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

MPC maintains status quo to
support growth; non-unanimous
vote on accommodative stance
highlights inflation unease

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HIGHLIGHTS



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Rates and monetary policy stance kept unchanged, with a non-unanimous decision for the latter

CPI inflation projection for FY2022 upped to 5.7% from 5.1%

Real GDP growth forecast retained at 9.5% for FY2022, with revision in quarterly estimates

In the Third Bi-Monthly Monetary Policy Statement for FY2022, the six-member Monetary Policy Committee (MPC) maintained a status quo on the policy rates in a unanimous decision. While it also decided to continue with the accommodative stance, this vote was not unanimous (5:1), revealing unease on the inflation outlook. In line with our anticipation, the MPC has increased its CPI inflation forecast for FY2022 to 5.7% from 5.1%. While it has retained its projection of the real GDP expansion at 9.5% for FY2022, the quarterly projections have undergone a revision. The RBI has decided to progressively hike the size of VRRR auctions to Rs. 4.0 trillion by end-September 2021.

- In the August 2021 policy review, the six-member MPC voted unanimously to maintain the repo rate unchanged at 4.0%, in line with our anticipation. While it decided to continue with the accommodative stance, the decision to do so was not unanimous (5:1). 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.
- The MPC's current assessment is that the recent inflationary pressures during Q1 FY2022 were largely driven by the supply-side shocks, which are expected to be transitory. Nevertheless, it revised its CPI inflation forecast for FY2022 to 5.7% from 5.1%, with risks broadly balanced. In quarterly terms, the CPI inflation projection has been revised upwards for Q2 FY2022 (to +5.9% from the earlier +5.4%), Q3 FY2022 (to +5.3% from +4.7%), and Q4 FY2022 (to +5.8% from +5.3%), compared to its June 2021 forecasts. Subsequently, the Committee expects the CPI inflation to ease to 5.1% in Q1 FY2023, while remaining well above the mid-point of the 2-6% range.
- On the growth front, the Committee has retained its real GDP growth forecast for FY2022 at 9.5%, in line with the forecast of June 2021 meeting. However, in quarterly terms, it has revised its growth forecasts upwards for Q1 FY2022 (to +21.4% from +18.5%), offset by a downward correction for Q2 FY2022 (to +7.3% from +7.9%), Q3 FY2022 (to +6.3% from +7.2%), and Q4 FY2022 (to +6.1% from +6.6%). For Q1 FY2023, the Committee has projected the YoY real GDP expansion at a high 17.2%.

Outlook: The Governor stated that the RBI remains in 'whatever it takes' mode, referring to the desire to support the growth impulses. At the same time, the MPC resolution explicitly stated that the Committee is conscious of its objective of anchoring inflationary expectations. In our view, as domestic demand strengthens and starts seeping into inflationary pressures, the MPC will shift its focus to preserving the anchoring of inflationary expectations. We anticipate a change in the stance to neutral from accommodative in the February 2022 policy review, followed by a hike in the repo rate of 25 bps each in the April 2022 and June 2022 reviews.

With the substantial surplus in systemic liquidity conditions, the gradual incremental absorption through VRRR should not materially impact the near-term rates. However, the new benchmark 10 year G sec yield may continue to creep up, with the average CPI inflation for FY2022 projected close to the upper threshold of the 2-6% medium term target, and a budgeted fiscal deficit of 6.8% of GDP. Until the new benchmark is routinely included in liquidity operations, which may be unlikely until its issuance attains a reasonable volume, we expect its yield to continue to inch up to as much as 6.35%.

THE MPC MAINTAINED STATUS QUO ON THE POLICY REPO RATE IN A UNANIMOUS VOTE; RETAINED THE “ACCOMMODATIVE STANCE” BY A VOTE OF 5:1

The six-member MPC unanimously maintained its policy repo rate at 4.0%; however, the decision to retain the accommodative stance was non-unanimous (5:1)

The recent spike in the CPI inflation was attributed to pressures that are transitory in nature, driven by supply-side shocks

The CPI inflation forecast for FY2022 was sharply raised to 5.7% from the earlier 5.1%

In the August 2021 policy review, the six-member MPC voted unanimously to maintain the repo rate unchanged at 4.0%, in line with our anticipation. It reiterated its support towards the nascent economic recovery, which was expected in light of the persisting uncertainty, growing concerns regarding the Delta variant and only gradual rise in the domestic vaccination levels. It also voted to continue with the accommodative stance for as long as necessary to revive and 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. However, this vote was not unanimous (5:1), revealing unease on the inflation outlook.

CPI inflation forecast for FY2022 revised to 5.7% from 5.1%: After the MPC's last meeting in June 2021, the data released by the NSO had revealed a spike in the headline YoY CPI inflation from 4.23% in April 2021 to 6.30% in May 2021, with a marginal easing to 6.26% in June 2021. Nevertheless, the June 2021 CPI print remained above the upper threshold of the MPC's 2-6% medium term target for the second month in a row. The Committee has assessed that this spike was largely driven by adverse supply shocks that are likely to be transitory.

Looking ahead, the Committee anticipates that the revival of southwest monsoon, pickup in kharif sowing and adequate availability of food stocks should aid in controlling the cereal price pressures. Moreover, the supply-side interventions by the Government related to the changes in customs duty on pulses and oilseeds have contributed to softer prices in July 2021, as per the daily data provided by the Department of Consumer Affairs. However, the MPC cautioned that input prices are rising across the manufacturing and services sectors, although cost-cutting measures and subdued demand conditions are limiting the transmission into output prices. The Committee once again nudged the Central and state governments to consider a calibrated reduction in taxes imposed on fuels to soften the cost pressures, amidst elevated international crude oil prices.

Taking all these factors into consideration, the MPC upwardly revised its CPI inflation forecast for FY2022 to 5.7% from the 5.1% projected in its June 2021 meeting, with risks broadly balanced. In quarterly terms, the CPI inflation has been revised upwards in Q2 FY2022 (to +5.9% from the earlier +5.4%), Q3 FY2022 (to +5.3% from +4.7%), and Q4 FY2022 (to +5.8% from +5.3%), compared to its June 2021 forecasts.

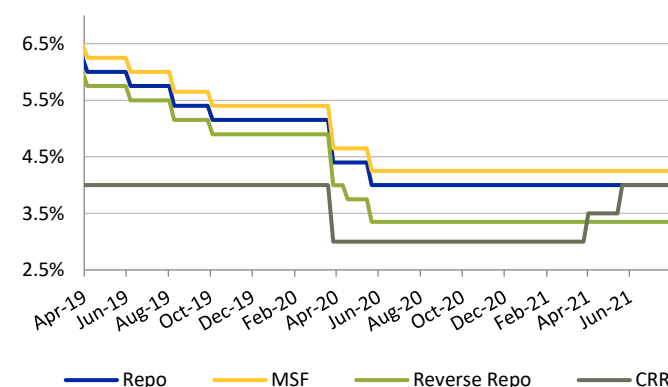
The Committee has projected the CPI inflation at an unnerving 5.9% in Q2 FY2022, practically at the upper threshold of its medium-term target. A subsequent base-effect led cooling to 5.3% in Q3 FY2022 is expected to reverse to 5.8% in Q4 FY2022, presumably as producers get emboldened to push through price hikes, once widening vaccine coverage strengthens domestic demand. While inflation is subsequently expected to ease to 5.1% in Q1 FY2023, this remains well above the 4% mid-point of the inflation target range.

The Committee has retained its June 2021 forecast of the FY2022 real GDP expansion at 9.5%; in quarterly terms, it has revised its growth forecasts upwards for Q1 FY2022, offset by modest downward revisions in the subsequent three quarters (Q2-Q4 FY2022)

Real GDP growth forecast for FY2022 retained at 9.5%: On the growth front, the Committee remarked that the domestic economic activity has started to recover with the easing of the second wave of Covid-19. Going forward, it expects the agricultural production and rural demand to remain resilient, while the urban demand is likely to recover with a lag as manufacturing and non-contact intensive services resume on a stronger pace, and the pent-up demand becomes durable with ramping up of vaccination coverage. Moreover, the MPC believes that the robust exports, expected pickup in government spending, including capex, and the recent economic relief package announced by the Government will provide a further push to aggregate demand. Although investment activity continues to be anaemic at present, an anticipated improvement in capacity utilisation levels, as well as supportive monetary and financial conditions will engender a revival, according to the Committee. Moreover, the RBI's recent quarterly survey result suggests an improvement in production and new orders of the polled firms in Q2 FY2022, which is likely to sustain until Q4 FY2022. Nevertheless, the MPC pointed out the elevated levels of global commodity prices and financial market volatility pose downside risks.

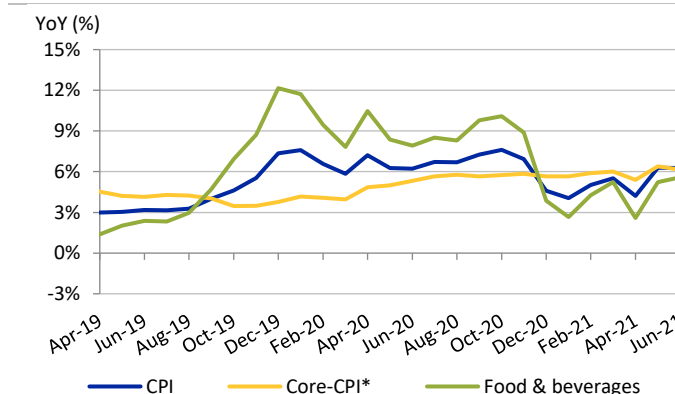
Taking these factors into consideration, the Committee has retained its June 2021 forecast of the FY2022 real GDP growth of 9.5%. However, in quarterly terms, it has revised its growth forecasts upwards for Q1 FY2022 (to +21.4% from +18.5%), offset by a downward correction for Q2 FY2022 (to +7.3% from +7.9%), Q3 FY2022 (to +6.3% from +7.2%), and Q4 FY2022 (to +6.1% from +6.6%). For Q1 FY2023, the Committee has projected the YoY real GDP expansion at a high 17.2%. The paring of the growth projections for Q2-Q4 FY2022, suggest that back-ended pent-up demand is now being viewed as a less potent force.

EXHIBIT 1: Movement in Key Rates



Source: RBI; CEIC; ICRA research

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



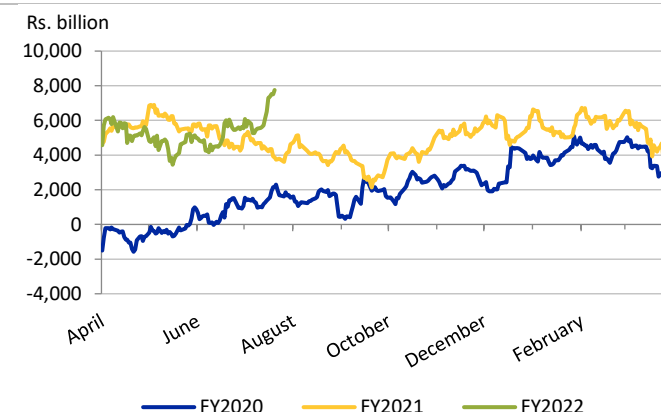
*Since detailed data is not available for March-April 2020, we have not excluded prices for petrol and diesel of vehicles in the calculation of the core-CPI index for the YoY inflation rates; Source: NSO; CEIC; ICRA research

The daily average liquidity surplus under the LAF increased from ~Rs. 4.9 trillion in Q1 FY2022 to ~Rs. 6.0 trillion in Q2 FY2022 (till August 5, 2021), due to robust liquidity operations conducted by the central bank

The MPC highlighted that while the Government has taken certain steps to ease supply constraints, further efforts are required to restore supply-demand balance. Accordingly, the fledgling recovery needs to be nurtured through fiscal, monetary and sectoral policy levers. It also emphasized that although the outlook for aggregate demand is improving, it remains feeble and clouded by the pandemic, and there is considerable slack in the economy, with output trailing the pre-pandemic level.

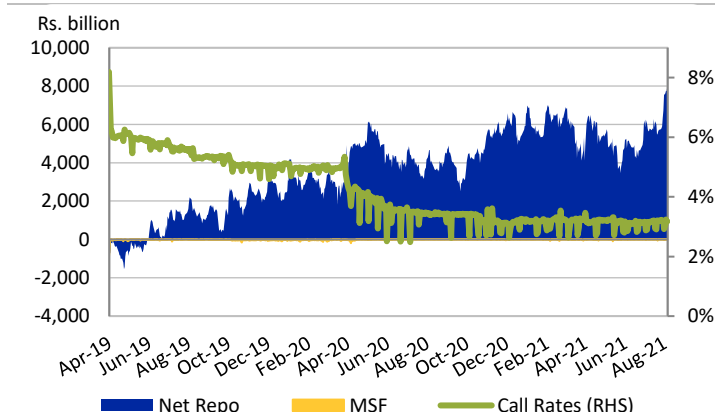
The Governor clearly stated that the RBI remains in 'whatever it takes' mode, referring to the desire to support the fledgling recovery. At the same time, the MPC resolution explicitly stated that the Committee is conscious of its objective of anchoring inflationary expectations. In our view, as domestic demand strengthens and starts dominating inflationary pressures in place of the current culprit of runaway commodity prices and supply constraints, the MPC will have to shift gears to prevent inflation expectations from unhinging.

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



*Data for FY2022 is available upto August 5, 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. 4.9 trillion in Q1 FY2022 to ~Rs. 6.0 trillion in Q2 FY2022 (till August 5, 2021), following the liquidity operations conducted by the central bank. On a monthly basis, it increased significantly from ~Rs. 4.8 trillion in June 2021 to ~Rs. 5.8 trillion during July 2021, partly benefitting from the net OMO purchases of Rs. 0.7 trillion conducted during the month (including two tranches of G-SAP 2.0 worth Rs. 200 billion each; refer Exhibit 3). Subsequently, the daily average liquidity surplus has increased to ~Rs. 7.5 trillion during August 2021 (till August 5, 2021). With the muted credit growth for large industries and general risk aversion in the system, the surplus liquidity parked by banks under Reverse Repo window stood at Rs. 8.8 trillion as on August 5, 2021.

The RBI decided to progressively hike the size of VRRR auctions to Rs. 4.0 trillion by end-September 2021

The RBI has injected net liquidity of Rs. 2.4 trillion through open market operations (OMO) of Government of India securities (G-secs) during FY2022 till now. Out of this, net OMO purchases of Rs. 0.6 trillion were conducted during April 2021, including Rs. 250 billion under the first tranche of G-SAP 1.0 conducted on April 15, 2021. Moreover, Rs. 0.4 trillion of net OMO purchases were conducted during May 2021, including Rs. 350 billion through the second tranche of G-SAP 1.0 on May 21, 2021. In addition, the Central Bank had conducted one Twist OMO of Rs. 100 billion on May 6, 2021.

Further, ~Rs. 0.8 trillion of net OMO purchases were conducted during June 2021, including Rs. 400 billion (which included open market purchases of SDLs worth Rs. 54.3 billion) through the third tranche of G-SAP 1.0 on June 17, 2021. Moreover, the RBI conducted outright OMO purchases worth Rs. 425.8 billion in June 2021.

Subsequently, during July 2021, the RBI conducted net OMO purchases of Rs. 0.7 trillion, including Rs. 200 billion each under the first and the second tranches of G-SAP 2.0 conducted on July 8, 2021 and July 22, 2021, respectively, and outright OMO purchases worth Rs. 263.5 billion. Further, it has announced two more auctions of Rs. 250 billion each under G-SAP 2.0 to be conducted on August 12, 2021 and August 26, 2021, respectively.

The RBI had commenced normal liquidity operations, with a resumption of the 14-day VRRR operations from January 15, 2021, for an amount of Rs. 2.0 trillion, that has been rolled over in the subsequent fortnightly auctions.

Following this, the average short terms rates, 91 days Treasury bills (T-bills), 182 days T-bills, and 364 days T-bills increased from 3.27%, 3.50% and 3.71%, respectively, in Q4 FY2021 to 3.39%, 3.61% and 3.77%, respectively, in Q1 FY2022. Further, in Q2 FY2022 so far (till August 4, 2021), 91 days T-bills, 182 days T-bills, and 364 days T-bills stood at 3.41%, 3.56% and 3.77%, respectively. Moreover, the daily weighted average call money rate increased marginally from 3.12% in Q1 FY2022 to 3.13% in Q2 FY2022 (till August 4, 2021; refer Exhibit 4), but remained below the Reverse Repo rate.

The RBI has now decided to progressively hike the size of VRRR auctions from the existing Rs. 2.0 trillion to Rs. 4.0 trillion by end-September 2021. The central bank would conduct VRRR auctions of Rs. 2.5 trillion on August 13, 2021, followed by Rs. 3.0 trillion on August 27, 2021, Rs. 3.5 trillion on September 9, 2021 and Rs. 4.0 trillion on September 24, 2021.

Notably, the Governor emphasized that enhanced VRR auctions should not be read as reversal of accommodative policy stance. With the substantial surplus in systemic liquidity conditions, the gradual incremental absorption through VRRR should not materially impact the near-term rates, in our view.

We expect the incremental demand to remain muted as the funding rates in the money market are much lower than the repo rate at which this TLTRO facility is given to banks by RBI.

Liquidity Coverage Ratio (LCR) for banks is much higher than the regulatory requirement and likely to remain so, even in absence of relaxation of the incremental MSF support.

The RBI's development and regulatory measures largely extend liquidity support for another quarter, even as systemic liquidity remains in substantial surplus. The Central Bank has largely held back from announcing any specific sectoral measures, similar to announcements seen during May 2021. In our view, RBI is likely to monitor the near term macro-economic recovery amidst uncertainty of a third Covid wave before announcing any further supportive measures.

1) Operating period of the On Tap TLTRO extended by a quarter

Given the continued economic uncertainty and the possibility of a third Covid-19 wave, the RBI has decided to extend the operating period of the targeted long-term repo operations (TLTRO) by an additional three months to December 31, 2021 from the earlier deadline of September 30, 2021. The On-Tap TLTRO scheme for Rs. 1.0 trillion had initially been announced on October 9, 2020, whereby the banks could borrow funds at the Repo rate from the RBI. The funds so borrowed from the Central Bank could be extended as credit to five sectors (agriculture, agri-infrastructure, secured retail, MSMEs and drugs, pharmaceutical and healthcare) and was initially available up to March 31, 2021. The scope of the scheme was later expanded to include stressed sectors identified by the Kamath Committee on December 4, 2020 and NBFCs on February 5, 2021. On April 7, 2021, the scheme had been extended till September 30, 2021.

Impact: As the economic recovery remain fragile amidst concerns of a resurgence in infections, the RBI has decided to extend the operating period for the TLTRO by a quarter. However, given the high liquidity levels and muted credit growth, the demand from banks under the TLTRO scheme has been muted at Rs. 53.2 billion, compared to the cap of Rs. 1.0 trillion. Incrementally, as the funding rates in the money market are much lower than the Repo rate, the extension in the deadline is unlikely to result in a meaningful demand from banks.

2) Marginal Standing Facility (MSF) relaxations deferred by a quarter

The RBI has announced an extension in the MSF relaxations to banks till December 31, 2021 from September 30, 2021. The MSF relaxation was first announced in [March 2020](#), under which banks were allowed to borrow under the MSF window by dipping into the Statutory Liquidity Ratio (SLR) by an additional 1% of Net Demand and Time Liabilities (NDTL) (cumulatively 3% of the NDTL). The dispensation will provide access to funds of Rs. 1.62 trillion rupees that will qualify for High Quality Liquid Assets (HQLA) and hence reported Liquidity Coverage Ratio (LCR) was expected to improve for banks.

Impact: The MSF relaxations were introduced amidst a failure of a private sector bank and the early onset of the first Covid-19 wave in March 2020. The measure was initially aimed at supporting banks' liquidity, given the expectations of reduced cash-inflows from borrowers because of the prevailing moratorium. Subsequently, deposit accretion for banks has been outpacing the credit growth leading to surplus liquidity levels and banks maintaining higher LCR levels in relation to the regulatory levels. Moreover, the excess liquidity has been deployed by banks in government bonds, thereby resulting in much higher holding of HQLAs. As a result, the LCR for banks is expected to remain higher than the regulatory requirement even in absence of relaxation of the incremental MSF support.

Deferral of some of the financial parameters to October 1, 2022 will provide relief to corporate borrowers who have availed restructuring.

3) Deadline for achieving financial parameters specified under the resolution Framework 1.0 extended

Taking cognizance of the impact of the delays in recovery of corporate borrowers because of the second wave of Covid-19, achieving financial parameters related to profitability in FY2022 could be a challenge for borrowers who availed of the restructuring. To address this stress, the RBI has announced a relaxation in the sector specific thresholds in respect of four out of the five ratios that are linked to the operational performance of the restructured entities. These four ratios are Total Debt to EBITDA ratio, Current Ratio, Debt Service Coverage Ratio and Average Debt Service Coverage Ratio. Restructured borrowers would have to demonstrate the achievement of these parameters by October 1, 2022 as against [March 31, 2022](#).

Impact: Extending the target date for meeting sector specific ratios notified by RBI considers the challenges faced by entities operating in stressed sectors because of the second wave. Breaching of these ratios or not rectified within a reasonable period of time could be treated as financial difficulty by lenders. In our view, the overall corporate restructuring is estimated to be ~Rs. 700 billion or 0.7% of the loan book of banks and the easing of deadline will stand to provide some relief to these borrowers as they have more time to meet these thresholds.

4) Review and amendment of LIBOR guidelines

In continuation to its [earlier directives](#) to banks and other participants in the financial market to phase out LIBOR and migrate to alternative reference rates (ARR) by December 31, 2021, the RBI has announced a set of amendments to guidelines. In this regard, the Central Bank has permitted banks to extend export credit in Foreign Currency using any other widely accepted ARR. Further, the RBI has allowed banks to treat the change in reference rate from LIBOR to an ARR as a 'force majeure' event for foreign currency derivative contracts.

Impact: The decision to migrate to ARR for export credit in foreign currency was largely along expected lines, given the earlier directives to shift to ARR by December 31, 2021. Further, as per the current guidelines that regulate derivative contracts, any change in contractual parameters would call for restructuring and necessitate recognition of mark-to market changes on the date of change. The RBI's decision to treat the change in the reference rate as a 'force majeure' event may provide some relief to banks and these contracts will not be classified as restructured. This could potentially reduce the negative impact on capital position of the banks, if such contracts would have been classified as restructured, as the off-balance sheet derivative contracts remain meaningfully large for many banks.



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