

Monetary policy | **First cut**

Calibrated normalisation

August 6, 2021

RBI keeps key rates unchanged, inches towards reducing excess liquidity

The Reserve Bank of India (RBI)'s Monetary Policy Committee (MPC) kept its policy rates and accommodative stance unchanged in today's meeting. It held economic recovery post second wave of the Covid-19 pandemic was still nascent and maintained that the shadow of rising inflation would pass. But its announcement of greater absorption of surplus liquidity through variable rate reverse repo (VRRR) operations could be read as the beginning of its imminent exit from unconventional monetary easing.

The RBI has reiterated its support to economic recovery as of now by maintaining low rates and conducive financial conditions. However, with growth expected to gain momentum in the second half of this fiscal, and inflation remaining elevated, we expect monetary policy to tighten in the coming months. The US Federal Reserve is also expected to begin tapering bond purchases by end-2021, further reducing scope for the RBI to continue its present policy stance. We therefore, expect a hike in repo rate by 25 basis points (bps) by end-fiscal 2022.

Key takeaways from today's monetary policy

- The MPC unanimously voted to keep policy rates unchanged, with the repo rate at 4%, reverse repo at 3.35%, and marginal standing facility (MSF) at 4.25%
 - It voted to maintain its accommodative stance, with a 5-1 majority, "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 inflation remains within the target going forward"
 - Consumer price index (CPI)-based inflation projection for fiscal 2022 was revised up to 5.7% from 5.1% previously. However, the MPC maintained that the current spike in inflation was transitory
 - The MPC retained gross domestic product (GDP) growth forecast at 9.5% for this fiscal
 - The RBI announced plans to increase absorption of liquidity under VRRR from Rs 2 lakh crore at present to Rs 4 lakh crore by September 2021
 - It announced bond purchases of Rs 50,000 crore for August under its G-Sec acquisition programme (GSAP 2.0). No further announcement was made for the next quarter
 - It extended targeted liquidity provision schemes such as on-tap targeted long-term repo operation (TLTRO) and relaxation under MSF until December 2021
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What weighed on RBI's decision

- **Sustained signs of economic recovery not yet in sight:** Like other major central banks, the RBI continues to prioritise growth over inflation till date, given the “nascent and fragile” economic recovery and risk of subsequent Covid-19 waves. However the MPC noted that the economy is in a much better position than viewed in the June meeting, as indicated by improving high frequency indicators such as e-way bills, steel consumption, import of capital goods and vehicle sales. Manufacturing has rebounded post second wave, as indicated by purchasing managers' index (PMI) moving to expansionary territory in July. However, services PMI remains in contractionary zone. The MPC believes that recovery remains uneven and needs support through coordinated fiscal-monetary action.

Going ahead, the MPC expects recovery to gain momentum as vaccinations pick up pace and pandemic-induced restrictions are eased further. Rural demand is expected to remain resilient with normal monsoon auguring well for agricultural production. Exports are already buoyant on strong global growth. Investments are expected to revive with improving capacity utilisation of firms and pickup in government capital expenditure. That said, headwinds from high commodity prices and financial market volatility would need to be monitored.

Considering these factors, the RBI retained GDP growth forecast at 9.5% for fiscal 2022, with 21.4% growth expected in first quarter (Q1), 7.3% in Q2, 6.3% in Q3 and 6.4% in Q4.

- **Inflationary pressures expected to subside:** The MPC believes that the recent rise in inflation is transitory and driven by temporary demand-supply mismatches. Although CPI inflation remained above the tolerance band of 2-6% for the past two months, sequentially, it slowed in June. Moderation in core inflation in June further comforted the MPC, though it remained above 6%.

The MPC expects inflation to ease, driven by lower food inflation owing to: (1) pickup in monsoon and kharif sowing, easing cereal prices (2) recent government interventions to lower prices of edible oils and pulses. However, the worry remains on elevated global commodity prices, which have raised costs in manufacturing and services sectors. Nevertheless, the MPC expects the pass-through to consumer prices to be limited, given the weak demand conditions.

Taking this into account, the MPC revised up CPI inflation forecast from 5.1% (estimated earlier) to 5.7% for fiscal 2022 (5.9% in Q2, 5.3% in Q3, and 5.8% in Q4).

- **Need to align financial conditions with external developments:** The RBI acknowledged that global financial conditions have become volatile over the past two months, with rising inflation raising fears of premature policy normalisation by major central banks. The impact of an adverse global financial shock, coupled with persisting worry on inflation, has prompted the RBI to gradually start withdrawing excess liquidity. While it had already begun absorbing Rs 2 lakh crore every fortnight through 14-day VRRR from January 2021, it announced a calibrated increase in quantum of absorption in today's meeting – to Rs 2.5 lakh crore on August 13, Rs 3 lakh crore on August 27, Rs 3.5 lakh crore on September 9 and Rs 4 lakh crore on September 24.

The RBI also announced more bond purchases aggregating Rs 50,000 crore under GSAP 2.0 in August. This was already accounted for under Rs. 1.2 lakh crore announced for Q2 in the June meeting.

Continuing its focus on providing targeted liquidity to stressed segments, the RBI further extended the deadlines for availing of on-tap TLTRO and relaxation under MSF up to December 31, 2021.

Our view

The RBI is taking baby steps in the direction of exit from an extremely easy monetary policy over the past one year, by a calibrated withdrawal of liquidity from the banking system. We expect monetary policy normalisation to gain pace as the central bank sees more definitive signs of economic recovery.

Inflation will remain a persisting concern driven by elevated global commodity prices. Global prices of metals and edible oils remain at decadal highs, while Brent crude oil prices are above \$70 per barrel mark – the highest since 2019. Unlike advanced economies such as the US, inflation in India is already on a high base of last year. Crucially, recent domestic inflation data indicates that firms are passing on rising input costs to consumers despite weak demand. This trend could accelerate as domestic demand recovers in the second half of this fiscal. Inflation expectations have also been rising since March, persistence of which could raise pressure on RBI to normalise policy.

Policy normalisation by other major central banks will further constrain RBI's policy space. S&P Global expects the US Fed to begin tapering of its bond purchases by end of calendar year 2021. Many emerging markets such as Brazil, Russia and Turkey have already moved ahead of the Fed in tightening policy.

Taking these factors into account, we expect the MPC to raise repo rate by 25 bps to 4.25% by end of this fiscal.

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