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The RBI maintains a status-quo on the policy rate and the accommodative stance; steps up liquidity normalization efforts

- The RBI October policy was on expected lines as the Monetary Policy Committee (MPC) maintained a status quo on its key policy rates and the accommodative stance.

- The central bank retained its economic growth forecast for FY22 at 9.5% YoY, factoring in traction in the economic recovery, improvement in prospects, Q1 FY22 GDP growth being lower than its projection, and ongoing uncertainty about the external environment.

- With regard to addressing the issue of excessive surplus liquidity in the system, the RBI announced suspension of secondary market G-Sec Acquisition Programme (GSAP) operations and increased quantum of the variable reverse repo (VRRR) operations from Rs 4 lakh crore to 6 lakh crore in a calibrated manner.

- The RBI Governor emphasized that the VRRR auctions are primarily a tool for rebalancing liquidity and should not be interpreted as a reversal of the accommodative policy stance.

- The Governor assured that RBI would ensure adequate liquidity to support the economic recovery and orderly completion of the government's borrowing programme.

- Recognizing the ongoing uncertainties surrounding the pandemic, the RBI announced targeted measures like an extension of the special long-term repo operations (SLTRO) facility for small finance banks by two months, and continuation of enhanced WMA limits for States/UTs, and extension of Priority Sector lending (PSL) classification for lending by banks to NBFCs for on-lending to Agriculture, MSME and Housing sectors for six months.

- Taking comfort from falling food prices and a favourable base effect in upcoming months, the RBI revised its inflation forecasts for FY22 downwards from 5.7% YoY to 5.3% YoY.

- We continue to expect the RBI to raise the reverse repo rate in the Dec' 21/Feb '22 meeting, while the repo rate hike is likely to be in H1-FY23.

Pramod Chowdhary
Chief Economist
pramod.chowdhary@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

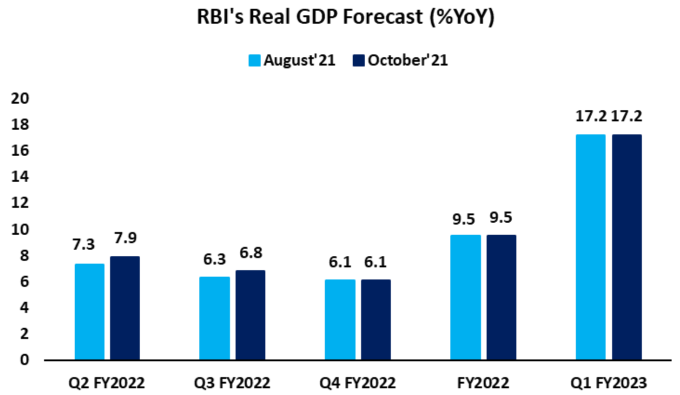
RBI continues to prioritize growth revival as economic slack continues to persist and recovery remains uneven

The RBI October policy was on expected lines as the Monetary Policy Committee (MPC) maintained a status quo on its key policy rates and the accommodative stance. The committee noted that economic recovery is gaining traction, and the outlook for aggregate demand is improving. However, recovery remains uneven, and the slack continues to be large. In addition, the uncertainty about the external environment has gone up. In this background, the RBI remains cautious of a pre-emptive withdrawal of policy support. Consequently, it believes that ***"the ongoing domestic recovery needs to be nurtured assiduously through all policy channels"***, which is in line with the continuation of its accommodative policy *stance* ***"as long as necessary to revive and sustain growth on a durable basis".*** With regard to addressing the issue of excessive surplus liquidity in the system, the RBI announced liquidity adjustment measures viz. suspending secondary market G-Sec Acquisition Programme (GSAP) operations and increasing the variable reverse repo (VRRR) auction amount from Rs 4 lakh crore to 6 lakh crore in a calibrated manner. The RBI Governor emphasized that the VRRR auctions are primarily a tool for rebalancing liquidity and should not be interpreted as a reversal of the accommodative policy stance. The Governor also stated that ***"We don't want to rock the boat when the shore is near as there is a journey beyond the shores"***, indicating that the central bank's liquidity and policy normalization approaches will be gradual and calibrated. Accordingly, the Governor noted that RBI would ensure adequate liquidity to support the economic recovery and orderly completion of the government's borrowing programme. Even as the RBI announced measures to manage system liquidity, it continues to provide policy support in a targeted manner. Recognizing the ongoing uncertainties surrounding the pandemic, the RBI announced targeted measures like an extension of the special long-term repo operations (SLTRO) facility for small finance banks from Oct'21 to Dec'21, and continuation of enhanced WMA limits for States/UTs, and extension of Priority Sector Lending (PSL) classification for lending by banks to NBFCs for on-lending to Agriculture, MSME and Housing sectors for six months.

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

In line with our expectations, the MPC kept policy rates unchanged at their respective levels - Repo rate at 4%, Reverse repo rate at 3.35%, 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"***. While the decision to keep the policy rate unchanged was unanimous, the decision to continue with the accommodative stance registered dissent by one member (Prof. Jayanth Varma) and resulted in a 5:1 vote in favour of the unchanged stance.

RBI retains growth forecast for FY22 with upward revisions to growth projections for Q2 and Q3

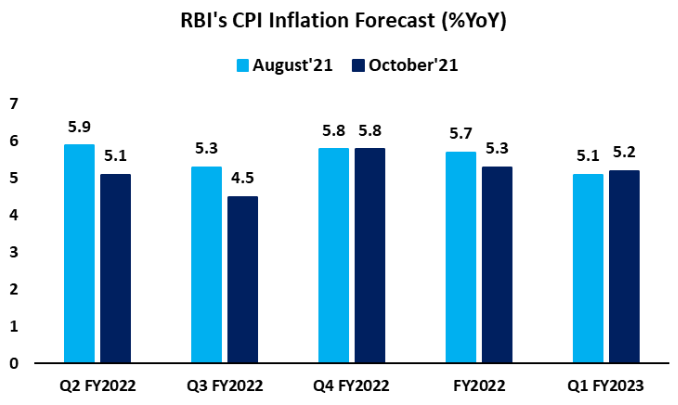


Source: RBI

After a temporary setback due to the COVID second wave, the recovery of the Indian economy is gaining traction. High-frequency indicators show the continuation of economic recovery; with Manufacturing Purchasing Managers' Index (PMI) rising to 53.7 in Sep'21 from 52.3 in Aug'21, Services PMI remaining high at 55.2 in Sep'21, though moderating slightly from an 18-month high of 56.7 in Aug'21, the government stepping up expenditure in Aug'21, and cement, GST, rail-freight, and electricity production maintaining good growth pace. The ebbing of infections, easing of restrictions, and a sharp pick-up in the pace of vaccination should facilitate further normalization of economic activity, including a rebound in the pent-up demand for contact intensive services and boosting urban demand. The outlook for rural demand remains positive, supported by the record production of Kharif food grains in 2021-22 as per the first advance estimates and bright prospects for rabi crops. The government has maintained its focus on CAPEX and recently started to raise revenue expenditure as well, given higher revenue receipts. Monetary and financial conditions remain supportive of growth. Aggregated demand continues to get an additional boost from robust exports, which remained over $30 billion for the seventh consecutive month in September 2021, reflecting strong global demand and policy support. However, the external environment is turning uncertain and challenging, with headwinds from slowing growth in select major Asian and advanced economies, a steep jump in natural gas prices, and a rise in volatility emanating from the normalization of monetary policy in some major advanced economies, which could pose downside risks. Moreover, uncertainty around the future COVID-19 trajectory, global semiconductor shortages, elevated commodity prices, and input costs could also pose downside risks to domestic growth prospects. Considering these factors against the ongoing pick-up of domestic economic recovery, the RBI retained its growth forecast at 9.5% for FY22. It tweaked quarterly forecasts: for Q2 FY22 to 7.9% YoY (7.3% YoY earlier), Q3 FY22 to 6.8% YoY (6.3% YoY earlier) while keeping the Q4FY22 forecast unchanged at 6.1% YoY and the Q1 FY23 growth projection at 17.2% YoY.

On the inflation outlook, the RBI drew comfort from recent moderation in the CPI print, with headline inflation coming at 5.3% YoY in August (vs 5.59% YoY in July). The softening of inflation print went beyond a favourable base effect from last year as the sequential momentum eased from 0.7% MoM in July to 0.2% MoM in August. The decline was primarily led by moderation in food prices which deflated by 0.1% MoM in August compared to an increase of 1.0% MoM in July. Meanwhile, core inflation remained sticky at ~6% YoY in August (vs 6.1% YoY in July), although its momentum eased marginally to 0.4% MoM compared to 0.6% MoM in July. With core inflation persisting at an elevated level, the RBI advocated measures to ameliorate supply-side and cost pressures (given rising metals and energy prices), including through cuts in indirect taxes on petrol and diesel by both Centre and States, which could contribute to a more durable reduction in inflation. Going ahead, we expect inflation prints to remain benign, supported by a favourable base effect (until November), moderating food prices on the back of improving progress on Kharif sowing activity and further easing of supply-side constraints. Factoring in recent lower inflation prints and projected further easing in price pressures, the RBI lowered its headline CPI inflation forecasts to 5.3% YoY for FY22 from 5.7% YoY earlier. The quarterly forecasts for Q2FY22 and Q3FY22 were revised lower to 5.1% and 4.5%, respectively, from 5.9% and 5.3% earlier, and the forecast for Q4FY22 was retained at 5.8% YoY. The CPI projection for Q1 FY23 is revised marginally upwards to 5.2% from 5.1% YoY earlier. As demand recovery continues and gets an additional boost during festival season, we see risks of pass-through of cost built-up to consumers, which could eat into the expected benefit from lower food inflation and base effect. Meanwhile, rising global energy prices are increasing the cost pressures further. Therefore, we see a possibility that the inflation outturn might exceed RBI's revised projection in the rest of FY22.

RBI CPI projections revised downwards for FY22



Source: RBI

RBI steps up liquidity normalization efforts; continues to provide targeted policy support

In the aftermath of COVID-19, the RBI has been injecting abundant liquidity in the system to contain the adverse impact of the pandemic on the economy. However, surplus liquidity has shot up considerably in recent months due to continued policy measures like GSAP and foreign capital inflows, etc. In its August meeting, the RBI had announced measures to address the extraordinary surge in systemic liquidity. It had increased its fortnightly Variable Rate Reverse Repo (VRRR) auction amount from Rs 2 lakh crore to Rs 4 lakh crore in a calibrated manner over August-September. The surplus liquidity remained in large surplus in August-September, with daily absorptions rising from an average of Rs 7.7 lakh crore in July-August to Rs 9.0 lakh crore during September and Rs 9.5 lakh crore during October (up to October 6) through the fixed-rate reverse repo, the 14-day VRRR and fine-tuning operations under the liquidity adjustment facility. In order to adjust the liquidity with evolving macro-conditions, the RBI today announced additional measures.

Firstly, the RBI suspended G-SAP given surplus systemic liquidity, the absence of a need for additional borrowing for GST compensation, and the expected expansion of liquidity in the system as the government spending increases in the coming months. However, the Governor emphasized that the central bank remains ready to restart GSAP or conduct other liquidity management operations, including Operation Twist (OT) and regular open market operations (OMOs) as needed. The yield on 10-year Gsec rose by 5 bps to 6.318% today, adding to pressures coming from higher oil prices.

Secondly, the RBI increased the variable reverse repo auction amount from Rs 4 lakh crore to 6 lakh crore in a calibrated manner, giving out a calendar for proposed operations. It will undertake the 14-day VRRR auctions on a fortnightly basis in the following manner: Rs 4.0 lakh crore today; Rs 4.5 lakh crore on October 22; Rs 5.0 lakh crore on November 3; Rs 5.5 lakh crore on November 18; and Rs 6.0 lakh crore on December 3. It will also consider complementing the 14-day VRRR auctions with 28-day VRRR auctions in a similar calibrated fashion depending on the liquidity conditions while also being ready to conduct fine-tuning operations of varying amounts when required.

The RBI Governor emphasized that the VRRR auctions are primarily a tool for rebalancing liquidity and should not be interpreted as a reversal of the accommodative policy stance. He assured that the RBI would ensure adequate liquidity to support the process of economic recovery and to support the market in ensuring an orderly completion of the government's borrowing programme. Given the liquidity overhang, we view liquidity normalization as a pre-condition to the policy normalization. The Governor emphasized that *"This process has to be gradual, calibrated and non-disruptive while remaining supportive of the economic recovery".* We continue to expect the RBI to raise the reverse repo rate in the Dec' 21/Feb '22 meeting, while the repo rate hike is likely to be in H1-FY23.

Even as the RBI announced measures to adjust systemic liquidity, it continues to provide policy support in a targeted manner. Recognizing the uneven impact of the pandemic on small business units, micro and small industries, and other organized entities, the RBI extended the deadline for SLTRO from Oct'21 to Dec'21. A three-year SLTRO facility of Rs 10,000 crore at the repo rate was made available to small finance banks in May'21 (till Oct'21) to be used for fresh lending for up to Rs 10 lakh per borrower. Further, this facility will now be available on tap to ensure extended support to these entities. It also extended the PSL classification for lending by banks to NBFCs for on-lending to Agriculture, MSME, and Housing sectors for six months till March 31, 2022. These measures should help credit flow to small borrowers and priority sectors

RBI extends support amidst pandemic related uncertainties

Extending support amidst uncertainties surrounding the pandemic and promoting digital transactions, the RBI announced the extension of earlier measures and also introduced new measures, as listed below -

Measures on Payment and Settlement System

- Keeping the learnings from the pilots conducted to test the innovative technology that enables retail digital payments even in situations where internet connectivity is low / not available (offline mode), the RBI has decided to introduce a framework for carrying out retail digital payments in offline mode.
- Considering the recent increase in settlement cycles of IMPS, the RBI has decided to enhance the per-transaction cap in IMPS from Rs 2 lakh to Rs 5 lakh for channels other than SMS and IVRS.
- To ensure a balanced spread of acceptance infrastructure across the entire country, the RBI has proposed geo-tagging of all the physical payment acceptance infrastructure, viz., Point of Sale (PoS) terminals, Quick Response (QR) codes, etc.
- With a view to providing further impetus to the fintech eco-system, a fourth cohort on 'Prevention and Mitigation of financial frauds' has been announced in addition to three cohorts already introduced by the Reserve Bank's Regulatory Sandbox on 'Retail Payments'; 'Cross Border Payments'; and 'MSME Lending. Additionally, the RBI also proposed to facilitate the 'On Tap' application for earlier themes for participating in the Regulatory Sandbox.

Measures on Debt Management

- To help States/UT manage their cash flows amidst ongoing pandemic related uncertainties, the RBI decided to continue with the interim enhanced Ways and Means Advances (WMA) limits of Rs 51,560 crore for States/UTs for six months up to Mar '22.
- Additionally, it decided to continue with the liberalized measures introduced during the pandemic, i.e., enhancement of the maximum number of days of overdraft (OD) in a quarter from 36 to 50 days and the number of consecutive days of OD from 14 to 21 days, up to March 31, 2022.

Measures on Customer protection

- With a view to strengthen the internal grievance redress mechanism of NBFCs, the RBI decided to introduce the Internal Ombudsman Scheme (IOS) for certain categories of NBFCs having higher customer interface.

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