RBI Policy Update

October 08, 2021

Assessment of Monetary Policy Committee's (MPC) October 8, 2021 Bi-Monthly Monetary Policy, FY 2021-22

RBI's Policy Stance:

The MPC, for the 8th consecutive meeting, decided to keep the benchmark interest rate unchanged and continued to maintain its stance as "accommodative", in order to sustain growth and overcome the impact of the COVID-19 pandemic to the economy. The MPC noted that the effects of the second wave of the pandemic have started to fade and there is a significant pick-up in the economic activities. To continue to support and boost the recovering economy, it was decided to maintain the benchmark interest rate and maintain accommodative stance for as long as necessary, to revive and sustain growth on a durable basis, while ensuring that inflation remains within the MPC's target. **As the CPI inflation has continued to ease in Aug'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	4.00%
MSF	4.25%
SLR	18.00%

Source: www.rbi.org.in

Policy Stance & Rationale:

- In the fourth bi-monthly policy meeting of FY2021-22, chaired by RBI governor Mr. Shaktikanta Das, the MPC members voted unanimously to keep its benchmark interest rate unchanged. The MPC also decided on a 5 to 1 majority to continue to remain accommodative with an aim to revive and sustain economic growth, while ensuring that inflation remains within the target going forward. As the economic recovery gained traction and growth has started to become visible with inflation receding from highs registered in Q1 FY2021-22, the **MPC kept the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.00%. 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, the economic recovery has been significantly impacted by the rising infections due to rapid spread of the delta variant of the coronavirus. There is a possibility of a greater impact on the recovering economies if the delta variant spreads further. Global commodity prices remain elevated and consequently, inflationary concerns continue with upward pressure on most advanced economies (AEs) and emerging market economies (EMEs). Due to this, many AEs and EMEs are tightening their monetary policies and withdrawing the ultra-accommodative measures. This, along with reduced bond purchases, has led to the rise in bond yields in most major economies. The US dollar strengthened steeply, while the EME currencies have weakened with capital outflows in recent weeks.

- Domestically, the economy is recovering fast as new cases of infections are significantly lower. The pace of vaccination has picked up, improving confidence. This helped in easing most of the restrictions put in place due to the pandemic, and which boosted growth along with the aid from rapid vaccinations. The pick-up in monsoons helped in kharif sowing exceeding the previous year's levels and produced record kharif food grains. Real GDP expanded by 20.1% Y-o-Y during Q1 FY2021-22 on a large favourable base. Aggregate demand, too, gathered pace as a sign of the economic recovery. Industrial production posted a high Y-o-Y growth for the fifth consecutive month in Jul'21.

- CPI inflation continued to remain stable in Aug'21 at 5.3% after a marginal dip from 5.6% in Jul'21. While fuel inflation surged with the rapid increase in crude oil prices, food inflation eased and helped in controlling retail inflation. Core inflation remained elevated at 5.8% in Aug'21. Headline inflation continues to be significantly influenced by very high inflation in select items such as edible oils, petrol and diesel, LPG and medicines. **CPI inflation is projected at 5.3% during 2021-22 with 5.1% in Q2, 4.5% in Q3 and 5.8% in Q4 of 2021-22, with risks broadly balanced. The projection for Q1 2022-23 is 5.2%.**

- System liquidity remained sufficient in Aug-Sep'21 with an average daily absorption under the LAF increasing from INR 7.7 lakh crs in Jul-Aug'21 to INR 9.0 lakh crs in Sep'21. Auctions of INR 1.2 lakh crore under the secondary market G-SAP 2.0 programme during Q2 FY2021-22 provided liquidity across the term structure. As on October 1, 2021, reserve money (adjusted for the first-round impact of the change in the cash reserve ratio) expanded by 8.3% (Y-o-Y); money supply (M3) and bank credit grew by 9.3% and 6.7%, respectively, as on September 24, 2021. India's foreign exchange reserves increased by USD 60.5 bn in 2021-22 (up to October 1) to USD 637.5 bn, partly reflecting the allocation of special drawing rights (SDRs) and were close to 14 months of projected imports for FY2021-22.
  Source: RBI

Outlook:

- In the domestic economy, as economic activity is gaining traction, rural demand is expected to be on the rise with a normal kharif sowing and a prospectively good rabi sowing. Monetary and financial conditions remain easy and supportive of growth. The broad-based reforms by the government focusing on infrastructure development, asset monetisation, taxation, telecom sector and banking sector are expected to lift investor confidence, enhance capacity expansion and facilitate private investment. However, external forces in the form of high global commodity prices and rising crude oil prices might hamper the rising growth of the economy in the near term. Concerns over the normalisation of monetary policies in most AEs and EMEs continue to perturb risk assets.

- The policy was on expected lines with the MPC maintaining status quo on rates with a unanimous decision and the stance was also maintained stance at "accommodative" with a 5-1 majority. However, the stopping of the G-SAP programme came as a surprise as market expected RBI to follow a gradual run down of asset purchases. The RBI reduced its CPI inflation target for FY2022 at 5.3% (from 5.7% in Aug'21 policy), on moderating retail inflation with expectation of further softening in the near term. Although food inflation has eased, pressures persist from crude oil prices which remain volatile over uncertainties on the global supply and demand conditions. This is likely to continue to challenge policy makers. Aggregate demand is further expected to improve as vaccinations are being administered widely, new cases of infections are low and the advent of the festival season. **Growth projections were maintained at 9.5% for FY2022 consisting of 7.9% in Q2, 6.8% in Q3 and 6.1% in Q4 of FY2021-22. Real GDP growth for Q1 FY2022-23 is projected at 17.2%.**

- The level of surplus liquidity in the banking system increased further during Sep'21, with absorption under the fixed rate reverse repo, variable rate reverse repo (VRRR) of 14 days and fine-tuning operations under the liquidity adjustment facility (LAF) averaging INR 9.0 lakh crs per day as against INR 7.0 lakh crore during Jun-Aug'21. The stoppage of the G-SAP programme indicates discomfort of RBI with current levels of liquidity, which may engender higher inflation expectations in future. To manage the surplus, the RBI has proposed to undertake the 14-day VRRR auctions on a fortnightly basis in a phased manner, whilst increasing the amount to be absorbed in VRRR from current INR 4 lakh crs to INR 6 lakh crs by early Dec'21. Depending upon the evolving liquidity conditions – especially the quantum of capital flows, pace of government expenditure and credit offtake – the RBI may also consider complementing current VRRR operations with 28-day VRRR auctions in a similar calibrated fashion. The discontinuation of the G-SAP and gradual increase in VRRR is an indication of first steps towards "normalisation" of rates from an extremely accommodative monetary policy stance.

- Markets reacted adversely to the stoppage of G-SAP, though RBI assured of ad-hoc bond buying operations to ensure orderly development of the yield curve. 10 Year G-Sec yields topped 6.30%. With US yields rising to 1.61%, in anticipation of FED taper, negative sentiments may prevail for some more time. On the positive side, government finances are in good shape with tax revenues beating budget targets, inflation is moderating, and weekly borrowings are likely to be lower in H2 FY2021-22. Further, inclusion of Indian bonds in global bond indices, which is gathering pace, may provide good support on demand side as there are expectations of USD 20-25 bn of inflows in next 1-2 years. The 10 Year G-Sec yields may remain in the range of 6.15%-6.40% in near term.

- The economic recovery, which continued in Sept'21, is fairly visible in the government tax collections which have been significantly higher than budget estimates. This can help the government to reduce the borrowing program, and which may present opportunity in long-term bonds. Inflation is moderating, which has provided comfort to RBI to continue with accommodative stance. While RBI may normalize short term rates via hike to reverse repo rate, expectations of any increase in repo rate in near term is very low. The curve may flatten over next few months (with short term rates rising more than long term rates), as RBI continues with its policy on liquidity normalization. Based on the current market dynamics, core allocation could be under the medium to long term duration. We believe that the investment opportunity in short duration category, corporate bond category and dynamic bond category is still present. Depending on the risk tolerance level and the investment horizon, investors may decide to allocate in fixed income portfolio.

  Source: RBI, Bloomberg