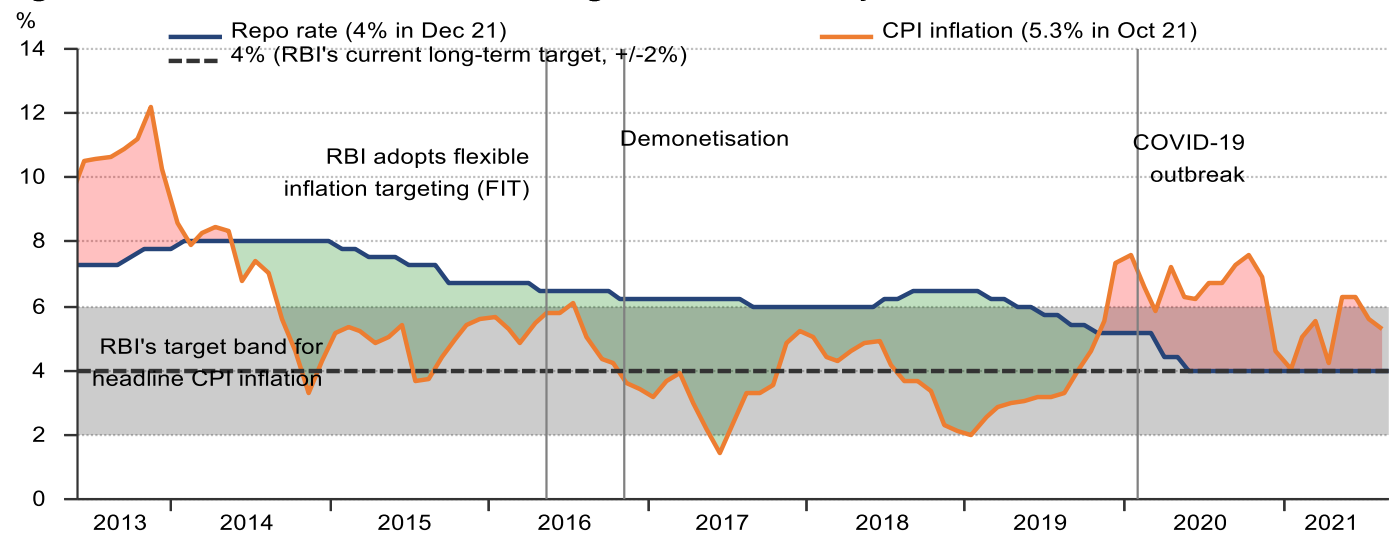
Table 1: Current policy rates

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


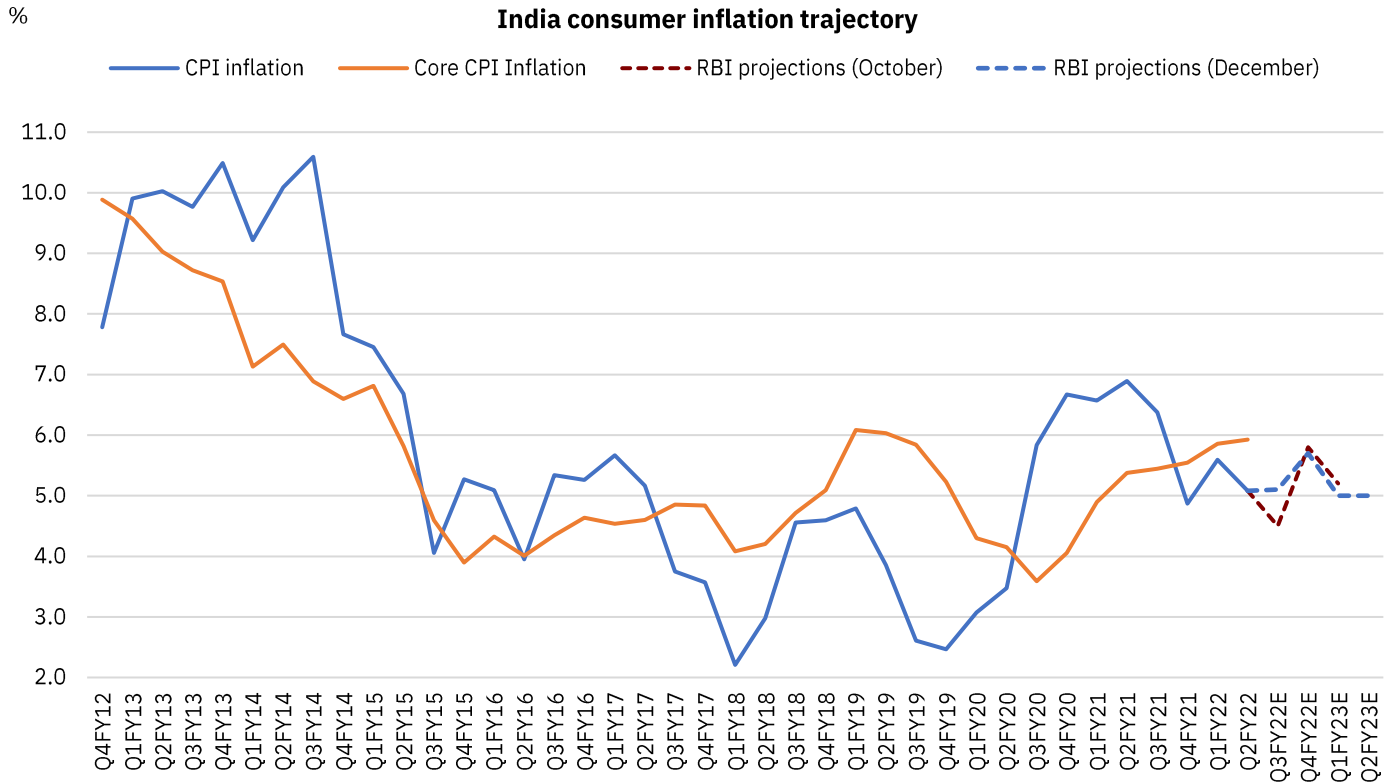
Source: Refinitiv Datastream.

Figure 2: Real interest rates have remained negative for almost two years now


Source: Refinitiv Datastream.

Figure 3: RBI has retained the headline CPI inflation estimate at 5.3% for FY22

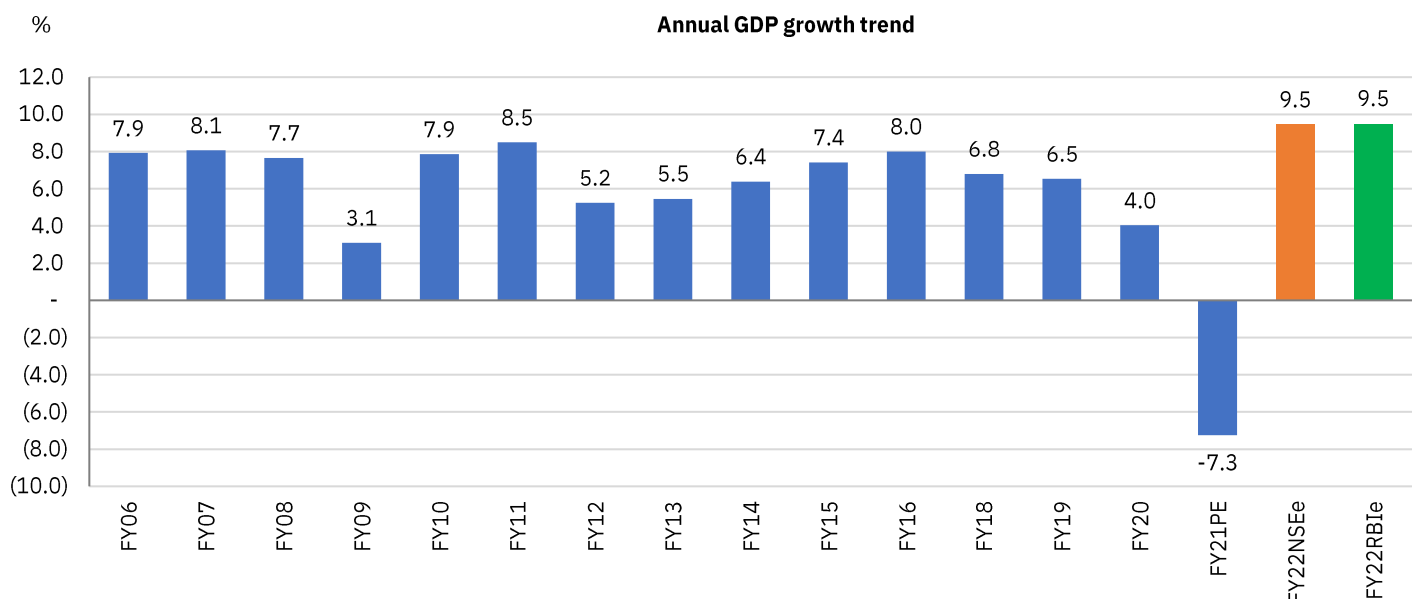
The RBI retained its inflation forecast for FY22 at 5.3%, with Q3 and Q4 forecasts pegged at 5.1% and 5.7% respectively. Inflation trajectory is expected to peak in Q4 and moderate thereafter, with RBI estimating headline CPI inflation at 5% in H1FY23.



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

Figure 4: GDP growth trend and estimate for FY22

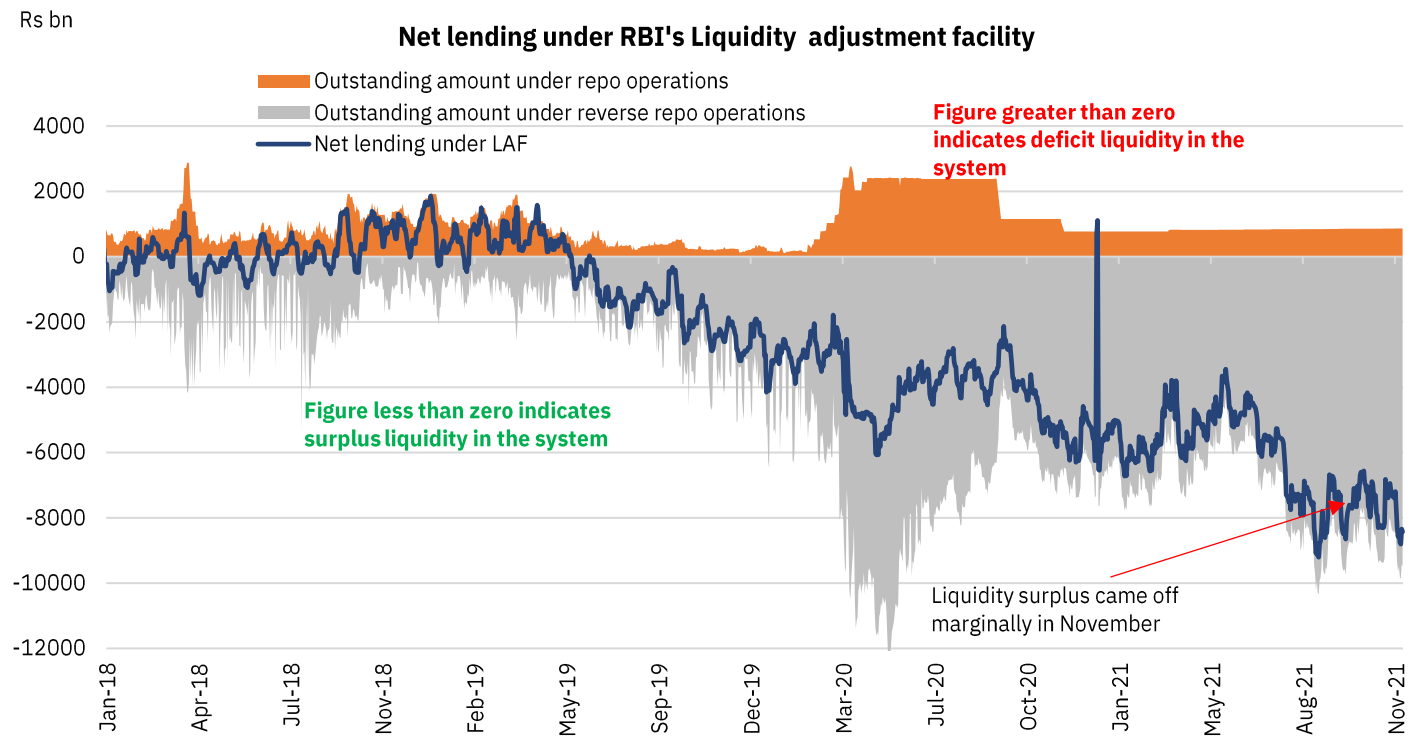
The RBI has retained its FY22 GDP growth forecast at 9.5%, in line with our estimate, with forecasts for Q3FY22 and Q4FY22 pegged at 6.6% and 6.0% respectively. For H1FY23, the RBI expects GDP growth at 12.2% (Q1: 17.2%; Q2: 7.8%).



Source: RBI. PE = Provisional estimates.

Figure 5: Net lending under RBI's Liquidity Adjustment Facility

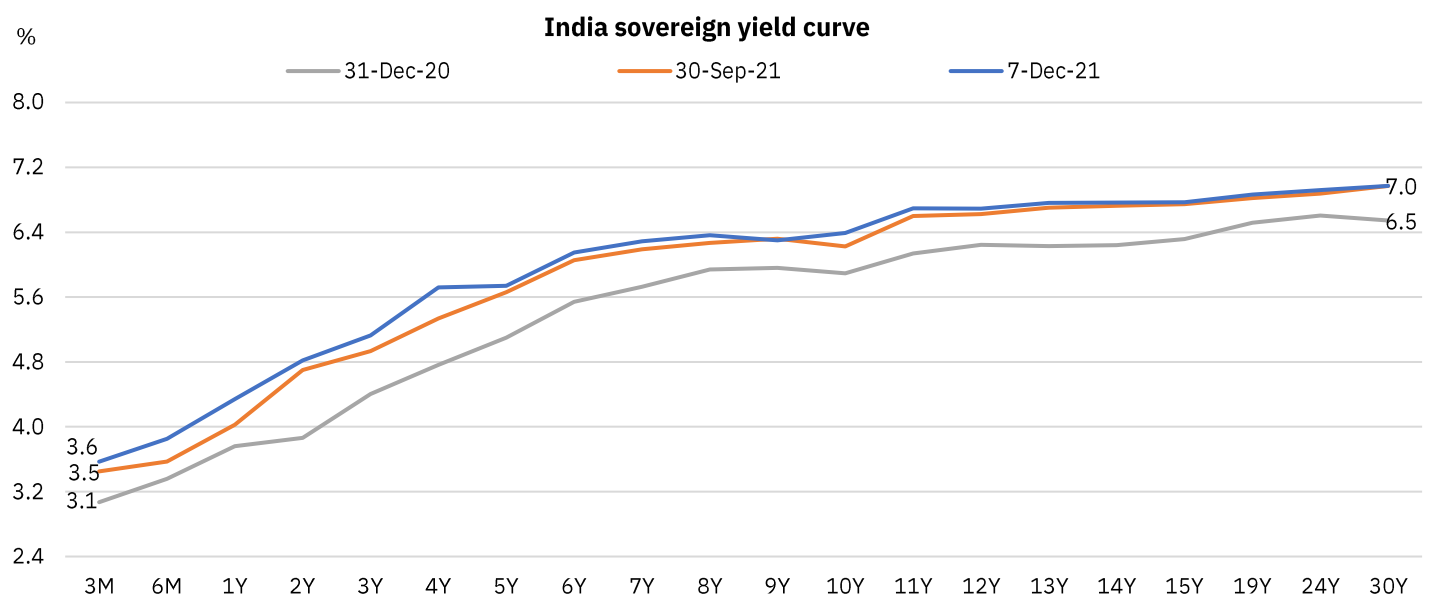
Average net daily liquidity in the system came off from Rs9trn in September to Rs7.5trn in October and November, even as it has risen again in December thus far.



Source: CMIE Economic Outlook, Refinitiv Datastream, NSE

Figure 6: India sovereign yield curve

The RBI's active liquidity normalization through enhanced VRRs have resulted in hardening of short-term rates over the last few months.



Source: Refinitiv Datastream, NSE.

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