Monetary policy | First cut

Staying accommodative

February 10, 2022

RBI keeps policy rates unchanged, banking on easing inflation

The Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC) kept policy rates unchanged and stance accommodative at its review meeting today. Policy rates have been left untouched since the start of the pandemic, and the gap of 65 basis points (bps) between repo rate and reverse repo rate remains well wider than the 25 bps seen before the pandemic. The central bank believes it has the space to remain accommodative, expecting inflation to move within its target range of 2-6%, and even falling next fiscal.

Monetary policy remains inclined towards supporting growth. The RBI believes it has space to stay accommodative based on the expectation that headline inflation will stay within its target range. However, with growth recovering from the brief impact of the third Covid-19 wave and becoming more broad-based next fiscal, the RBI could soon turn towards managing rising risks from external factors. Surging crude oil prices pose a risk to major macros in the Indian economy, including inflation. The US Federal Reserve is expected to raise rates six times in 2022 — the fastest pace since the 2008 Global Financial Crisis. Given this, we expect the RBI to start raising the repo rate next fiscal. We foresee three rate hikes of 25 bps each, with the first move in April.

Highlights of the February monetary policy

- The MPC voted unanimously to keep the repo rate unchanged at 4%. Reverse repo rate was maintained at 3.35%, and marginal standing facility at 4.25%
- It voted 5-1 to continue the accommodative stance
- The MPC has projected gross domestic product (GDP) growth at 7.8% in fiscal 2023, compared with 9.2%[1] in the current fiscal
- MPC expects consumer price index (CPI)-based inflation reduce to 4.5% in fiscal 2023 compared 5.3% in fiscal 2022
- The RBI will have a dynamic approach to managing liquidity in accordance with the liquidity management framework of February 2020
- The limit on foreign portfolio investment (FPI) in the debt market through the voluntary retention route (VRR) will be increased from Rs 1.5 lakh crore at present to Rs 2.5 lakh crore from April 2022
- On-tap liquidity facility for contact-intensive sectors and emergency health services will be extended from March 2022 to June 2022

[1] First Advance Estimate by National Statistical Office (NSO)

What drove the RBI's decision?

- **Gradual economic recovery**: With 9.2% GDP growth estimated for fiscal 2022, GDP level will be just 1.3% above the pre-pandemic level seen in fiscal 2020. Recovery remains uneven, with household consumption and contact-intensive services expected to grow slower than pre-pandemic levels this fiscal. The MPC was concerned about the recent softening of economic activity amid the third wave, as indicated by the Purchasing Managers Index (PMI), two-wheeler, passenger vehicle and tractor sales, consumer durables and air traffic. However, it believes impact of the third wave to be temporary. Going forward, growth is expected to be supported by healthy agriculture output, increased government's capital expenditure, robust exports, improving capacity utilisation, conducive liquidity conditions, and pick up in credit growth. However, it sees downside risks from surging crude oil prices, global supply disruptions, and volatile global financial conditions.

  Considering these factors, the MPC felt the policy needs to stay accommodative to nurture recovery.

- **Inflation within the target**: Since the last MPC meeting, CPI inflation has risen to 5.6% in December 2021 from 4.9% in November, but remained below the upper limit of RBI's target range. The MPC expects inflation to peak in the last quarter (Q4) of this fiscal at 5.7%, subsequently easing in fiscal 2023 to 4.9% in Q1, 5% in Q2, 4% in Q3 and 4.2% in Q4. Thus, the MPC has projected inflation to remain within its target until next fiscal, which has given it the confidence to continue with the accommodative policy.

  The MPC expects the easing in inflation to be driven by food, with monsoon assumed to be normal, adequate food buffer stocks, easing vegetable prices, and government's supply side interventions softening pulses and edible oil prices. It views the outlook on crude prices to be uncertain, with upside risks from geopolitical developments. While the MPC is worried about elevated core inflation, it believes weak demand can limit pass-through of cost pressures to consumers.

- **Resilience to external shocks:** The governor noted that global financial conditions are turning volatile on account of changing monetary policies by other central banks, surging crude oil prices, and geopolitical tensions, which could spill-over to emerging markets. However, he observed that rupee has not been affected much despite rising global shocks. The central bank believes high foreign exchange reserves and modest current account deficit help Indian economy tide over impact of adverse external shocks. Domestic monetary policy can, hence, be driven in accordance with domestic macroeconomic developments.

  However, while keeping policy rates unchanged, the RBI highlighted the need to continue normalising liquidity in a calibrated manner. The management of liquidity will now be done in accordance with the liquidity management framework adopted in February 2020, but suspended after the pandemic. Under this framework, variable repo operations of varying tenures will be conducted as and when warranted, with the 14-day one being the main tool for liquidity management. The approach to liquidity management will be dynamic, as per the evolving financial conditions.

Our view

Since the previous monetary policy meeting, risks have increased from the external front. First, Brent crude prices have jumped from $74.3 per barrel on average in December 2021 to over ~$90 now[2]. CRISIL Research expects it to average $80-85 in 2022, the highest since 2015. Elevated crude oil prices have an adverse impact on India's macros such as the current account deficit, inflation, GDP growth, and in some cases, the fiscal deficit.

[2] As on February 9

In the past, the RBI has raised rates when crude oil prices rose, such as in 2010 (150 bps cumulative hike in repo rate), 2011 (225 bps), and 2018 (50 bps).

Second, the US Federal Reserve is expected to raise its policy rate at the fastest pace seen after the Global Financial Crisis. S&P Global expects six Fed rate hikes in 2022 itself (starting March), followed by five more in the next two years. The Fed will have taken seven years after the Global Financial Crisis to raise its funds rate for the first time, and two years after Covid-19 pandemic began. The projected number of hikes in 2022 are also much higher than seen at the peak of Fed tightening after the Global Financial Crisis (four hikes in 2018). Peak tightening in 2018 had coincided with repo rate hikes by the RBI.

The primary target of RBI – CPI inflation — remains within its comfort band of 2-6%. However, it faces upside risks from rising crude oil prices. This is expected to be partially offset by lower excise duties on fuel compared with last year. Meanwhile, we believe firms facing sustained cost pressure would pass it on to a great extent to consumers next fiscal as demand strengthens. We expect a modest reduction in CPI inflation from 5.5% this fiscal to 5.2% in the next.

Summing up, we expect the MPC to begin raising the repo rate from its next review meeting in April. Following that, we expect two more hikes of 25 bps each next fiscal, which will take repo rate to 4.75% by March 2023.

Banking

Various schemes announced by the RBI to continue drive higher economic growth:

- **On-tap term liquidity facility:** On account of continued uncertainties brought by the omicron wave, the timeline for on-tap liquidity windows has been extended from March 31, 2022, to June 30, 2022. On May 5, 2021, an on-tap liquidity window of Rs 50,000 crore with tenors of up to three years up to March 31, 2022, (at the repo rate) was opened to boost provision of immediate liquidity for ramping up pandemic-related healthcare infrastructure and services in the country. Further, on June 4, 2021, a separate liquidity window was opened for Rs 15,000 crore, with tenures of up to three years at the repo rate, till March 31, 2022, for certain contact-intensive sectors. These include hotels and restaurants; tourism — travel agents, tour operators and adventure/heritage facilities; aviation ancillary services — ground handling and supply chain; and other services that include private bus operators, car repair services, rent-a-car service providers, event/conference organisers, spa clinics, and beauty parlours/saloons. Our interactions indicate that the window has not been aggressively utilised so far, so the overall impact may be muted.

- **e-RUPI:** A new digital payment solution built on the Unified Payments Interface (UPI), was launched by the government on August 2, 2021. This prepaid voucher solution has been developed by the National Payments Corporation of India. The e-RUPI is a one-time use prepaid e-voucher generated through partner-banks, which can be sent by sponsors (government or private organisations) directly to the mobile phones of the intended beneficiaries in the form of an SMS-string or a QR code. The voucher can be only redeemed for purchase of goods or services from designated merchants or at the voucher accepting points as defined by the issuing bank at the time of issuance. The limit of e-RUPI voucher was set at Rs 10,000 for a single use is now increased to Rs 100,000 per voucher and permit such e-RUPI vouchers to be used more than once (until the amount of the voucher is completely redeemed). With this increase in limit, the e-RUPI can be used for delivering services under various government linked health, nutrition and beneficiary programs and schemes. The government also said that even the private sector can leverage these digital vouchers as part of their employee welfare and corporate social responsibility programmes.

- **MSME receivable financing:** The Trade Receivables Discounting System (TReDS) platform facilitates financing of trade receivables of micro, small and medium enterprises (MSMEs). Transactions on TReDS are settled through the National Automated Clearing House (NACH) system. The RBI has proposed to increase the NACH mandate limit from Rs 1 crore at present to Rs 3 crore. As per the RBI's Trends and Progress Report, the value of invoices uploaded on TReDS from fiscal 2018 to fiscal 2021 was Rs 40,550 crore, of which invoices financed aggregated Rs 34,910 crore. The proposed increase will improve the liquidity situation of MSMEs and help fill the credit GAP in this segment.

- **Voluntary retention route (VRR):** The RBI has decided to enhance the limit for investments under the VRR scheme to Rs. 2.5 lakh crore from Rs 1.5 lakh crore earlier, with effect from April 1, 2022. The RBI introduced the VRR for investments by foreign portfolio investors (FPIs) on March 1, 2019. This scheme encourages FPIs to invest in debt markets in India. All the investments made through this channel are free of macro-prudential and other regulatory requirements for FPI investments in debt markets. But it is mandatory for them to voluntarily commit to retaining a required minimum percentage of their investments in India for a period of their choice. This scheme encourages long-term and stable FPI investments in India's debt markets, while providing FPIs with operational flexibility to manage their investments. The RBI also aims at currency appreciation by extending this scheme.

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