The RBI holds steady on policy rates, defers policy normalization on rising global uncertainty

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- As expected, the Monetary Policy Committee decided to keep the repo rate and the accommodative stance unchanged, reiterating the need to support a durable economic recovery.
- It also maintained its FY22 projections for economic growth (at 9.5% YoY) and inflation (at 5.3% YoY) with minor tweaks in quarterly forecasts.
- While acknowledging the improving economic conditions, it noted rising downside risks to the economic outlook emanating from global developments, including the uncertainty from the Omicron variant.
- Accordingly, the central bank deferred the policy normalization and kept the reverse repo rate unchanged at 3.35% against our expectation of a small hike in the range of 10 bps to 20 bps.
- It kept the focus on liquidity management to strengthen the RBI's control over the liquidity overhang, enhancing the 14-day VRRR auction amounts to Rs 6.5 lakh crore on December 17, and further to Rs 7.5 lakh crore on December 31, from Rs 6 crore on the December 3 auction.
- It stated that the main operation of 14-day VRRRs will continue to be complemented by longer-term VRRRs, the size, and maturities of which will be decided based on the evolving liquidity conditions.
- In other liquidity management measures, it decided to return to normal dispensation under the Marginal Standing Facility, wherein banks will now be able to dip up to 2% of the NDTL instead of 3% for overnight borrowing under the facility from January 1, 2022.
- It also provided banks with one more option to prepay outstanding funds availed through TLTRO 1.0 & 2.0 schemes announced on March 27 and April 17, 2020.
- We see these liquidity adjustment steps as continued work towards the start of policy normalization, which we now expect to begin from Feb ’22 with a reverse repo rate hike in the range of 10 bps to 25 bps, assuming no major disruption to the economic outlook from the new COVID variant. A new COVID wave could delay that.

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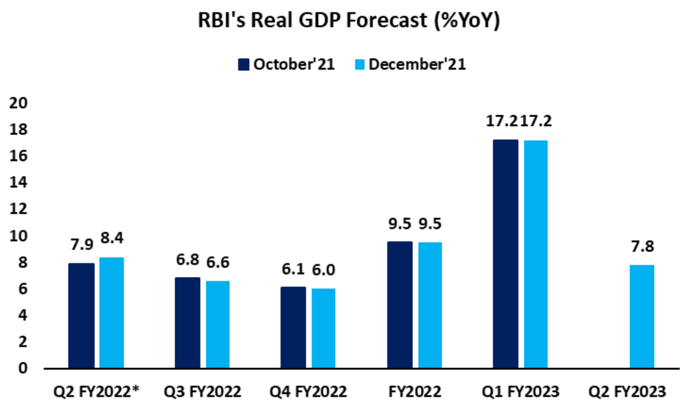
Amidst rising global headwinds, the RBI adopts a cautious approach; reiterates the need to support a durable economic recovery

The RBI policy announcement today indicated a very dovish leaning. As expected, it decided to keep the repo rate and the accommodative stance unchanged. It also maintained its FY22 projections for economic growth and inflation. While acknowledging the improving economic conditions, it noted rising downside risks to the economic outlook emanating from global developments, including the uncertainty from the Omicron variant. Against this background, the central bank deferred the policy normalization without giving any forward guidance when it might start. We had expected the RBI to hike the reverse repo rate (presently at 3.35%) by a small size (ranging from 10 bps to 20 bps) to start the policy normalization process. In today's policy announcement, the RBI erred on the side of caution and kept the reverse repo rate unchanged. It kept the focus on liquidity management to strengthen the RBI's control over the liquidity overhang. The central bank enhanced the size of the 14-day variable rate reverse repo (VRRR) auctions, decided to return to normal dispensation under the MSF, and provided banks with an option to prepay outstanding funds availed through TLTRO 1.0 & 2.0 schemes. We see these liquidity adjustment steps as continued work towards the start of policy normalization, which we now expect to begin from Feb '22 with a reverse repo rate hike in the range of 10 bps to 25 bps, assuming no major disruption to the economic outlook from the new COVID variant. We don't rule out further delays in policy normalization if a new COVID wave strikes, weighing on the economic recovery.

RBI maintains a status-quo on policy rates; defers policy normalization due to rising global uncertainty

In line with our expectations, the Monetary Policy Committee (MPC) kept policy rates unchanged at their respective levels - Repo Rate at 4%, 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"***. Similar to the October policy - the decision to keep the policy rate unchanged was unanimous, while the decision to continue with the accommodative stance noted a dissent by MPC member Prof. Jayanth Varma and resulted in a 5:1 vote in favour of the unchanged stance. The reverse repo rate was also maintained at 3.35%, against our projection of a 10-20 bps hike, thereby providing a dovish policy. The MPC noted increased downside risks to growth mainly emanating from global developments, including the Omicron variant, potential volatility in global financial markets due to a faster normalization of monetary policy in advanced economies, and prolonged global supply bottlenecks. Accordingly, the central bank decided to be cautious and maintained a status quo on policy rates and the stance. The governor also recognized that the continuing slack in the economy, despite the strong recovery, warranted policy support to ensure a durable and broad-based recovery.

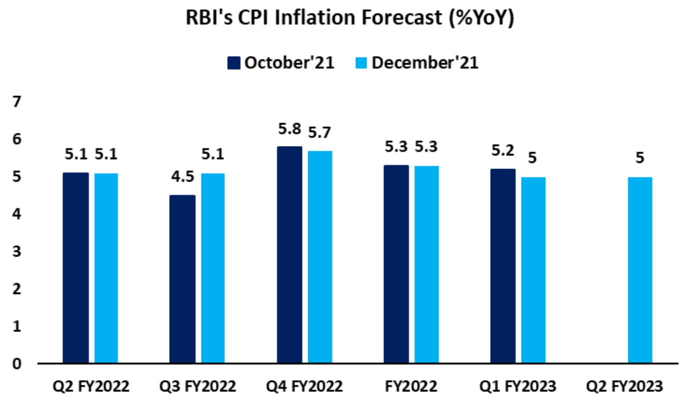
RBI retains growth forecast for FY22, noting the rising headwinds to the outlook



*Source: RBI; *Q2FY22 number as per December 2021 policy is actual data*

Assuming no new COVID cases resurgence, the RBI retained its growth forecast at 9.5% YoY for FY22, despite a better-than-expected growth in Q2 FY22 (Q3 and Q4 GDP growth expected at 6.6% and 6.0% vs 6.8% and 6.1% previously). The RBI also maintained its Q1 FY23 growth projection at 17.2% YoY while stipulating Q2 FY23 growth at 7.8% YoY. The RBI acknowledged that India's growth recovery continued to gain traction, as was noted in the recent Q2 FY22 GDP print, where the Indian economy resurfaced above its pre-COVID output levels. High-frequency indicators also indicate a continuance and broadening of recovery in the festive period. Rural demand remains underpinned by the robust performance of the agriculture sector, supported by the strong rabi sowing season, along with the extension of direct transfers from the government. Urban demand has also strengthened, as reflected in higher festive spending and other evolving indicators such as petrol consumptions, toll collections, GST receipts, etc. Investment activity also appears to be picking up, led by the government's focus on capital expenditure. However, despite the ongoing recovery, the slack in the economy continues to persist, as is visible in private consumption demand (that remained ~3.5% below its pre-pandemic levels in Q2 FY22) and private investment activity that is still lagging. **Against this backdrop, the RBI recognized that the current recovery is not strong** enough to be self-sustaining and durable and, as such, requires continued policy support.**

RBI expects CPI to peak in Q4 FY22 and eases thereafter



Source: RBI

On the inflation front, the RBI painted a relatively benign outlook as it retained its CPI forecast of 5.3% YoY for FY22. Amidst the backdrop of overshooting inflationary pressures in major economies, the RBI governor noted that domestic inflation is broadly aligned with the target of 4%, barring short-lived spikes. With respect to food inflation - vegetable prices are expected to see a seasonal correction during the winter months, in light of the bright prospects for the rabi crops. Government interventions on the supply side have also offset rising prices for edible oils, pulses, vegetables and are expected to keep some lid on prices. Meanwhile, the excise duty cuts and VAT reduction on petrol and diesel prices are expected to ease fuel and transportation inflation through direct and indirect channels. The RBI noted that the persistence of high core inflation (which has remained sticky above the 6% mark) remains an area of policy concern. However, the RBI expects the current slack in the economy to limit the pass-through of rising input prices to retail inflation. Overall, the RBI expects the risks to inflation to be broadly balanced with inflation expected to pick up in the remainder of the year due to the waning of a favourable base. Accordingly, the RBI expects inflation to increase to 5.1% in Q3 FY22 (revised higher from 4.5% earlier) and thereafter peak at 5.7% in Q4 FY22 (revised from 5.8% earlier), following which it expects CPI to moderate to 5% in Q1 FY23 (v/s 5.2% earlier) and stay at 5% in Q2 FY23. Moreover, this is expected to ease further to 4-4.3% by the end of FY23, as noted by deputy governor Michael Patra in the press conference. We believe that inflation could potentially surprise on the upside in the coming months as we have started to see a pass-through of cost built-up to consumers. If this becomes broad-based, it could lead to RBI having to recalibrate its present dovish policy stance.

RBI continues to embark on its path of liquidity normalization while ensuring it happens in a non-disruptive manner

Although the RBI deferred its first move towards policy normalization, it maintained its focus on liquidity normalization. After the ultra-loose monetary policy and abundant liquidity injection in response to COVID-19, the RBI has been trying to rebalance the surplus liquidity by shifting from the fixed-rate overnight reverse repo window to the VRRR auctions of longer maturity. Accordingly, to strengthen the RBI's control over the liquidity overhang, the central bank enhanced the 14-day VRRR auction amounts to Rs 6.5 lakh crore on December 17 and further to Rs 7.5 lakh crore on December 31 (from Rs 6 crore in the December 3 auction). This broadly equates to the surplus liquidity in the system that stood at Rs 7.6 lakh crore on average in November 2021 and translates to a near-complete shift from the fixed-rate overnight reverse repo window to the VRRR window. This also aligns with the RBI’s objective to re-establish the 14-day VRRR auction as the main liquidity management operation. Accordingly, the RBI stated that from January 2022 onwards, liquidity absorption will be undertaken mainly through the auction route. It also stated that the main operation of 14-day VRRRs will continue to be complemented by longer-term VRRRs (RBI has already been conducting 28-day VRRR auctions), the size and maturities of which will be decided based on an assessment of the evolving liquidity conditions. Given the increased VRRR auctions and tenors that have been conducted recently, the cut-off rates, along with other money market rates, have firmed up gradually over the past few months. We believe this sits well with the RBI's calibrated approach to ensure liquidity normalization in a non-disruptive manner that is also likely to extend to the policy normalization process when that happens. This was further backed by RBI's reaffirmation and commitment to undertake operations twists and regular open market operations (OMO) as may be required for effective monetary transmission and anchoring of interest rate expectations in line with the evolving macro-economic and financial conditions.

Meanwhile, in other liquidity management measures, the RBI decided to return to the normal dispensation under the Marginal Standing Facility (MSF) window - wherein banks can now dip up to 2% of the net demand and time liabilities (NDTL) instead of 3% for overnight borrowing under the MSF from January 1, 2022. While the dispensation had boosted market confidence during a crucial time of the pandemic, its usage has been low due to surplus liquidity in the system. In addition, the RBI also provided one more option to banks to prepay outstanding funds availed through

TLTRO 1.0 & 2.0 schemes announced on March 27 and April 17, 2020. So far, banks had availed ~Rs 1.13 lakh crores under the scheme and prepaid ~1/3rd of the amount (Rs 37,348 crores) in November 2020. Additionally, the RBI also announced that on-tap liquidity windows of Rs 50,000 crores for healthcare infrastructure and services and Rs 15,000 crores for certain contact-intensive sectors will continue till their terminal date, i.e., March 31, 2022.

The RBI also announced additional measures in its policy today as listed below

- With a view to providing operational flexibility to the bank, the RBI has decided that banks need not seek prior approval of the RBI to infuse capital in overseas subsidiaries and repatriate the profits if they meet the regulatory requirements on capital, subject to post-facto reporting.
- Recognizing the significant developments seen in domestic financial markets and global standards, the RBI will publish a discussion paper to review and update the existing norms on the classification and valuation of investment portfolios by scheduled commercial banks.
- UPI: Simplification, Deepening, and Enhancement of Limits
    - Given the increasing usage of digital payment methods, the RBI will release a discussion paper on various charges in the digital payment system in India.
    - The RBI has proposed to launch UPI-based payment products for feature phone users, leveraging on innovative products from the RBI's Regulatory Sandbox on Retail Payments.
    - It has also proposed to make small-value UPI process flow simpler via an on-device wallet.
    - Enhance the transaction limit for payments through UPI for the Retail Direct Scheme for investment in G-secs and Initial Public Offering (IPO) applications from Rs 2 lakh to Rs 5 lakh.
- In view of the imminent discontinuance of LIBOR, the RBI allowed usage of any widely accepted interbank rate or alternative reference rate (ARR) applicable to the currency of borrowing as a benchmark, post discontinuation.
- To take into account differences in credit risk and term premia between LIBOR and the ARRs, for new foreign currency ECBs and TCs, the central bank decided to revise the all-in-cost ceiling from 450 bps to 500 bps and from 250 bps to 300 bps, respectively, over the ARRs.
- To enable transition of existing ECBs and TCs linked to LIBOR, it is proposed to revise the all-in-cost ceiling from 450 bps to 550 bps and from 250 bps to 350 bps respectively, over the ARRs.

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