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RBI Policy Review: the central bank delivers an ultra-dovish policy

- The RBI delivered an ultra-dovish policy today, continuing its focus on economic growth revival over inflation risks.
- As expected, the RBI kept the repo rate unchanged and maintained an accommodative policy stance.
- It surprised the markets by postponing policy normalization by keeping the reverse repo rate unchanged.
- With the third COVID wave receding and its impact on the economy expected to be limited relative to the earlier waves, it was an opportune time for the RBI to formally start the policy normalization process in today's meeting. Markets had also factored in a reverse repo rate hike.
- However, the central bank was of the view that continued policy support is warranted for a durable and broad-based recovery given downside risks to economic growth and an improving inflation outlook.
- The RBI projected economic growth to be at 7.8% YoY and CPI inflation at 4.5% YoY in FY23. Its inflation projection shows a downward trajectory after peaking in Q4FY22.
- We see upside risks to RBI's inflation projection given elevated global crude oil prices and domestic price pressures (reflected in high WPI and core CPI). If these risks were to materialize, the RBI would have to adjust policy at a faster pace than presently anticipated.
- Bonds markets cheered RBI's dovish policy today. This is despite a lack of explicit guidance from the RBI on how it would support bond markets in absorbing the government's larger borrowing program in FY23.
- The RBI also announced an extension of on-tap liquidity facilities for emergency health services and contact-intensive sectors by three months to June'22, some tweaks to liquidity operations, and a hike in the limit for investments under Voluntary Retention Route by Rs 1.0 lakh crore to Rs 2.5 lakh crore.
- Based on the RBI's dovish stance and its inflation projection, the RBI is expected to adopt a gradual policy normalization approach with a hike in reverse repo likely to start in Q1FY23 and in the repo rate in H2FY23.

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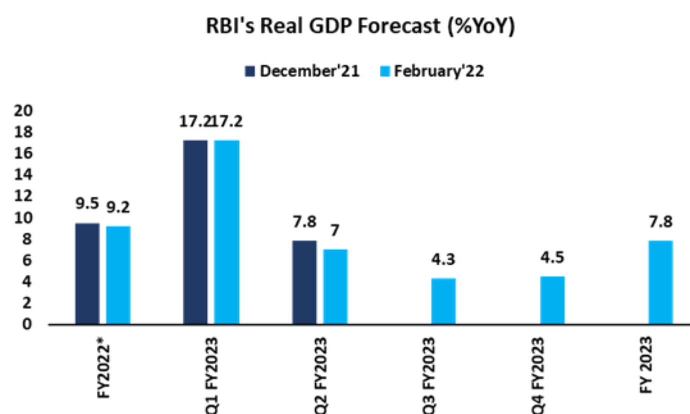
Dovish policy all the way

The RBI delivered an ultra-dovish policy today, continuing its focus on economic growth revival over inflation risks. As expected, the RBI kept the repo rate unchanged and maintained an accommodative policy stance. It surprised the markets by postponing policy normalization and keeping the reverse repo rate unchanged. With the third wave receding and its impact on the economy expected to be limited relative to the earlier waves, it was an opportune time for the RBI to formally start the policy normalization process in today's meeting. It would not have been disruptive to markets as the effective reverse repo rate is ~50 bps above the policy reverse repo. However, the central bank was of the view that continued policy support is warranted for a durable and broad-based recovery given downside risks to economic growth and an improving inflation outlook. Based on the RBI's dovish stance and its inflation projection, the RBI is expected to adopt a gradual policy normalization approach with a hike in reverse repo likely to start in Q1FY23 and in the repo rate in H2FY23. On the assumption of a normal monsoon in 2022, the RBI projects CPI inflation in FY23 at 4.5%. We see upside risks to this projection given elevated global crude oil prices and domestic price pressures (reflected in high WPI and core CPI). If these inflation risks were to materialize, the RBI would have to adjust policy at a faster pace in the future than presently anticipated. Markets reacted positively to today's policy announcement; NIFTY50 rose by 0.81%, 10-yr Gsec yield fell by ~7bps to 6.73%, but the rupee depreciated by ~0.2% to 74.97 versus the dollar.

RBI maintains a status-quo on key policy rates and the accommodative stance

The Monetary Policy Committee (MPC) kept policy rates unchanged at their respective levels - Repo Rate at 4%, and Marginal Standing Facility Rate and Bank Rate at 4.25%. The MPC also decided to maintain its accommodative stance *"**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 that inflation remains within the target going forward**"*. The decision to keep the policy rate unchanged was unanimous, while the decision to continue with the accommodative stance came in with a 5:1 majority vote. The RBI delayed the policy normalization process as it kept the Reverse Repo Rate unchanged at 3.35% against the market expectations of a hike and delivered a dovish policy. The RBI governor broadly held on to his previous policy remarks as he continued to flag downside risks to economic growth due to the perpetuating uncertainty from the Omicron variant, a spike in inflation in a number of countries that are resulting in divergent monetary policies, persisting supply disruptions, recent geo-political tensions, and global financial market volatility. Alongside, the RBI also envisaged an optimistic inflation outlook as it projects a downward trajectory for inflation into FY23. Accordingly, the MPC was of the view that continued policy support is warranted for a durable and broad-based recovery. However, we note possible risks of the RBI falling behind the curve, particularly from the risk of missing the optimistic inflation projections, which in turn may require faster policy adjustment in the future.

RBI's real GDP growth forecasts



Source: RBI; * February 22 growth forecasts are CSO estimates

The RBI governor highlighted that India's economic output remained barely above its pre-pandemic levels despite ongoing recovery from the pandemic shock. Referring to the CSO's first advance estimate for GDP growth at 9.2% YoY in FY22, India's output will be only modestly above the FY20 levels. Moreover, certain contact-intensive sectors continue to remain below their pre-pandemic output levels, and private consumption, the mainstay of domestic demand, continues to underperform. The RBI governor acknowledged a loss in momentum in economic activity due to the disruptions from the third COVID wave, as seen in the evolving high-frequency indicators such as PMI surveys, steel consumption, and auto sales. With the third COVID wave now receding, we expect the economic recovery to resume from February onwards. Going ahead, the RBI maintained its growth forecast for Q1 FY23 at 17.2% YoY while revising its Q2 FY23 forecast lower to 7% YoY (from 7.8% YoY earlier). The RBI also released its growth projections for FY23 at 7.8% YoY with growth rates of 4.3% YoY and 4.5% YoY for Q3 FY23 and Q4 FY23, respectively, owing to the large base effects from the previous year. The RBI expects positive impulses from the favourable prospects for agriculture, robust export, and the government's thrust on capital expenditure in FY23. Alongside, the accommodative monetary and liquidity conditions are also likely to further provide a fillip to investment activity and credit off-take that has already started seeing signs of a turnaround (Banks

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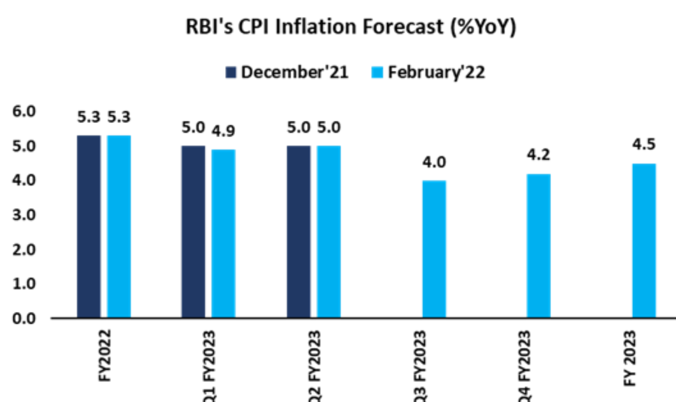
non-food credit growth jumped to 11.4% YoY in December, its fastest pace of growth since April 2019).

RBI expects CPI to move lower in FY23



Source: RBI

On the inflation front, the RBI outlined a very favourable outlook for FY23, with the inflation trajectory expected to ease from 5.3% in FY22 to 4.5% in FY23. The RBI retained its Q4FY22 and FY22 forecasts at 5.7% and 5.3%, respectively, outlining that inflation for January 2022 could inch closer to the upper tolerance band of 6%, primarily due to the adverse base effect. While the RBI notes upside risks from the hardening of crude oil prices and elevated core inflation prints, it expects the continued softening of food prices (assuming normal monsoons in FY23), supply-side interventions by the government and the pass-through of tax cuts to petrol and diesel (in November 2021) to balance the risks to inflation. Moreover, perceiving the continued slack in demand, the RBI expects input cost pressures to remain muted and envisages a softening in core inflation as risks from the Omicron variant wane and supply chain pressures also ease. Accordingly, the RBI expects inflation to moderate to 4.9% in Q1FY23 (vs 5% previous projection), 5% in Q2FY23, 4% in Q3FY23 and 4.2% in Q4FY23 with risks to the inflation outlook broadly balanced. The improved inflation outlook remains a key factor in providing the MPC space to remain accommodative. However, we see upside risks to these projections given the elevated global crude oil prices and domestic price pressures (reflected in high WPI and core CPI). We expect inflation to average around 5% in FY23, with upside risks. Household inflation expectations also remain elevated, and the assumption of normal monsoons could be fluid. If these inflation risks were to materialize, the RBI would have to adjust policy at a faster pace than presently anticipated.

RBI continues to tread on its path of liquidity normalization

While the RBI extended its accommodative policy stance and postponed the formal process of policy normalization, it maintained its liquidity stance via a rebalancing, and gradual normalization of the unprecedented liquidity rolled out in response to the pandemic. Since the commencement of the rebalancing of liquidity in August last year, the RBI has focused on migrating from the fixed-rate overnight reverse repo window to the VRRR auctions of longer maturity (supported by fine-tuning auctions of various tenors). These have resulted in continued success with the absorption through the VRRR window, increasing to Rs 6.26 lakh crore as on January 8th, 2022. Consequently, the effective reverse repo rate (weighted average rate of fixed-rate reverse repo and VRRR of longer maturities) has increased from 3.37% at the end of August 2021 to 3.87% as of February 2022, which is ~50 basis points above the current reverse repo rate. Accordingly, we believe this was an opportune time for the RBI to formally start the policy normalization process as a hike would not have been disruptive to market rates and would have curtailed some of the uncertainty around the policy outlook. Instead, the RBI chose to announce some tweaks in the liquidity operations with an aim to restore the revised liquidity management framework –

- Firstly, the RBI decided the variable-rate repo operations of varying tenor will be conducted as and when warranted by the evolving liquidity and financial conditions.
- Secondly, Variable-rate repos (VRRs) and variable rate reverse repo (VRRRs) of 14-day tenor will operate as the main liquidity management tool based on liquidity conditions.
- Thirdly, the RBI also retained the flexibility to conduct fine-tuning operations of varying amounts/maturities as and when required.
- Lastly, with effect from March 1, 2022, the fixed-rate reverse repo and Marginal Standing Facility will be available from 5:30 pm – 11:59 pm on all days (which was earlier increased in March 2020 to 9:00 am- 11:59 pm in response to the pandemic situation).

RBI refrained from announcing an explicit guidance to support the government's large borrowing program

The RBI policy meeting followed the budget announcement for FY23, where the government announced a record market borrowing of Rs 14.95 lakh crore (~Rs 14.3 lakh crore after adjusting for switch operations). To this effect, market participants were closely awaiting any explicit assurance/guidance from the RBI in terms of the possibility of a calendar for OMOs/Operation twists, etc., to support the longer end of the curve. Post FY23 budget, the GSec 10Y had increased closer to the 7% threshold, and the 10Y repo spread had increased to its highest levels in more than 12 years. However, the Governor refrained from any explicit

guidance on this front and stated - "***while the RBI will continue to focus on smooth completion of the government borrowing programme, market participants also have a stake in the orderly evolution of financial conditions and the yield curve***". On this point in the press conference, the Governor mentioned that the RBI will deal with the new borrowing calendar when they enter the new financial year and execute the government borrowing smoothly and in a non-disruptive manner.

The RBI's participation in the absorption of government supply is going to be challenging in FY23 as it works towards normalizing the surplus liquidity in the system. After purchasing government bonds to the tune of Rs 2.37 lakh crores via OMOs in H1FY22, the RBI has sold ~Rs 23,265 crores worth of government bonds through OMOs from November 2021 until January 2022. The role of the RBI in meeting government bond demand remains especially crucial with no clear communication around the sovereign bond inclusion in global debt indices. In today's meeting, the RBI did propose to enhance the limit under the Voluntary Retention Route (VRRR) by Rs 1 lakh crore to Rs 2.5 lakh crore. The Governor also indicated that the government's FY23 market borrowing size could be lower than budgeted as an alternative source of funding viz small savings collections could be higher by Rs1-1.2 lakh crore. We could see some space for OMOs being created on the back of likely foreign capital outflows (given US Fed's projected rate hikes) in FY23.

The RBI also announced developmental and regulatory policy measures listed below related to financial markets and payment and settlement systems –

Guidelines for Credit Default Swap (CDS)

- Given the importance of CDS for the development of a liquid market for corporate bonds, the RBI will issue final guidelines later today post review and feedback received on the draft guidelines. The RBI expects these guidelines to facilitate the development of a credit derivatives market and deepen the corporate bond market in India.

Permitting Banks to Deal in offshore Foreign Currency Settled Rupee Derivatives Market

- To provide a further fillip to the interest rate derivative market in the country, removing the segmentation between onshore and offshore markets and improving the efficiency of price discovery, the RBI has decided to allow banks in India to undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) market with non-residents and other market makers. Banks could participate through their branches in India, their foreign branches or through their IFSC Banking Units.
- It is worth noting that Banks in India have already been permitted in June 2019 to offer rupee interest rate derivatives such as overnight indexed swaps (OIS) to non-residents to hedge their interest rate risk.

Measures pertaining to payment and settlement systems

- With an intent to facilitate digital delivery of various government schemes to beneficiaries, the RBI has enhanced the cap on e-rupee vouchers issued by Governments from Rs 10,000 per voucher to Rs 1 lakh per voucher and allowed multiple uses of the voucher (until the amount of the voucher is completely redeemed).
- In view of the growing liquidity requirements of the MSMEs, the RBI has decided to increase the NACH (National Automated Clearing House) mandate limit from Rs 1 crore to Rs 3 crore for TReDS (Trade Receivables Discounting System) settlements.
- Considering potential financial, operational, and reputational risks to the Regulated Entities due to outsourcing of critical IT services, leveraging of technology by the Regulated Entities of RBI and increasing use of digital channels by customers, the RBI will review and consolidate the extant guidelines. Accordingly, it will issue two draft directions for comments of stakeholders and members of the public: (i) Reserve Bank of India (IT Outsourcing) Directions, 2022; and (ii) Reserve Bank of India (Information Technology Governance, Risk, Controls and Assurance Practices) Directions, 2022.

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