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RBI reiterates dovish policy stance; keeps rates on hold and assures ample liquidity

- As expected, the Monetary Policy Committee (MPC) maintained a status-quo on key policy rates and decided *"to continue with the accommodative stance of monetary policy as long as necessary*".

- In line with our view, the RBI governor stated that the policy normalization process would be gradual and conducted in a calibrated manner, keeping market sentiments in mind.

- Governor stated that the RBI stands committed to ensuring *"ample liquidity in the system"* and thereby fostering congenial financial conditions for recovery to gain traction.

- In view of the above, the RBI announced that the restoration of cash reserve ratio (CRR) to 4% from 3% would be done in two phases. It also extended relaxation under the marginal standing facility by six months.

- To allay concerns regarding government large gross borrowing needs in FY22, the governor assured that the central bank would ensure orderly completion of the market borrowing program in a non-disruptive manner.

- To support demand for bond supply, the RBI has allowed retail investor participation in the G-sec market and extended dispensation of enhanced held to maturity limit of 22% of net demand and time liabilities (NDTL) up to March 31, 2023, to include securities acquired between April 1, 2021, and March 31, 2022.

- To incentivize new credit flow to MSME borrowers, the central bank has allowed banks to deduct credit disbursed to 'New MSME borrowers' from their NDTL to calculate CRR.

- The RBI also widened the coverage of the on-tap Targeted Long-term Repo Operations (TLTRO) to include NBFCs to avail funds from banks for incremental lending to specified stressed sectors.

- The MPC projected real GDP growth of 10.5% YoY in FY22 and tweaked its H1 FY22 inflation forecasts marginally higher to 5.2%-5% from 5.2%-4.6% earlier. Based on these, we believe the RBI is likely to maintain a long pause on rates, at least till Q3 FY22.

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MPC reiterates dovish policy stance; holds status-quo on rates and maintains forward guidance

The RBI led policy response to the COVID pandemic for most part of FY21 through front-loaded policy rate cuts (cumulatively 115 basis points (bps) since March 2020) and significant liquidity injections besides targeted measures. In FY22, the fiscal policy is projected to take a leading role, as reflected in the growth-oriented FY22 budget announced earlier this week, to drive ongoing economic recovery (Please refer to report titled *"India's budget doubles down on economic growth"*; dated February 2, 2021). Accordingly, as the policy response baton is now being passed on to the government, the central bank's role still remains crucial in complementing fiscal policy. It needs to ensure adequate system liquidity and support smooth completion of governments' sizeable borrowing program in FY22 after a record high borrowing in FY21. In the policy, the RBI tried to deliver on these fronts.

As expected, the RBI's Monetary Policy Committee (MPC) maintained the status quo on key policy rates and the accommodative policy stance. As such, key policy rates stand at their respective levels: Repo Rate: 4%, Reverse Repo Rate: 3.35%, Marginal Standing Facility Rate (MSF): 4.25%, Bank Rate: 4.25%. Concerning forward guidance, the MPC decided to continue with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year. The RBI noted that signs of economic recovery had strengthened further since the last meeting of the MPC. However, it did not make any revision to its FY21 real GDP projection of -7.5% YoY. We see a rising possibility that economic contraction in FY21 is likely to be below 7%, not least because of higher-than-previously-expected government spending in the second half of the current financial year. For FY22, the RBI, rightly, sounded upbeat. In addition to ongoing economic activity normalization, economic recovery is likely to broaden into the next financial year. The vaccination drive is expected to provide an impetus for restoration of contact intensive sectors. Moreover, considering fiscal stimulus under Aatmanirbhar 2.0 and 3.0 and higher budgeted capital allocation in FY22, the RBI notes that the projected increase in capital expenditure augurs well for capacity creation and crowding in private investment, improving prospects for growth. Accordingly, the RBI expects real GDP growth of 10.5% YoY in FY22 with a range of 26.2% YoY to 8.3% YoY in H1 FY22 and 6.0% YoY in Q3.

The RBI dropped the reference made in the December policy meeting regarding the inflation outlook constraining policy space use. Since the last policy meeting, CPI inflation has fallen sharply, led by food prices, particularly vegetable prices. Consequently, CPI inflation fell to 4.6% YoY in December after breaching the upper tolerance threshold of 4% (+2%/-2%) policy band for six consecutive months (June-November 2020). The RBI sees near-term inflation outlook as stable, thanks to expected higher fresh arrivals. But it notes the need for concerted policy action by both the centre and states to ensure cost build-up pressures, on the back of rising industrial raw material prices, do not escalate further. Considering these factors, the RBI revised inflation projection downward to 5.2% YoY for Q4 FY21 from 5.8% YoY earlier. However, it tweaked its H1 FY22 forecasts marginally higher to 5.2%-5% YoY from 5.2%-4.6% YoY earlier, highlighting a firming up of core prices. It views inflation at 4.3% YoY in Q3 FY22. Given the RBI's growth and revised inflation projection, we believe that the central bank will maintain a long pause on policy rates, at least till the third quarter of FY22. We see only an outside chance of rate cut if economic recovery was to falter, say because of a slow pace of vaccination or virus resurgence.

RBI to adopt a calibrated approach to liquidity normalization; assures markets on orderly completion of government's elevated borrowing programme in FY22

Going into the February monetary policy, there were some apprehensions about how the RBI would manage liquidity normalization and the government's large borrowing needs in FY22. We expected the RBI to adopt a calibrated and gradual approach to normalizing liquidity and ensuring bond markets of a smooth run to governments' borrowing program. The central bank did not disappoint. Firstly, the central bank decided to continue with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year – to revive growth on a durable basis. Noting the rise in short-term rates in Jan-Feb 2021, the RBI governor stressed that markets misconceived the restarting of variable reverse repo auctions to indicate that the central bank was reversing its accommodative policy stance. He emphasized that the RBI stands committed to *"ensuring ample liquidity in the system"* and thereby fostering *"congenial financial conditions"* for recovery to gain traction. He assured that *"systemic liquidity would continue to remain comfortable over the ensuing year"*.

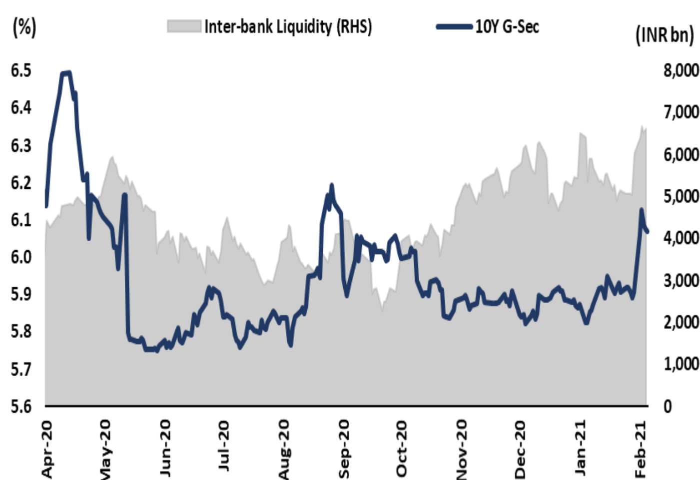
The central bank also announced select important steps to support this policy stance. Notably, the central bank decided that CRR restoration from 3% to 4% will now be done in two phases (to 3.5% with effect March 27, 2021, and 4% with effect May 22, 2021) instead of at one-go (to 4% on March 31, 2021). The governor rightly noted that the normalization of CRR would open up space for RBI's market operations to inject additional liquidity. The central bank also extended

relaxation in Marginal Standing Facility for banks by dipping into the Statutory Liquidity Ratio (SLR), up to an additional one percent of NDTL by six months until September 30, 2021. This dispensation provides banks with increased access to funds of around Rs1.53 lakh crores.

To allay concerns regarding the government's large gross borrowing needs of Rs 12 trillion in FY22, the governor assured that the Reserve Bank would ensure orderly completion of the market borrowing programme in a non-disruptive manner. He stated the RBI's recent track record in ensuring a smooth run of a record-high borrowing programme in FY21. To ensure demand for high government borrowing needs in FY22, the RBI announced a major structural change by allowing retail investor participation in both primary and secondary G-sec markets. Moreover, the RBI decided to extend the dispensation of enhanced HTM limit of 22% up to March 31, 2023, to include securities acquired between April 1, 2021, and March 31, 2022. HTM limits will be restored from 22% to 19.5% in a phased manner, starting from the quarter ending June 30, 2023. This is expected to allow banks to plan their investments in SLR securities optimally with a clear glide path for restoration of HTM limits while incentivizing demand for government bond supply.

Despite these steps and governor's assurance, the bond market was not enthused as it seemed to have hoped for an explicit OMO calendar. Moreover, steps such as the normalization of CRR was not taken in a very conducive manner, despite attempts to signal a continued accommodative stance. The 10Y G-sec yield increased to an intra-day high of 6.15%, before it settled back at 6.07%, similar to the previous day close.

Bond markets remain apprehensive about liquidity normalization and government borrowing plan



Source: RBI, Bloomberg

Targeted measures to incentivize credit flow

The RBI continued its targeted measures to incentivize the flow of credit to affected sectors. It widened the coverage of the on-tap TLTRO to include NBFCs to avail funds from banks for incremental lending to specified stressed sectors and further support recovery in the economy. It is to be noted that in addition to the five sectors (Agriculture, Agri-infrastructure, Secured Retail, MSMEs, and Drugs, Pharmaceuticals and Healthcare) announced under the scheme on October 21, 2020, 26 stressed sectors identified by the Kamath Committee were brought within the ambit of sectors eligible under on-tap TLTRO on December 4, 2020. To incentivize new credit flow to MSMEs borrowers, Scheduled Commercial Banks will be allowed to deduct credit disbursed to 'New MSME borrowers' from their NDTL for calculation of CRR. This exemption will be available for exposures up to Rs 25 lakh per borrower for credit extended up to the fortnight ending October 1, 2021.

The RBI also announced a slew of other developmental and regulatory policy measures to strengthen the framework of microfinance institutes, co-operative banks and to offer some relaxation on capital requirements for banks. Measures to deepen financial markets, improve payments and settlement systems, and consumer protection were also announced. These are detailed below.

Measures on regulation and supervision:

- Implementation of the last tranche of the Capital Conservation Buffer of 0.625% has been deferred by another six months from April 1 to October 1, 2021, along with the implementation of Net Stable Funding Ratio by a similar period.
- The RBI will provide a consultative document harmonizing regulatory frameworks applicable to various regulated lenders in the microfinance space (NBFC-Micro Finance Institutions, Scheduled Commercial Banks, Small Finance Banks and NBFC–Investment and Credit Companies)
- An expert committee will be constituted to provide a medium-term roadmap for strengthening Primary (Urban) Co-operative Banks, leveraging legislative amendments.
- Resident individuals will be permitted to make remittances to IFSCs for investment in securities issued by non-resident entities in IFSCs. Resident individuals will be allowed to open a non-interest-bearing Foreign Currency Account in IFSCs.

Measures on deepening financial markets:

- Retail investors will be provided with online access to the government securities market – both primary and

secondary – directly through the Reserve Bank ('Retail Direct'). This will broaden the investor base and provide retail investors with enhanced access to participate in the government securities market.

- FPI investment in defaulted corporate bonds will be exempted from the short-term limit and the minimum residual maturity requirement under the Medium-Term Framework.

Measures on payments and settlements system:

- Major payment system operators would be required to facilitate setting-up of a centralized industry-wide 24x7 helpline for addressing customer queries with respect to various digital payment products and give information on available grievance redressal mechanisms.
- The RBI will issue guidelines on outsourcing for payment system operators and participants of authorized payment systems to manage operational risks.
- The RBI proposes to bring all legacy clearing house bank branches under CTS clearing by September 2021.

Measures on consumer protection:

- The central bank has announced the integration of the three Ombudsman schemes and introduced centralized processing of grievances following a 'One Nation One Ombudsman' approach.

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