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CANARA ROBECO Mutual Fund

RBI Policy Update

June 04, 2021

Assessment of Monetary Policy Committee's (MPC)

June 4, 2021 Bi-Monthly Monetary Policy, FY 2021-22

RBI's Policy Stance:

The MPC decided to keep the benchmark interest rate unchanged for the 6th consecutive meeting and continued to maintain its stance as "accommodative" due to the continued second wave of the COVID-19 pandemic. As the country is fighting a humongous number of infections, the benchmark interest rate will be maintained for as long as necessary, to revive growth on a durable basis, while ensuring that inflation remains within the MPC's target, in order to mitigate the impact of the pandemic in the economy. **With the CPI inflation coming down in Apr'21, the MPC noted that it would continue within the policy of 4+/-2% in FY2022 as well and decided to**:

- **keep** the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4%;
- maintain the monetary policy stance as **accommodative**

Variable	Stands at
Repo	4.00%
Reverse Repo	3.35%
CRR	3.00%
MSF	4.25%
SLR	18.00%

Source: www.rbi.org.in

Policy Stance & Rationale:

- In the second bi-monthly policy meeting of FY22, chaired by RBI governor Mr. Shaktikanta Das, the members voted unanimously to keep its benchmark interest rate unchanged and continued to remain accommodative with an aim to mitigate the impact of the second wave of COVID-19 infections on the economy, while ensuring that inflation remains within the target going forward. The focus is on providing policy support required to gain momentum in the economic growth and its recovery. **The MPC kept the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.0%. The reverse repo rate under the LAF too continues to stand at 3.35%, and the marginal standing facility (MSF) rate and the Bank Rate at 4.25%.**

- Globally, financial conditions remain benign. Economic recovery has seen significant improvement as vaccination programmes and stimulus packages have given the much-needed momentum to economic growth. Major advanced economies (AEs) are quite ahead on the road to recovery whereas activity remains uneven in major emerging market economies (EMEs) due to renewed waves of infections and slow vaccination progress. Inflation is stiffening for most AEs due to release of pent-up demand, elevated input prices and unfavourable base effects. However, it continues to remain close or above targets for major EMEs on account of rising global food and commodity prices.

- Domestically, the National Statistics Office (NSO) announced India's GDP contraction at 7.3% for 2020-21 with GDP growth in Q4 at 1.6% Y-o-Y. **The forecast of a normal south-west monsoon will be instrumental for agriculture and will impact food prices. Industrial production witnessed improvement, but manufacturing activities remained below levels.** Other high-frequency indicators – electricity generation, railway freight traffic, port cargo, steel consumption, etc – recorded restraint during Apr-May'21, reflecting the impact of restrictions and lockdowns imposed by states with exemptions. This was reflected in urban demand being mostly moderate. However, the vaccination process is expected to garner pace in the coming months which should help normalise economic activity.

- CPI inflation fell to 4.3% in Apr'21 from 5.5% in Mar'21 largely due to favourable base effects. While fuel inflation surged, core inflation moderated in Apr'21 also mainly due to base effects. Food inflation fell to 2.7% in Apr'21 from 5.2% in Mar'21, with prices of cereals, vegetables and sugar continuing to decline. However, upside risks to inflation remain due to the continuity of the second wave and consequent restrictions on activity across the country. Inflation in transport and communication remained high. **CPI inflation is projected at 5.1% during 2021-22 with 5.2% in Q1, 5.4% in Q2, 4.7% in Q3 and 5.3% in Q4 of 2021-22, with risks broadly balanced.**

- System liquidity remained in large surplus in Apr'21 and May'21 with an average daily net liquidity absorption amounting to INR 5.2 lakh crore. Reserve money (adjusted for the first-round impact of the change in the cash reserve ratio) expanded by 12.4% (Y-o-Y) on May 28, 2021, driven by currency demand. Money supply (M3) and bank credit grew by 9.9% and 6.0%, respectively, as on May 21, 2021 as compared to the growth of 11.7% and 6.2%, respectively, a year ago. India's foreign exchange reserves increased by USD 21.2 billion in 2021-22 (up to May 28) to USD 598.2 billion.

  Source: RBI

Outlook:

- In the home ground, with the rise in spread of COVID-19 infections in rural areas, there is a downside risk to rural demand although the expectation of a normal monsoon is keeping it strong. Urban demand too has been impacted by the surge in cases with the second wave. However, with the global economy recovering and strengthening, the export sector should receive significant support. Domestic monetary and financial conditions remain highly accommodative and supportive of economic activity. **Real GDP growth is now projected at 9.5% in 2021-22, consisting of 18.5% in Q1, 7.9% in Q2, 7.2% in Q3 and 6.6% in Q4 of FY2021-22.**

- The inflation trajectory is likely to be impacted by uncertainties. The rise in global commodity prices, especially of crude, can push inflation to rise further. Besides, supply side measures and interventions are needed to soften pressures on pulses and edible oil prices. A normal south-west monsoon along with adequate buffer stocks will prove essential to keep cereal prices in check. **With declining infections and easing restrictions across states, disruptions to supply chains can be gradually mitigated, resulting in reduced cost pressures. Core inflation can also be adversely impacted by weak demand conditions.**

- The RBI has announced a set of measures in May to create a financial safety net for the economy as the country is battling the second wave of the pandemic. One of the steps is to provide liquidity of INR 50,000 crore for a period of up to three years to banks 'on tap' so that they, in turn, can on-lend and support vaccine manufactures, importers/suppliers of vaccines, priority medical devices and COVID related drugs, which will prove to be instrumental in tackling the current situation and fulfilling the objective of getting majority of the population vaccinated. **Besides, adequate system level liquidity has been ensured and targeted liquidity to stressed institutions and sectors has been provided which resulted into lowering of borrowing costs and spreads to historic lows.** Another operation under G-SAP 1.0 for purchase of G-Secs of INR 40,000 crore will be conducted on June 17, 2021. Further the Governor announced G-SAP 2.0 for amount of INR 1.2 lac crore for 2Q FY2022 to support markets.

- Market sold off, post policy, as the participants thought that the enhanced amount of G-SAP 2.0 was not enough to support markets. Market was expecting G-SAP amount to increase to INR 1.5 lac crore. However, RBI has the leeway of conducting ad-hoc open market operations, if required. Inflation continues to rise and additional borrowing of INR 1.58 lac crore on account of GST compensation will likely continue to pressure markets. Devolvement in last few auctions has further added to overhang in the markets. **Near term markets will likely trade in a narrow range on continued RBI support via open market operations (OMOs) / G-SAP program to prevent any spike in yields. Any downward movement of yields will likely see traders booking profit and cut long positions.** Global cues relating to commodities, interest rate movements, and any change in policy stance of major central banks will likely drive sentiment as well.

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