

RBI Monetary Policy: Status quo on rates; Inflation/growth forecasts upgraded

In the last meeting of this calendar year, the Monetary Policy Committee (MPC) of the RBI unanimously decided to keep policy rates unchanged in the bi-monthly policy review. This was on expected lines as persistence of inflation **trajectory above the RBI's target range and nascent signs of economic recovery had left the RBI with limited room** to cut rates at this juncture. That said, the MPC provided reassurance of maintaining an accommodative stance in the current as well as next financial year and using all available monetary policy tools at its disposal to ensure a durable revival in economic growth. This was despite significant upward revisions in inflation (6.3% in H2FY21 vs. 5.4-4.5% estimated earlier) and growth (-7.5% in FY21; our est. at -8%—detailed note [here](#)) forecasts, clearly underscoring the priority of supporting growth over a supply-led spike in inflation. Additionally, no change in the **RBI's stance** on liquidity management, particularly in the wake of persistence of money market rates below the reverse repo rate, further aided market sentiments.

The policy also focused on a slew of developmental and regulatory measures to a) enhance liquidity support by extending On Tap TLTROs (Targeted Long-term Repo Operations) to 26 stressed sectors identified by the Kamath Committee and permitting Regional Rural Banks (RRBs) to access call/notice money and liquidity windows of the RBI, b) ensure financial stability by disallowing banks to pay dividends for FY20, formulating guidelines on dividend distribution by NBFCs, strengthening audit systems of supervised entities, and imposing security controls on digital payments, c) deepen financial markets by taking steps to develop interest rate and currency derivatives, and d) boost external trade by liberalising extant policies pertaining to certain export transactions.

With inflation expected to remain above or closer to the upper bound of RBI's target range in the foreseeable future, further rate cuts are ruled out in this fiscal year. Rate cut action in the next financial year would be contingent on a durable reduction in inflation trajectory. The RBI for now is expected to continue to focus on liquidity management to facilitate ongoing monetary transmission and revive growth in a credible manner.

- RBI keeps policy rates unchanged; maintains an accommodative stance: In the wake of persistence of inflation **trajectory above the RBI's tolerance band** over the last seven months and nascent signs of economic recovery, the **RBI's MPC** unanimously decided to maintain status quo on policy rates in its bimonthly review meeting and awaits an opportune time to utilise the available policy space. As such, the repo, reverse repo and bank/Marginal Standing Facility (MSF) rates remain unchanged at 4.0%, 3.35% and 4.25% respectively. The commentary, however, remained dovish with the MPC a) reassuring maintenance of an accommodative stance in the current as well as next financial year, b) using all available monetary policy tools at its disposal to ensure a durable revival in economic growth, and c) keeping its stance on liquidity management unchanged despite persistence of money market rates below the reverse repo rate for quite some time now.
- Inflation forecasts revised upwards: Recent inflation trajectory has surprised on the downside, thanks to persistence of supply-chain bottlenecks and strengthened cost-push pressures emanating from higher indirect taxes and excessive margins. While vegetable and cereal prices are expected to come off, prices of other food categories are expected to remain elevated over the coming months. A pick-up in crude oil prices have also added to inflation woes. Core inflation has remained quite sticky and may harden further as demand picks up. Accordingly, the RBI expects inflation to harden from an earlier estimate of 5.4-4.5% to an average of 6.3% in H2FY21 (6.8% in Q3FY21 and 5.8% in Q4FY21). Headline inflation in H1FY22 is also expected to remain well **above the RBI's mid-point target** at 5.2-4.6%. Importantly, the RBI called out for proactive supply management strategies to break the inflation spiral.

The RBI expectedly kept policy rates unchanged but provided reassurance of maintaining an accommodative stance in the foreseeable future.

The RBI has revised inflation and growth forecasts upwards.

Inflation is expected to remain Headline inflation is expected to ease to 5.4% in Q3FY21 and 4.5% in Q4.

- GDP growth in FY21 expected at -7.5%: A strong improvement in several high-frequency indicators, many of which are now back to pre-COVID levels, and a higher-than-expected Q2FY21 GDP print led to the RBI revising its FY21 GDP growth estimate upwards to -7.5% from -9.5% estimated earlier. This is a tad lower than our estimate of -8% for the current financial year (please refer to our report titled [Q2FY21 GDP points to a strong recovery; FY21E revised up to -8.0%](#)). Unlike earlier expectation of growth entering positive territory by fourth quarter of this fiscal year, the RBI now expects growth to turn positive in the second half itself, with Q3FY21 and Q4FY12 GDP growth pegged at +0.1% and +0.7% respectively. In FY22, GDP growth is pegged at 21.9% in Q1FY22 and 6.5% in Q2FY22. Despite an improvement in economic outlook, the RBI doesn't see the underlying recovery as broad-based in nature, thereby requiring continued policy support.
- Additional measures: The policy also focused on a slew of developmental and regulatory measures to a) enhance liquidity support by extending On Tap TLTROs (Targeted Long-term Repo Operations) to 26 stressed sectors identified by the Kamath Committee and permitting Regional Rural Banks (RRBs) to access call/notice money and liquidity windows of the RBI, b) ensure financial stability by disallowing banks to pay dividends for FY20, formulating guidelines on dividend distribution by NBFCs, strengthening audit systems of supervised entities, and imposing security controls on digital payments, c) deepen financial markets by taking steps to develop credit default swaps based on market feedback and reviewing extant guidelines related to interest rate and currency derivatives to improve efficiency while ensuring high governance standards at the same time, and d) boost external trade by liberalising extant policies pertaining to certain export transactions including delegation of more powers to authorised dealer banks to regularise export shipments, write-off unrealised export bills, allow setting-off of export receivables against import payables by Indian companies and consider refund requests of export proceeds without insisting on import of goods.
- Rate cuts unlikely in the foreseeable future: **The RBI's decision to keep surplus liquidity unchanged, along with reassurance of maintaining an accommodative stance for as long as necessary (current and next financial year), is expected to further aid monetary transmission across the board, thereby ensuring a durable revival in economic growth. With headline retail inflation expected to remain above or closer to the upper bound of RBI's target range in the foreseeable future, any rate cut action is ruled out in the rest of this fiscal year. Space for rate cuts by another 25-50bps may open in the next financial year provided inflation trajectory subsides on a durable basis. Until then, the RBI's focus is likely to remain on ensuring adequate liquidity in the system.**

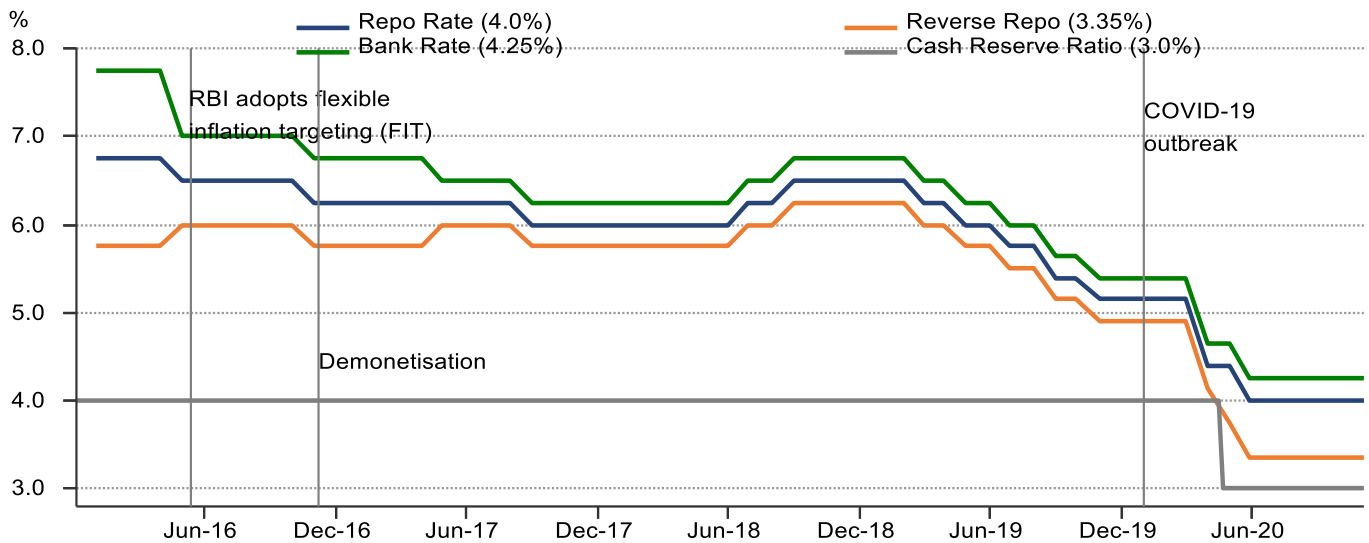
Rate cut action is ruled out at least in the current financial year, with any easing thereon to be contingent on a durable reduction in inflation trajectory.

Figure 1: Current policy rates

Key rates	Current value
Repo Rate	4.0%
Reverse Repo Rate	3.35%
Marginal Standing Facility (MSF) Rate	4.25%
Bank Rate	4.25%
Cash Reserve Ratio (CRR)	3.0%
Statutory Liquidity Ratio (SLR)	18.0%

Source: RBI

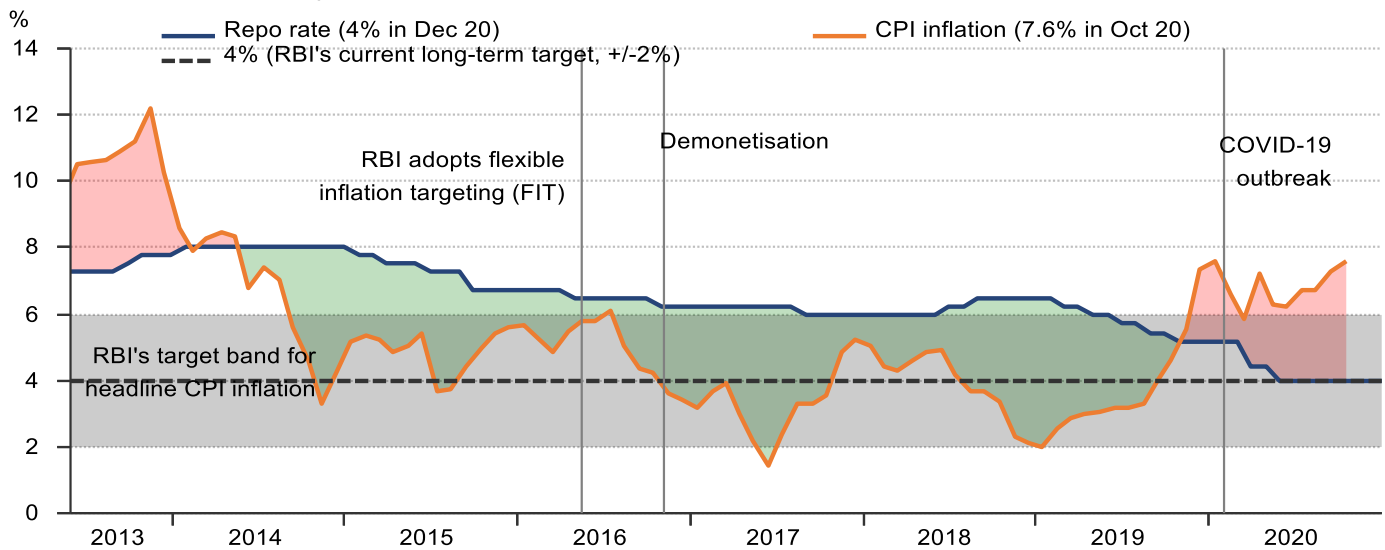
Figure 2: Policy rates kept unchanged



Source: Refinitiv Datastream.

Figure 3: India headline Consumer Price Inflation (CPI) and real interest rates

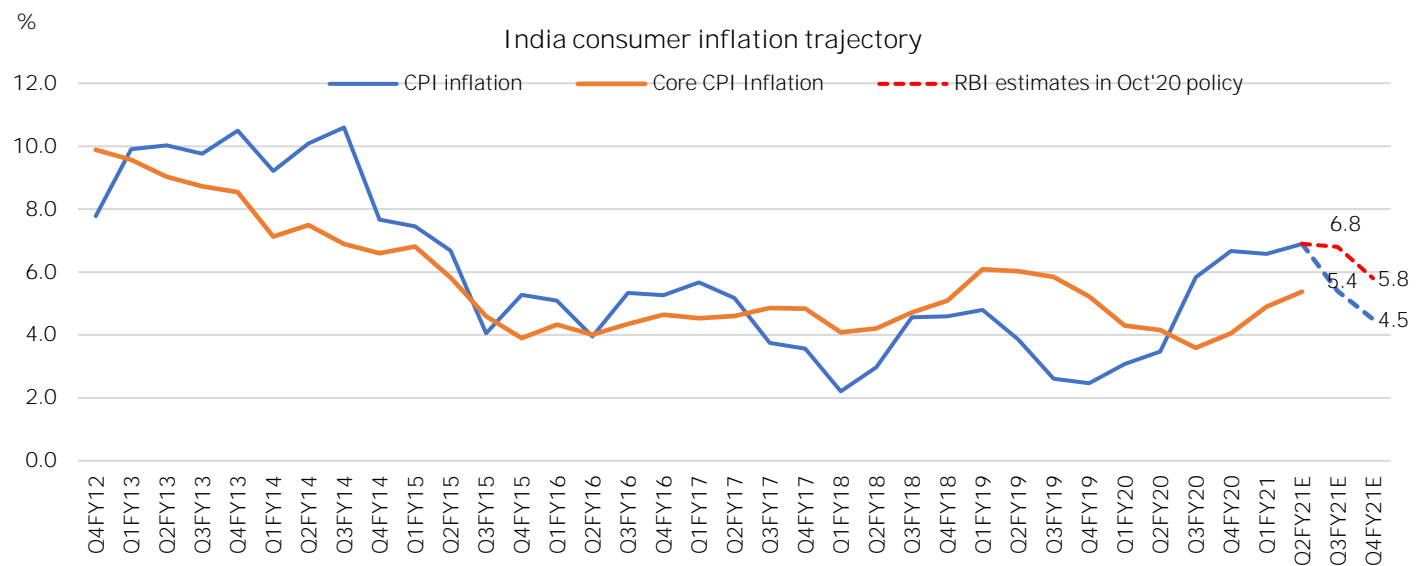
India headline CPI inflation has remained above the upper-bound of RBI's target range of 4% +/- 2% since the last seven consecutive months and over 10 out of last 11 months. This has translated into persistence of negative real interest rates for almost a year now.



Source: Refinitiv Datastream.

RBI expects inflation to remain elevated: Recent inflation trajectory has surprised on the downside, thanks to persistence of supply-chain bottlenecks and strengthened cost-push pressures emanating from higher indirect taxes and excessive margins. While vegetable and cereal prices are expected to come off, prices of other food categories are expected to remain elevated over the coming months. A pick-up in crude oil prices have also added to inflation woes. Core inflation has remained quite sticky and may harden further as demand picks up. Accordingly, the RBI expects inflation to harden from an earlier estimate of 5.4-4.5% to an average of 6.3% in H2FY21 (6.8% in Q3FY21 and 5.8% in Q4FY21). Headline inflation in H1FY22 is also expected to remain well above the RBI's mid-point target at 5.2-4.6%. Importantly, the RBI called out for proactive supply management strategies to break the inflation spiral.

Figure 4: RBI expects headline CPI inflation to harden to an average of 6.3% in H2FY21

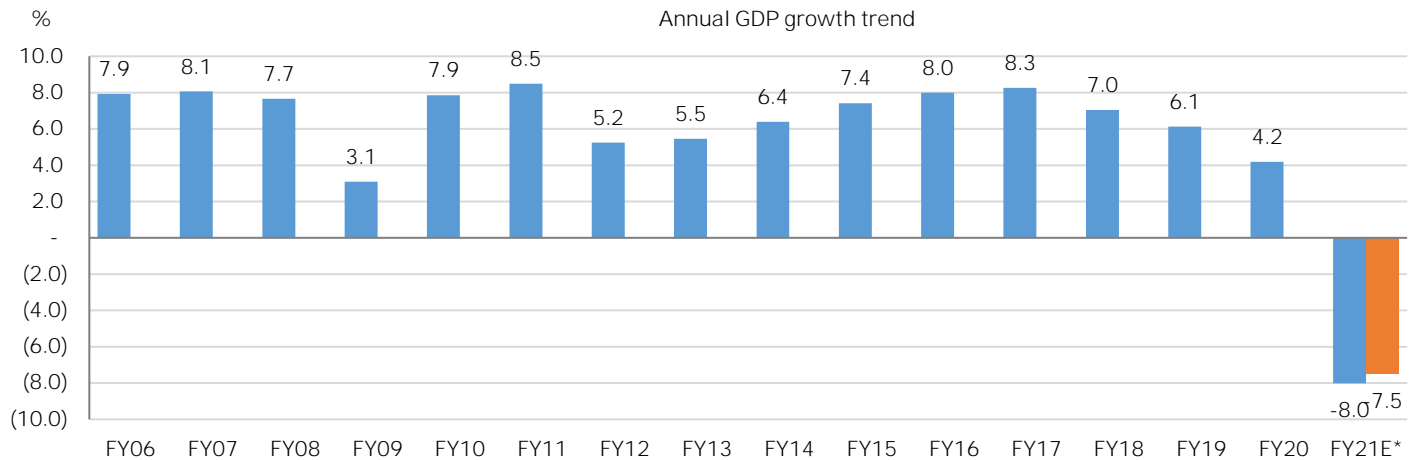


Source: RBI. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

FY21 GDP expected to now contract by 7.5% vs. -9.5% estimated earlier: The RBI had estimated a GDP contraction of 9.5% in FY21 in the October policy review, assuming a gradual normalisation of economic activity in H2FY21, and expected growth to return in the positive zone by Q4FY21. However, a meaningful pick-up in high-frequency indicators—many of which are now back to pre-COVID levels, and a much lower-than-expected contraction in Q2FY21 (-7.5% vs. market expectations of -8.2%) led to the RBI revising its GDP growth forecast upwards for FY21. The RBI now expects GDP to contract by a much lower 7.5% in FY21, a tad better than our estimate of -8%.

Unlike earlier expectation of growth entering positive territory by fourth quarter of this fiscal year, the RBI now expects growth to turn positive in the second half itself, with Q3FY21 and Q4FY21 GDP growth pegged at +0.1% and +0.7% respectively. In FY22, GDP growth is pegged at 21.9% in Q1FY22 and 6.5% in Q2FY22. Despite an improvement in economic outlook, the RBI doesn't see the underlying recovery as broad-based in nature, thereby requiring continued policy support.

Figure 5: GDP growth trend and estimates for FY21

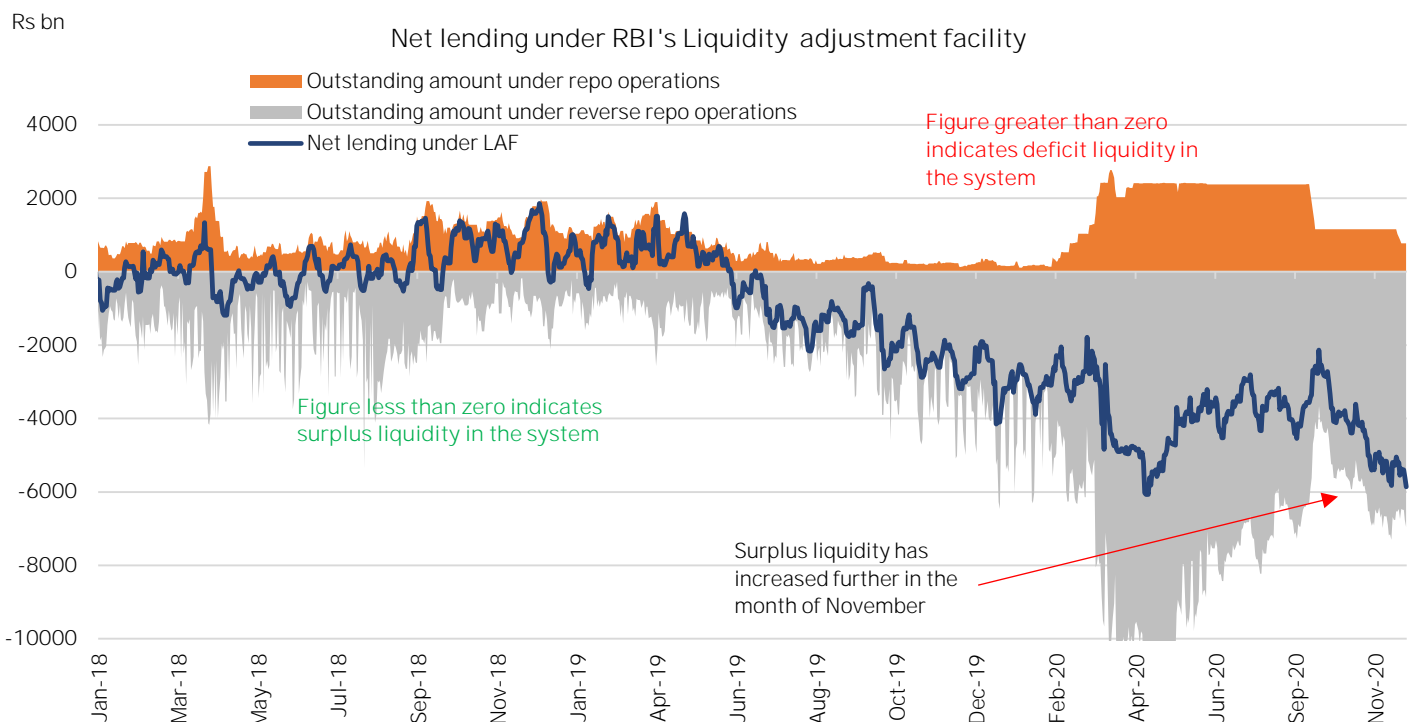


Source: RBI, NSE. * Blue bar for FY21 is NSE's estimate and orange bar is RBI's estimate.

Liquidity support to remain a preferred route to support economic growth: The RBI's decision to keep surplus liquidity unchanged, along with reassurance of maintaining an accommodative stance for as long as necessary (current and next financial year), is expected to further aid monetary transmission across the board, thereby ensuring a durable growth revival. With headline retail inflation expected to remain above or closer to the upper bound of RBI's target range in the foreseeable future, any rate cut action is ruled out in the rest of this fiscal year. Space for rate cuts by another 25-50bps may open in the next financial year provided inflation trajectory subsides on a durable basis. Until then, the RBI's focus is likely to remain on ensuring adequate liquidity in the system.

 Figure 6: **Net lending under RBI's Liquidity Adjustment Facility**

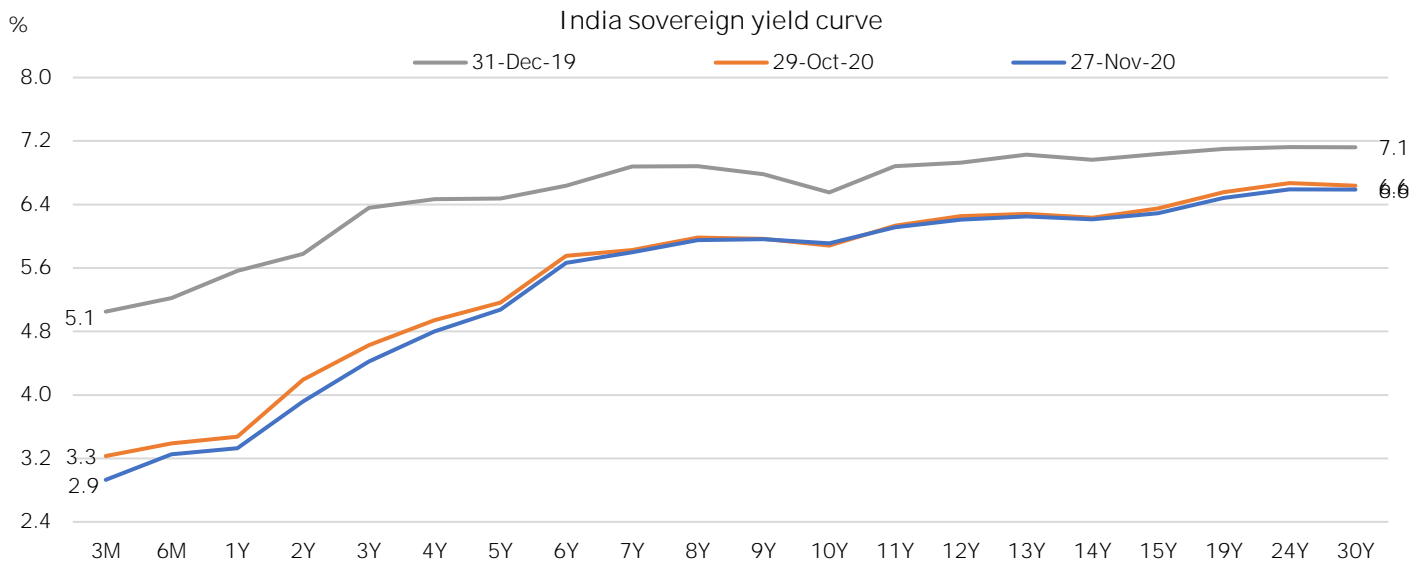
Surplus liquidity in the system widened meaningfully in October and further in November following a drop in September in the wake of advance tax-related outflows. New lending under LAF widened from an average of Rs3.3trn in September to Rs4.1trn in October and further to Rs5.3trn in November.



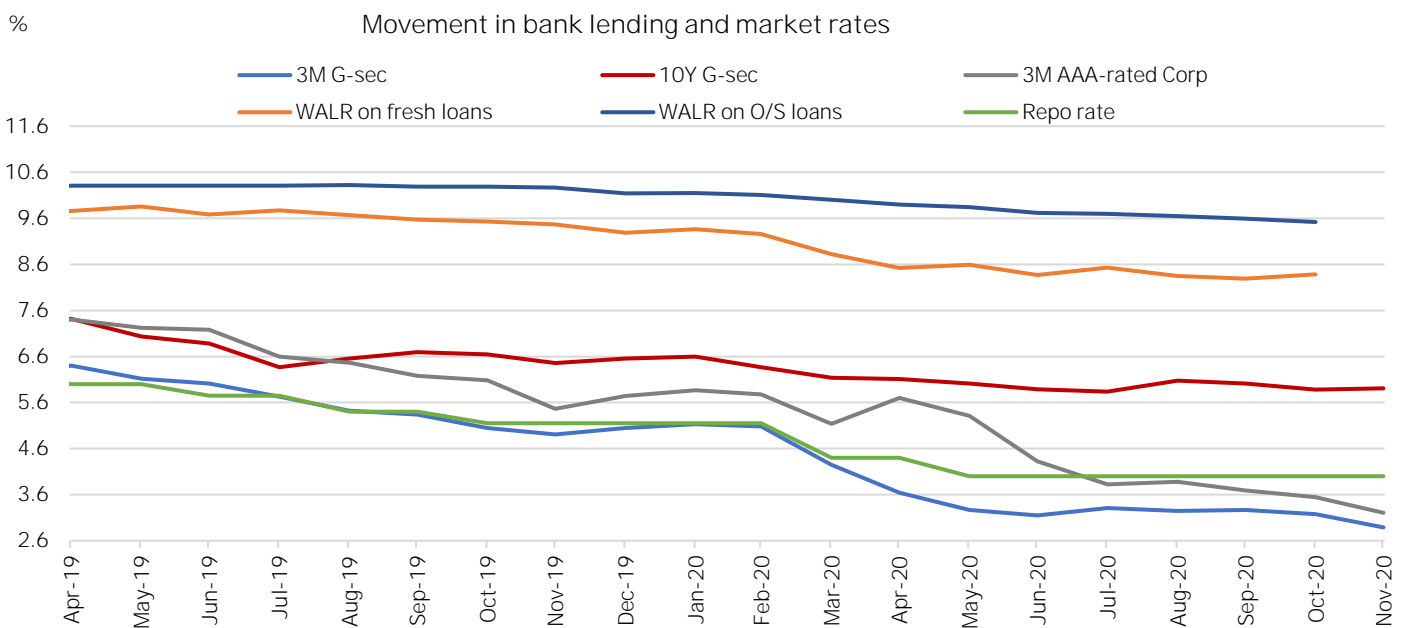
Source: CMIE Economic Outlook, NSE

Figure 7: India sovereign yield curve

The India sovereign yield curve has fallen sharply this year across tenors, even as the falls has been far steeper at the short-end of the curve. The long-end of the curve, however, hasn't fallen much, reflecting strained Government's fiscal balances.

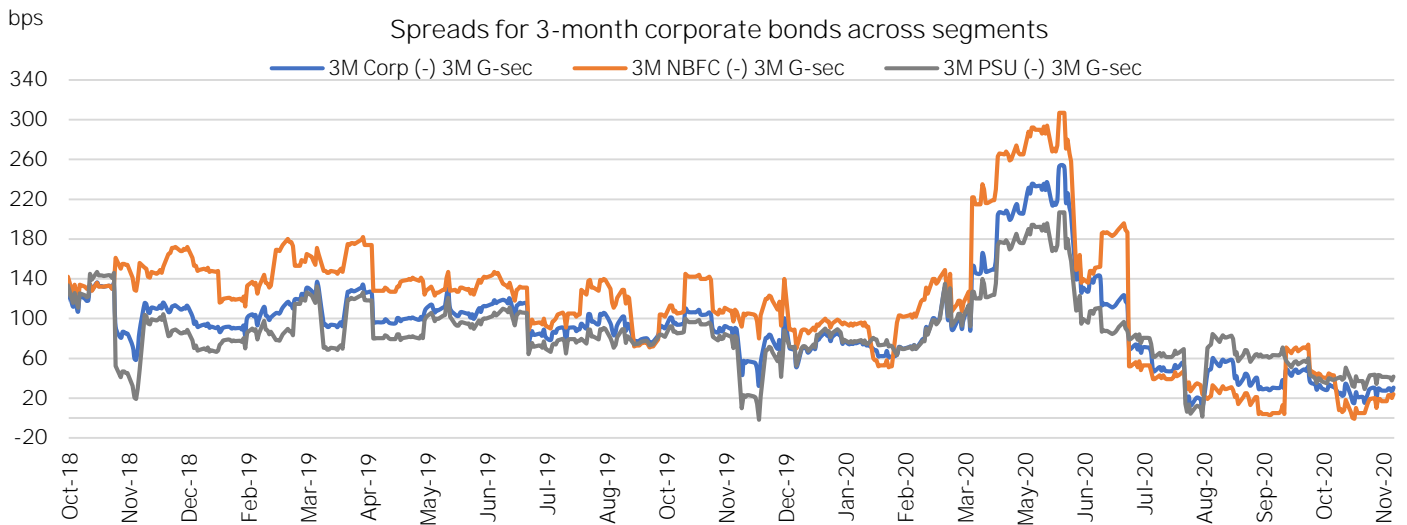


Source: Refinitiv Datastream, NSE.

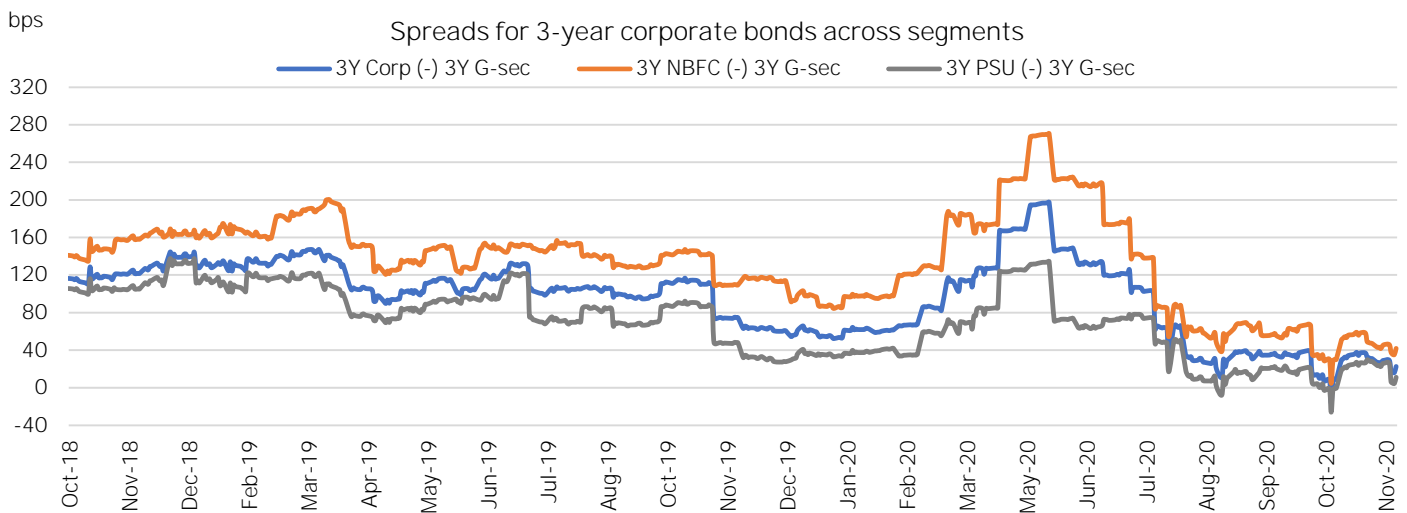
Figure 8: Movement in bank lending rates and market rates vs. policy repo rate


Source: RBI, Refinitiv Datastream, NSE.

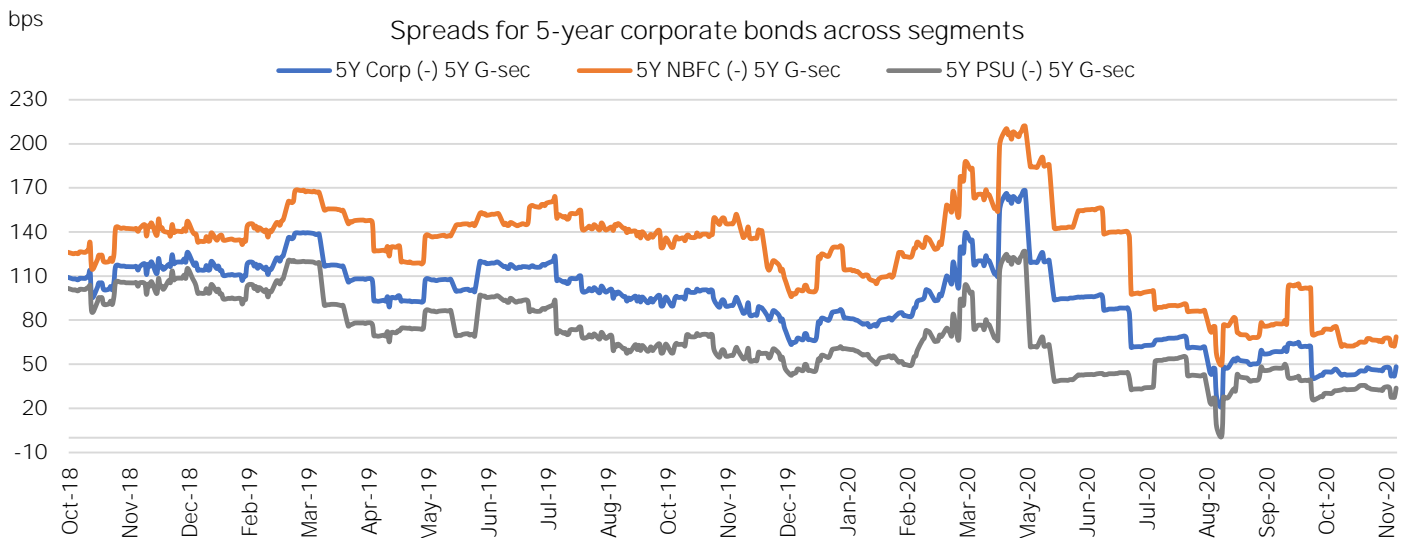
A huge access liquidity in the system, thanks to a slew of measures taken by the RBI over the last few months, has resulted in a sharp fall in interest rates across the spectrum, thereby resulting in significant narrowing of credit spreads.

Figure 9: Spreads for 3-month corporate bonds across segments


Source: Refinitiv Datastream, Bloomberg, NSE.

Figure 10: Spreads for 3-year corporate bonds across segments.


Source: Refinitiv Datastream, Bloomberg, NSE.

Figure 11: Spreads for 5-year corporate bonds across segments


Source: Refinitiv Datastream, Bloomberg, NSE.

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