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ICRA COMMENTS ON RBI'S FIRST BI-MONTHLY MONETARY POLICY STATEMENT FOR 2021-22

MPC maintains status quo on Repo rate, continuation of accommodative stance without explicit timeframe

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HIGHLIGHTS

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Rates and monetary policy stance kept unchanged in first MPC review of FY2022

The Committee revised its CPI inflation forecast for 9M FY2022 upwards, while retaining its GDP growth projection for FY2022 at 10.5%

We expect an extended pause for the repo rate through 2021, with the reverse repo rate and accommodative stance to be kept unchanged in H1 FY2022

- In a unanimous vote, the six-member Monetary Policy Committee (MPC) decided to maintain status quo on the policy repo rate under the Liquidity Adjustment Facility (LAF) at 4.0%, in line with our expectation, and continue with the accommodative stance for as long as necessary to sustain growth on a durable basis and continue to mitigate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target going forward, in the First Bi-Monthly Monetary Policy Statement for FY2022.
- Other policy rates, such as the Marginal standing facility (MSF) rate, Reverse Repo rate and bank rate were also kept unchanged at 4.25%, 3.35%, and 4.25%, respectively.
- Taking into account the evolving inflation trajectory and an uptrend in global commodity prices, the MPC upwardly revised its projection of the CPI inflation to 5.2% each in Q1 FY2022 and Q2 FY2022, 4.4% in Q3 FY2022, and 5.1% in Q4 FY2022 with risks broadly balanced, from the previous forecasts of 5.2-5.0% in H1 FY2022, and 4.3% in Q3 FY2022 in the February 2021 meeting. Simultaneously, it revised its forecast downwards for the just-concluded quarter i.e. Q4 FY2021 (to 5.0% from the previous 5.2% in the February 2021 meeting).
- On the growth front, the Committee retained the pace of GDP expansion in FY2022 at 10.5% (ICRA's expected range: 10-11%), indicating a YoY growth of 26.2% in Q1 FY2022 and 8.3% in Q2 FY2022 on the back of a low base, and a moderate 5.4% and 6.2%, respectively, in the subsequent two quarters (Q3 FY2022 and Q4 FY2022).
- The Governor reiterated the RBI's commitment to ensuring ample systemic liquidity in consonance with the accommodative stance of monetary policy, and announced that variable rate reverse repo auctions of longer maturity will be conducted given the rising level of surplus liquidity.

Outlook: With the MPC forecasting the CPI inflation to average ~5.0% in FY2022, rate cuts appear to be ruled out, unless economic activity undergoes another deep Covid-induced disruption. However, even in this situation, supply disruptions may harden inflation, limiting the extent of the monetary policy support that may be forthcoming. Simultaneously, early rate hikes seem unlikely, with inflation expected below the 6% upper threshold of the MPC's medium-term target range. Therefore, we maintain our view of a pause in the repo rate through 2021, and in the reverse repo rate during H1 FY2022. The MPC has committed to continue the accommodative stance for as long as necessary to durably sustain growth, without providing any explicit timeframe for the same. By doing so, it has signalled that it will remain data dependent. We expect it to remain cautious, and continue the accommodative stance during H1 FY2022, until the uncertainty related to the growth outlook subsides, after a much larger portion of the adult population are administered the Covid-19 vaccines.

The announcement of the secondary market government securities (G-sec) acquisition programme (GSAP 1.0) should ease the anxieties of the bond market regarding the size of the Government borrowing programme for FY2022. Aided by the expectation of comfortable cash balances of the Central Government, we expect the 10-year G-sec yield to range between 6.05% and 6.15% in the next two months, influenced by global factors such as US treasury yields and commodity prices, as well as the impact of the latter on domestic inflation.

As Expected, MPC maintained status quo on the policy repo rate; to continue with the "accommodative stance" as long as necessary to durably sustain growth whilst ensuring inflation remains within the target

In the April 2021 policy review, the MPC voted unanimously to maintain the repo rate unchanged at 4.0%, in line with our anticipation. It also voted unanimously to continue with the accommodative stance for as long as necessary to sustain growth on a durable basis and continue to mitigate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target going forward.

After the MPC's last meeting in February 2021, retail inflation data released by the NSO had revealed a sharper-than-expected uptick in the headline CPI inflation to 5.0% in February 2021 from the 16-month low 4.1% in January 2021, driven by food and beverages, miscellaneous items, and clothing and footwear, even as the inflation for fuel and light eased somewhat in February 2021.

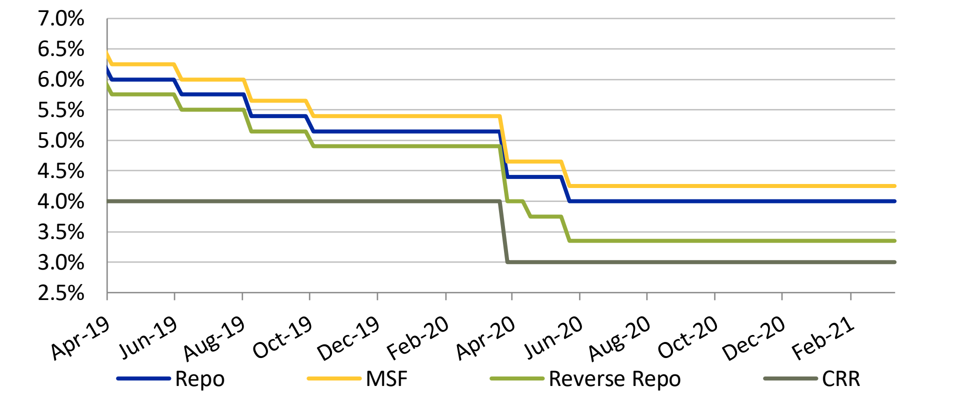
Looking ahead, the Committee remarked that the CPI inflation trajectory is likely to be afflicted by both upside and downside pressures. It cited the bumper foodgrains production on the one hand, and the high international commodity prices and increased logistics costs on the other, whilst again nudging the Central and state governments to pare taxes and cesses on petroleum products. While the prices of some pulses remain elevated, the MPC expects the rabi arrivals in the markets and the overall increase in the domestic production in FY2021 to boost the supply and soften prices in the near term. In addition, the cut in import duties on edible oils and incentives to augment domestic productivity could improve the demand-supply balance over the medium-term, according to the MPC. On a cautionary note, the March 2021 round of the RBI's survey of inflation expectations of urban household has revealed a marginal uptick in the one-year ahead expectations over the three months ahead horizon. Taking all these factors into account, the MPC upwardly revised its projection of the CPI inflation to 5.2% each in Q1 FY2022 and Q2 FY2022, 4.4% in Q3 FY2022, and 5.1% in Q4 FY2022 with risks broadly balanced, from the previous forecasts of 5.2-5.0% in H1 FY2022, and 4.3% in Q3 FY2022 in February 2021 meeting, whereas it revised its inflation forecast slightly downwards for the just-concluded quarter i.e. Q4 FY2021 (to 5.0% from the previous 5.2% in February 2021 meeting).

With the MPC forecasting the CPI inflation to average around 5.0% in FY2022, rate cuts appear to be virtually ruled out, unless economic activity undergoes another deep Covid-induced disruption. Simultaneously, early rate hikes seem rather unlikely, with the average retail inflation expected to remain below the 6% upper threshold of the MPC's medium-term target range. Therefore, we maintain our view of an extended pause in the repo rate through 2021, and in the reverse repo rate during H1 FY2022.

On the growth front, the MPC expects the urban demand to strengthen with the Covid-19 vaccine rollout, whereas rural demand would remain robust with the record harvest. In addition, the enhanced allocation for capital expenditure under the Union Budget for FY2022, extension of the Production-Linked Incentives Scheme to other sectors and an uptick in the capacity utilisation levels (to 66.6% in Q3 FY2021 from 63.3% in Q2 FY2021) bodes well for investment demand and exports. However, the rise in Covid-19 cases has resulted in a dip in consumer confidence and reignited uncertainty regarding the near-term outlook. Taking these factors into consideration, the Committee has retained the pace of GDP expansion in FY2022 at 10.5%, indicating a YoY growth of 26.2% in Q1 FY2022 and 8.3% in Q2 FY2022 on the back of a low base, and a moderate 5.4% and 6.2%, respectively, in the subsequent two quarters (Q3 FY2022 and Q4 FY2022).

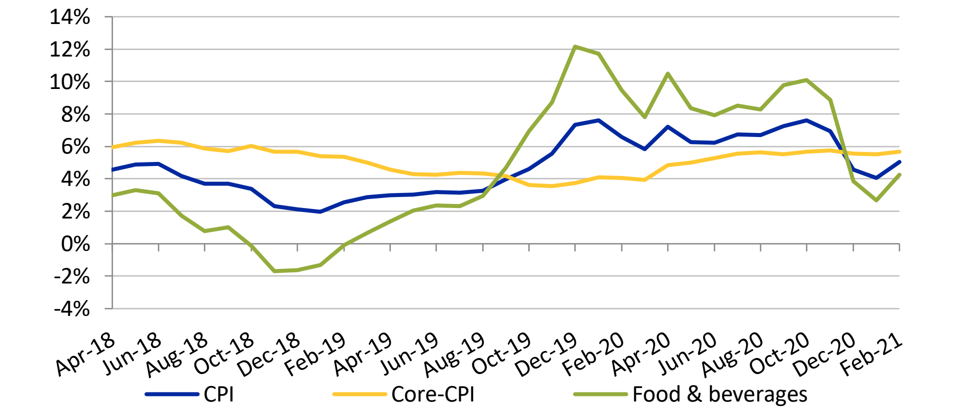
With the resurgence in localised restrictions, ICRA expects demand to get back-ended into H2 FY2022 from H1 FY2022, with the GDP growth expected to print in a range of 10-11% for the year as a whole. We expect the MPC to remain cautious, and continue the accommodative stance during H1 FY2022, until the uncertainty related to the growth outlook subsides, after a much larger portion of the adult population are administered the Covid-19 vaccines.

Exhibit 1: Movement in Key Rates



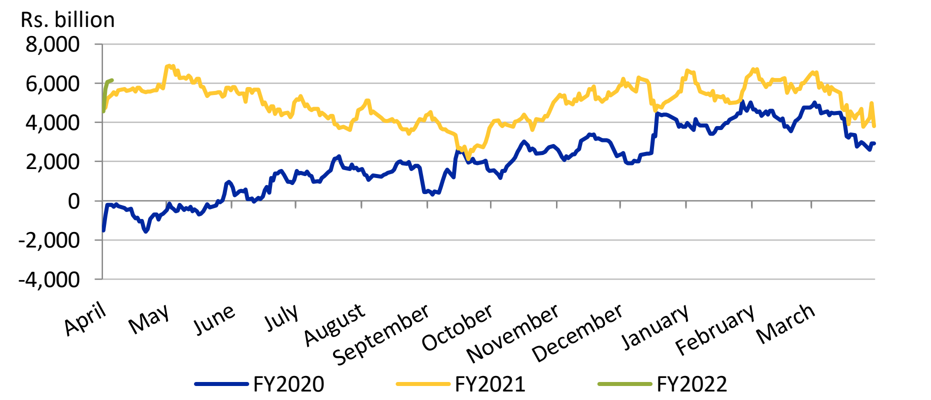
Source: *RBI; CEIC; ICRA research*

Exhibit 2: CPI Inflation, CPI-food and core-CPI inflation (YoY)



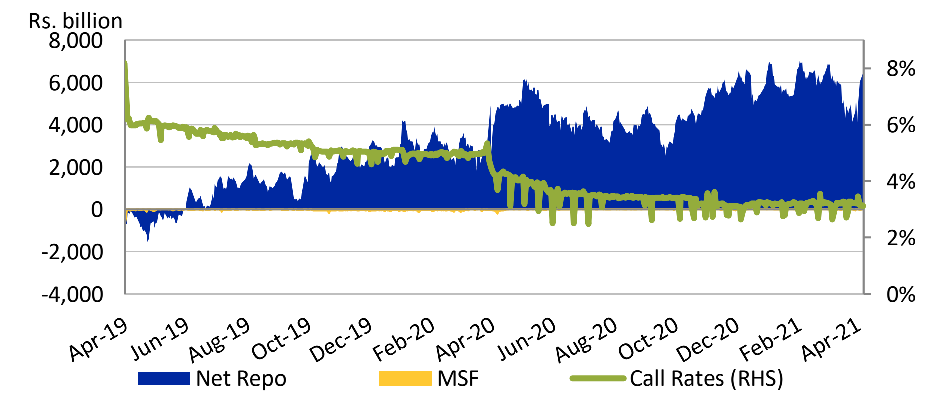
Source*: RBI; CEIC; ICRA research*

Exhibit 3: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; MSS)



Data for FY2022 is available upto April 6, 2021;* ***Source:* *RBI; CEIC; ICRA research*

Exhibit 4: Call money rates



Source: *RBI; ICRA research*

The daily average liquidity surplus under the LAF increased from ~Rs. 5.0 trillion in Q3 FY2021 to ~Rs. 5.6 trillion in Q4 FY2021 (till March 31, 2021), following robust foreign capital inflows and liquidity operations by the RBI. On a monthly basis, the daily average liquidity surplus increased from ~Rs. 5.57 trillion in December 2020 to ~Rs. 5.61 trillion in January 2021, and further to ~Rs. 6.1 trillion in February 2021, before easing to ~Rs. 5.2 trillion during March 2021 (till March 31, 2021) partly on account of the advance tax outflows towards the second half of the month (refer Exhibit 3). Despite a pick-up in the credit growth during H2 FY2021, it remained much lower than the deposit growth, and the surplus liquidity parked by banks under Reverse Repo window stood at Rs. 7.3 trillion as on April 6, 2021.

In his statement, the Governor clarified that the stance of liquidity management remains accommodative, and completely in consonance with the stance of monetary policy. In aggregate, the RBI injected net liquidity of Rs. 3.22 trillion through open market operations (OMO) of Government of India securities (G-secs) during FY2021. Out of this, Rs. 0.5 trillion of net OMO purchases were conducted during February 2021, boosting the liquidity surplus in that month. In addition, the RBI conducted five "Twist OMOs" in February-March 2021. Moreover, the RBI has conducted three OMO purchase of State Developments Loans worth Rs. 100 billion each on October 22, 2020, November 5, 2020 and December 23, 2020, which boosted liquidity during FY2021.

For FY2022, the RBI has now announced a secondary market G-sec acquisition programme or G-SAP 1.0. Under this programme, the Central Bank will commit to a specific amount of OMO purchases of G-sec with the intention of enabling a stable and orderly evolution of the yield curve. For Q1 FY2022, the RBI has now announced a G-SAP of Rs. 1.0 trillion. The first purchase of G-sec for an aggregate amount of Rs. 250 billion under G-SAP 1.0 is to be conducted on April 15, 2021.

The announcement of the GSAP 1.0 should help to subdue the anxieties of the bond market regarding the size of the Central and State Government borrowing programme for FY2022. As per our assessment, the Government of India's (GoI's) fiscal deficit likely undershot its FY2021 Revised Estimates by a substantial Rs. 1.3-1.5 trillion, whereas only Rs. 0.2 trillion of planned market issuance was cancelled. Therefore, we expect the GoI to have commenced FY2022 with a comfortable cash balance, which should also keep bond yields tempered in the near term. On balance, we expect the 10-year G-sec yield to range between 6.05% and 6.15% in the next two months, influenced by global factors such as US treasury yields and commodity prices, as well as the impact of the latter on domestic inflation.

Following the resumption of 14-day variable rate reverse repo (VRRR) operations under the revised liquidity management framework since January 15, 2021, the short terms rates, 91 days Treasury bills (T-bills), 182 days T-bills, and 364 days T-bills increased from 3.1%, 3.3% and 3.4%, respectively, in Q3 FY2021 to 3.3%, 3.5% and 3.7%, respectively, in Q4 FY2021 (till March 30, 2021). Similarly, the daily weighted average call money rate increased marginally from 3.16% in Q3 FY2021 to 3.17% in Q4 FY2021 (refer Exhibit 4), but continued to remain below the Reverse Repo rate.

The RBI has now announced that VRRR auctions of longer maturity will be conducted given the rising level of surplus liquidity. The amount and tenor of such auctions is to be decided based on the evolving liquidity and financial conditions. It was reiterated that this announcement is a part of the RBI's liquidity management operations, and should not be read as liquidity tightening.

The RBI provided an update on the various other initiatives undertaken to enhance liquidity for certain targeted sectors, conservation of capital among banks and NBFCs, strengthening of supervision through audit functions of banks and NBFCs and deepening of financial markets.

1) On-Tap Targeted Long-term Repo operations (TLTROs) – extension of scheme till September 30, 2021.

In its policy announcements of October 2020, RBI had announced facility of on-tap TLTROs for banks of upto Rs 1.0 trillion which will be available at Repo rate for upto three years. The facility will be available till March 31, 2021. The said facility was initially available for certain identified sectors in a) Agriculture, b) Agri-infrastructure, c) secured retail, d) Micro, small and Medium enterprises (MSMEs) and e) Drugs, pharmaceuticals and healthcare. Subsequently in December 2020 statement, RBI had extended the on-tap TLTRO facility to 26 stressed sectors identified by the Kamath Committee. The funds availed under this mechanism can be deployed by banks as loans and advances or investments in corporate bonds.

In its policy announcements of February 5, 2021, RBI has further expanded the scope of lending under on-Tap TLTROs for lending to NBFCs, provided the incremental lending by NBFCs is to the sectors identified earlier. As notified earlier, the incremental exposure through such lending will be exempted from calculation of large exposure limits and investments made under bonds could be held under Held to maturity (HTM) category by the banks.

In the policy announcements today, RBI has extended the availability of said facility by another six months to September 30, 2021.

Given the surplus liquidity position in the banking system, with banks parking over Rs. 7.0 trillion in reverse repo with RBI, the outstanding balance against the said facility has remained low at Rs. 5,000 crore as on April 6, 2021 despite six months being elapsed since notification of the scheme. Moreover, since NBFCs were included in the scheme only in February 2021, the earlier timeframe till March 31, 2021 for utilization of funding under the scheme was limited for onward lending to NBFCs. Hence, the extension of the scheme is positive as it provides one more tool to lenders to support credit growth and could be positive for NBFCs.

2) Standing Liquidity facility for All-India Financial Institutions.

In the backdrop of Covid-19 induced stress, on April 17, 2020, RBI announced Rs. 500 billion of standing liquidity facility (SLF) to NABARD (Rs. 250 billion), SIDBI (Rs. 150 billion) and NHB (Rs. 100 billion) at repo rate for on-lending/refinance the various institutions like Banks, NBFCs, HFCs. In addition to the said facilities of Rs. 500 billion, RBI also announced Rs. 50 billion of additional SLF for NABARD on August 6, 2020 for refinancing NBFC-MFIs and other smaller NBFCs and another Rs 50 billion to NHB for refinancing HFCs. The outstanding against the said facility stood at Rs. 311 billion as on April 6, 2021 and the facility was sanctioned for 1 year to AIFIs.

In its announcements today, RBI has extended the said facility by another one year for Rs. 500 billion sanctioned in April 2020. With proposed rollover of the said facility by another year, these institutions will in-turn be able to rollover the loans extended to borrowers at competitive rates and will be positives for credit flow/liquidity of regional rural banks, NBFCs, MFIs and HFCs.

The recent resurgence of Covid-19 cases and consequent partial lockdowns announced by various states, there could be concerns on the asset quality of lenders, which could create an environment of risk aversion to lenders. The rollover of these facilities is hence positive from liquidity perspective of the lenders.

3) Priority status for onward lending to NBFCs by banks:

To improve the credit flow to priority sector such as Agriculture, MSME and Housing, during August 2019, RBI included bank credit to NBFCs for on-lending to these sectors for classifying them as priority sector loans (PSL) for banks. The said scheme was initially valid upto March 31, 2020 and was later extended till March 31, 2021. With almost Rs. 370 billion of lending by banks to NBFCs till December 31, 2020, the credit flow to NBFCs/HFCs has improved at competitive rates under the said scheme.

In its policy announcements today, RBI extended the said scheme by another six months till September 30, 2021 and is positive for the sustaining of credit flow to NBFCs/HFCs and in-turn for on lending to identified sectors like MSMEs, agriculture and housing. It also enables the banks to meet their PSL requirements and is also better from risk-return perspective.

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