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Monetary policy | First cut

Balancing act

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Status quo on policy rates, new instruments to support financial conditions

Faced with renewed challenges to growth and inflationary pressures, the Reserve Bank of India-led (RBI) Monetary Policy Committee (MPC) kept repo rate unchanged in the today's meeting. It continued with its accommodative stance "as long as necessary" to ensure a durable economic recovery, especially since the second pandemic wave threatens the country's growth prospects. The central bank also chose to focus on supporting desired financial conditions through new instruments, the highlight being the 'G-sec acquisition programme' (GSAP) to ease yields on government securities (G-secs).

MPC's status quo was expected in view of growing pandemic-induced restrictions and uncertainty around the inflation trajectory. We believe the MPC will keep the repo rate unchanged and remain accommodative in the foreseeable future. Even as inflation remains a concern, the RBI will use the available policy space as innovatively as possible to support financial conditions.

Key takeaways from the meeting

- The MPC unanimously voted to keep policy rates unchanged, with the repo rate at 4%, reverse repo at 3.35%, and marginal standing facility at 4.25%
- It extended its accommodative stance, also unanimously, *"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 inflation remains within the target going forward"*
- The MPC believes the consumer price index-linked (CPI) inflation trajectory faces both upside and downside pressures. Its 5.2% forecast for the first half of this fiscal was slightly higher than the 5-5.2% estimated in February. For fiscal 2022 as a whole, it expects 5%, in line with CRISIL's forecast
- The gross domestic product (GDP) forecast was unchanged at 10.5% for this fiscal. While growth prospects have brightened post vaccination, the second pandemic wave has brought new uncertainties
- The RBI announced the GSAP, under which it will commit upfront a specific amount of open market purchases of G-secs. At the same time, it announced variable reverse repo operations to normalise liquidity at the shorter end of the yield curve

What weighed on the RBI's decision

- **Rising risks to growth**: The second pandemic wave has presented fresh obstacles to economic recovery. With the restrictions across the country intensifying, high-frequency indicators such as Google mobility and Purchasing Managers' Index manufacturing have started showing signs of weakness. The MPC also said consumer confidence has dipped with the recent rise in cases. That said, the MPC maintained rural demand remains buoyant. It is hopeful urban demand would strengthen with the ongoing vaccination. The government-driven capex push also augurs well for industry. While global growth is recovering gradually, it will depend on the pace of vaccine distribution. With these factors in view, the MPC kept the GDP forecast unchanged at 10.5% for this fiscal

- **Inflation uncertainty**: While headline CPI inflation has managed to come within the RBI's target range of 2-6% in 2021, it continues to face pressures from rising input prices. Moreover, core CPI inflation, which was already above 5% in the pandemic-hit 2020, reached a 28-month high of 6% in February 2021. While high petrol and diesel prices have primarily contributed to the rise, firms are also increasingly passing rising input costs to consumers since demand had picked up. The MPC believes inflation faces upside and downside pressures. It maintained rising commodity prices and logistics costs will put input price pressures across manufacturing and services. However, it expects bumper agriculture production to bring down food inflation. It suggested inflation can be capped by reducing taxes on petrol and diesel, and duties on critical import items such as edible oil.

  Overall, the MPC forecast CPI inflation at 5.2% in the first quarter of this fiscal (Q1), 5.2% in Q2, 4.4% in Q3, and 5.1% in Q4

- **Tightening financial conditions**: The RBI remains concerned about benchmark government bond yields, which have risen over the past two months. Bond markets are bracing for yet another year of high government borrowing. Moreover, yields have started rising globally, led by the United States as it begins to roll out its large fiscal stimulus. Even as the central banks of major advanced economies remain accommodative, investors fearing a rapid rise in inflation have begun withdrawing from emerging markets.

  Some emerging markets such as Brazil, Russia and Turkey have even started hiking their policy rates in response to rapid depreciation of their currencies. However, the situation is different in India. Here, the central bank is worried rising interest rates could tighten financial conditions. It believes rising G-sec yields in particular could also put pressure on financial segments that use G-secs as the benchmark.

  Hence, it introduced the GSAP, under which it will commit in advance a specific amount of G-secs to be purchased under secondary market open market operations (OMOs). For Q1, it has announced a GSAP of Rs 1 lakh crore

- **Impact of surplus liquidity at short-end:** Even as the RBI has begun normalising liquidity in the financial system through variable rate reverse repo (VRRR) operations, and two-phase restoration of cash reserve ratio to 4% by May, liquidity remains in surplus. Money market rates, including call money, 91-day and 364-day Treasury bills, remained below the repo rate till March.

  To correct this, the RBI announced VRRRs of maturities longer than 14 days. The amount and tenure of these auctions will be based on evolving liquidity conditions. The RBI maintained that liquidity will remain comfortable to ensure conducive financial conditions

Our view

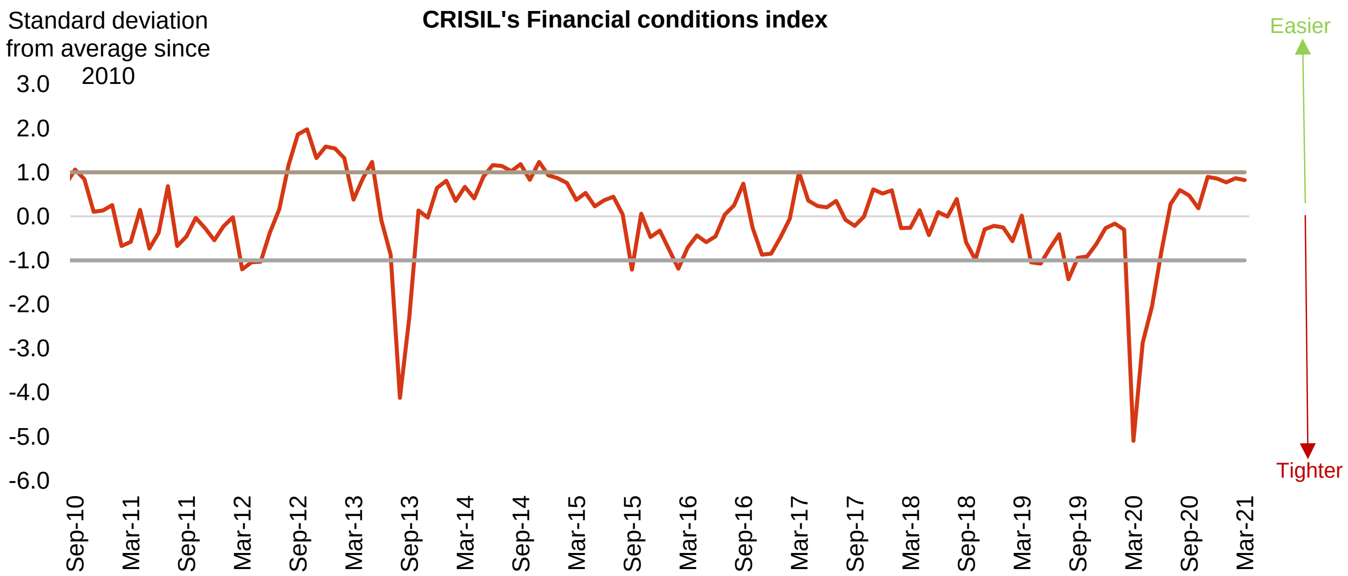
The RBI faces a tough road ahead – it needs to keep inflation within its target while supporting an economic recovery that faces renewed risks from surging Covid-19 cases. While we expect reduced food inflation will keep overall CPI inflation lower than in fiscal 2021, there are inflationary pressures on fuel and core inflation. The degree of pass-through of rising input prices to consumers will remain a key monitorable. On average, we expect CPI inflation at 5% in fiscal 2022 compared with ~6.2% in April 2020-February 2021.

We believe the MPC will keep the repo rate unchanged and the stance accommodative in the foreseeable future. Even as inflation continues to face pressures, the RBI will use other innovative tools to support financial conditions. It is using liquidity instruments to correct for the abnormally low short-term interest rates, while creating space to support longer-term bond yields through OMOs. Return of the current account deficit this fiscal will further reduce the liquidity overhang on account of surplus external flows.

We expect 10-year bond yields to harden to 6.5% by March 2022, and bank credit growth at 9-10% in the current fiscal.

Despite the recent rise in global yields, overall financial conditions remain accommodative, as shown by CRISIL's Financial Conditions Index below.

RBI's recent measures will lend further support to easy financial conditions



Source: CRISIL

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