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RBI reiterates dovish policy stance; announces bond-purchase programme to manage yield

- As expected, the Reserve Bank of India's (RBI) Monetary Policy Committee (MPC) maintained status quo on key policy rates.

- It also retained its accommodative stance "as long as necessary to sustain growth on a durable basis and to continue to mitigate the impact of COVID-19 on the economy".

- But the MPC changed its forward guidance from time-based to state-based, committing that the policy stance will remain accommodative till the "prospects of sustained recovery are well secured". This helped push back against market expectations of a near-term liquidity tightening.

- The MPC retained its real Gross Domestic Product (GDP) growth projection of 10.5% YoY in FY22 and revised inflation forecasts marginally higher. Against this background, additional liquidity measures highlight RBI's dovish leaning and continued prioritization of economic growth revival.

- The RBI stated its commitment to keeping system liquidity in "surplus", announcing several measures, including the extension of the on-tap Targeted Long-Term Refinancing Operations (TLTRO) scheme, liquidity support to the All India Finance Institutions (AIFIs), and extension of Priority Sector Lending (PSL) classification for lending by banks to Non-Banking Financial Companies (NBFCs) for "on-lending".

- With regard to yield curve management, the RBI came out with a new programme, "the secondary market G-sec acquisition programme" or G-SAP 1.0, under which it will commit upfront to a specific amount of open market purchases of government securities, starting with Rs 1 lakh crore in Q1 FY21, in the secondary market.

- This, coupled with RBI's decision to conduct variable rate reverse repo (VRRR) of longer tenure (from the present 14-day tenure), should narrow the term premium and flatten the yield curve.

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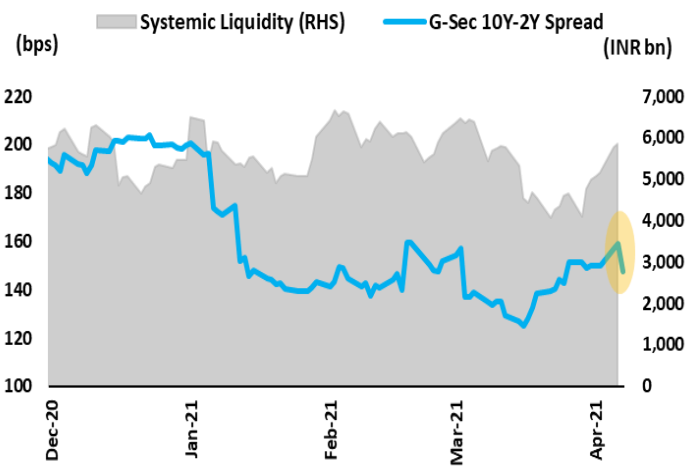
A dovish RBI continues prioritization of economic growth revival over inflation risks

The RBI MPC was beset by global volatility, increasing commodity prices, inflation expectations and a recent surge in COVID cases as it met for the first policy meeting in the current financial year. As expected, it maintained status quo on policy rates and reiterated an accommodative policy stance in its policy meeting today. But the RBI changed its forward guidance from a time-based one to state-based, committing that the stance of policy will remain accommodative till prospects of sustained recovery are well secured. Given continued prioritization of growth revival, it indicated its commitment to keep system liquidity in surplus, announcing several measures including the extension of on-tap TLTRO scheme, additional liquidity support to AIFIs, and extension of Priority Sector Lending (PSL) classification for lending by banks to NBFCs for further "on-lending".

With regard to yield curve management, the RBI came out with a new programme, "the secondary market G-sec acquisition programme" or G-SAP 1.0, under which it will commit upfront to a specific amount of open market purchases of government securities. The G-SAP 1.0 will run in addition to other liquidity measures (such as open market operations (OMOs) including special OMOs undertaken by the central bank. This, coupled with RBI's decision to conduct a variable rate reverse repo (VRRR) of longer tenure (from the present 14-day tenure), should narrow the term premium and flatten the yield curve. Measures announced today further reinforce the RBI's dovish leaning and continued prioritizing of economic growth revival over temporary inflation risks.

India G-sec term premium narrows following policy announcement

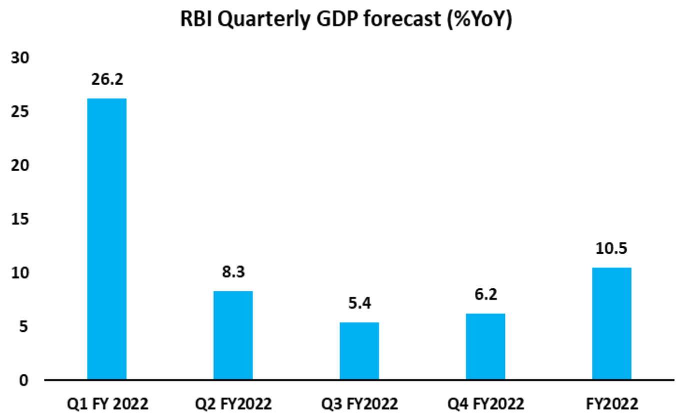


Source: RBI

State-based forward guidance replaces time-bound guidance: an accommodative stance to ensure "surplus" liquidity till prospects of sustained recovery are "well secured"

The MPC kept policy rates unchanged, in line with our expectations and market consensus. Accordingly, key policy rates stand at their respective levels: Repo Rate (RR): 4%, Reverse Repo Rate (RRR): 3.35%, Marginal Standing Facility Rate (MSF): 4.25%, Bank Rate: 4.25%. The MPC retained its accommodative stance "*as long as necessary to sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy*". As such, the policy stance has shifted from time-based (removal of the verbiage "*at least during the current financial year and into the next financial year [i.e.FY22]*" from the policy statement) to a state-based (i.e. "*necessary to sustain growth on a durable basis*") guidance, considering the uncertainty related to the economic outlook, especially given the ongoing second wave. The state-based guidance was also tweaked slightly, replacing the wording from - "revive" growth on a durable basis to – "sustain" growth on a durable basis, emphasizing a more lasting form of support.

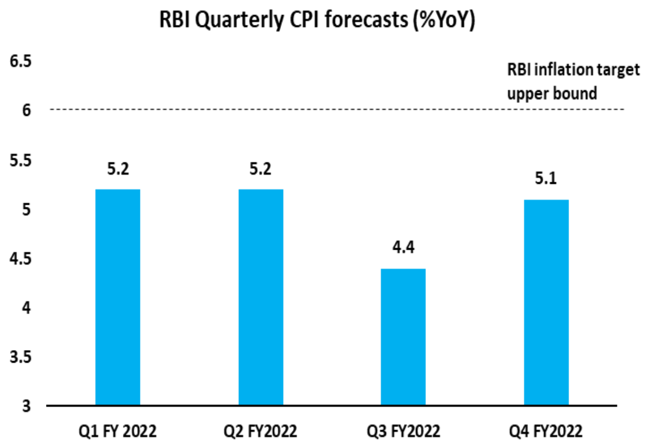
RBI Quarterly GDP Forecast



Source: RBI

The RBI governor acknowledged the recent surge in COVID cases and global financial market volatility (at the end of February) that have exacerbated downside risks to the domestic economic outlook. However, the governor also noted upside risks from the ongoing vaccination drive, gradual release of pent-up demand, and government reform measures. As such, the RBI kept its growth forecast unchanged at 10.5% YoY for FY22. The RBI noted that the fallout from the ongoing second COVID wave could be limited given better preparedness and readiness of coordinated policy actions by fiscal and monetary authorities. Besides this, we also note that despite a faster rise in COVID cases – a higher degree of COVID case concentration this time, faster reaction function of the government and low severity (fatality rate continues to remain low) are likely to keep economic activity more resilient, with exceptions in some contact intensive service sectors restricted to certain states. We also note that the Indian economy is likely to be more resilient from a global financial market shock given its strong macro-economic position (Please refer to our report - *Global reflation trade spills bouts of volatility; India's improved external position to help avoid a repeat of the "2013 taper-tantrum"*). Nevertheless, the COVID situation remains a wild card, and the successful completion of the vaccination drive is vital for an unhindered return to normalcy.

RBI Quarterly Inflation Forecast



Source: RBI

On inflation, the RBI revised its forecasts for the current financial year marginally higher to 5.2% YoY for Q1 FY22 and Q2 FY22, respectively (from 5.2-5% YoY in H1 FY22 in the February policy) and 4.4% in Q3FY22 (from 4.3% YoY in the February policy). The RBI also expects Consumer Price Index (CPI) to increase to 5.1% YoY in Q4 FY22. The RBI expects inflation to remain within its tolerance band of 4% (+/-2%) in the coming quarters. The government has also retained the inflation target for the next five years, noting its success in anchoring inflation expectations around the 4% target while also providing flexibility to respond to the sharp growth-inflation trade-offs during the COVID period. We expect the RBI to continue to prioritize growth as it overlooks some of the temporary shocks to inflation.

RBI adds to its toolkit to manage yield curve

While the policy stance of the RBI was broadly expected in this policy, market participants were focused on forward and liquidity guidance. The RBI provided a dovish angle as it announced an upfront government buying programme (G-SAP 1.0) of Rs. 1 lakh crore in the secondary market (in Q1 FY21), to enable a stable and orderly evolution of the yield curve (the first tranche of the G-SAP 1.0 programme will entail an aggregate amount of Rs 25,000 crore, to be held on April 15, 2021). While the RBI has repeatedly ensured support in the orderly completion of the government borrowing programme, bond yields have remained elevated and diverged sharply from the RBI stance. The explicit and upfront bond-buying programme of the RBI is being viewed to hold similar characteristics as an OMO calendar and is likely to address the divergence between the RBI and market yield expectations.

The governor in a recent press interview - also communicated – the RBI's intent in conducting more than Rs 3 lakh crore of OMOs in FY22 (at least similar to the amount conducted in FY21), and supporting the (net) borrowing requirement (Rs ~9 lakh crore) of the central government in the current fiscal year. With the Held-to-maturity dispensation likely to open up space for another Rs 4 lakh crore of bond demand, ~Rs 2 lakh crore of bond supply is left to be absorbed by market participants. Given the balance of at least Rs 2 lakh crore of OMOs are conducted in a similar "upfront" fashion in the subsequent quarters, it could lead to better compression of bond yields with a more frequent and explicit reminder of the RBI's hand. This was visible in the cheer from bond markets that saw yields on the 10-year decline by ~5 basis points to settle below the 6.1% mark. There was also a sharp fall in the rupee by 1.5% to 74.55 against the USD today due to additional liquidity prospects, besides exchange market related factors. The G-SAP 1.0 should balance the impact from the announcement on conducting VRRR auctions of longer maturity that had previously led to spill-over to even the longer-end of the yield curve despite being aimed at only managing the short-term rates (some of which had even fallen below the reverse repo rate).

Targeted liquidity/credit measures announced

The RBI also announced measures to continue supporting the more stressed sectors, such as the extension of the on-tap TLTRO scheme (for another 6 months). The scheme has witnessed tepid demand from banks so far (only Rs 5,000 crore of the Rs 1 lakh crore limit), despite the inclusion of the twenty-six stressed sectors notified under Emergency Credit Line Guarantee Scheme (ECLGS) 2.0 (identified by the Kamath Committee of the RBI) and NBFCs. However, this is a good precautionary measure and is likely to provide liquidity to stressed sectors in the event of demand picking up in the coming months. The RBI also announced liquidity support (Rs 50,000 crore) to AIFIs for new lending in FY22 - Rs 25,000 crore to National Bank for Agriculture and Rural Development (NABARD); Rs 10,000 crore to National Housing Bank (NHB); and Rs 15,000 crore to Small Industries Development Bank of India (SIDBI). Last year, the RBI provided special refinance facilities for a total amount of Rs 60,000 crore to NABARD, SIDBI and NHB to meet sectoral credit requirements. The scheme yielded positive results with these AIFIs availing liquidity of Rs 46,000 crore and disbursing total loans of around Rs 51,000 crore by the end of December 2020. For NBFCs - the RBI extended the PSL classification for lending by banks to NBFCs for "on-lending" (to agriculture, Medium and Small and Medium Enterprises [MSMEs] and the Housing sector) for six months until September 30, 2021. An amount of Rs 37,000 crore has already been lent by banks to NBFCs for on-lending to the above sectors until December 2020, and an extension is likely to support credit to these sectors.

Institution-wise Loan Availment as on December 4, 2020 (in cr)

Loan Extended to	SLF Availed by AIFIs	Loans disbursed by AIFIs
Co-operative Banks	16300	16300
Regional Rural Banks	6700	6700
Microfinance Institutions	3350	4278
Small Finance Banks	3587	3772
MSMEs	6155	9806
Housing Finance Companies	9999	10425
Total	**46091**	**51281**

Source: RBI

The RBI also decided to increase the overall revised limit of Ways and Means Advances (WMA) for states/UTs by 46% to Rs 47,010 crore and to continue with the enhanced interim WMA limit of Rs. 51,560 that it had allowed during the last fiscal to help states/UTs tide over difficulties faced during the pandemic for another six months (until September 30, 2021). This is likely to support state governments in their spending by reducing their borrowing costs, especially given the resurgence in COVID cases and the possibility of local lockdowns reverting.

The RBI also announced other measures of regulation & supervision, financial inclusion, payment systems and external commercial borrowing that have been listed below.

Measures on regulation and supervision:

- Enhancement of loan limit from Rs 50 lakhs to Rs 75 lakhs per borrower against the pledge/hypothecation of agricultural produce backed by NWRs/(e-NWRs) issued by warehouses registered and regulated by WDRA
- Enhancement of limit of maximum balance per customer at the end of the day from Rs 1 lakh to Rs 2 lakhs for Payments Banks
- Constitution of a committee to undertake a comprehensive review of the working of Asset Reconstruction Companies (ARCs) and recommend measures to enable these entities to meet the growing requirements of the financial sector.

Measures on financial inclusion and external commercial borrowing:

- To measure the extent of financial inclusion in the country, the RBI proposes to construct and publish a Financial Inclusion Index to be published in July every year for the financial year ending previous March.
- The RBI will permit parking of unutilized External Commercial Borrowing (ECB) proceeds drawn down on or before March 1, 2020, in term deposits with Authorised Dealer (AD) Category-I banks in India prospectively up to March 1, 2022.

Measures on payment systems:

- The RBI will enable non-bank payment system operators like Prepaid Payment Instrument (PPI) issuers, card networks, White label ATM operators and Trade Receivables Discounting System (TReDS) platforms regulated by the Reserve Bank, to take direct membership in Centralised Payment Systems (CPS).
- The RBI proposed to make interoperability mandatory for full Know Your Customer (KYC) PPIs and for all payment acceptance infrastructure. To incentivize PPIs' migration to full KYC, the RBI decided to increase the current limit on the outstanding balance in such PPIs from Rs 1 lakh to Rs 2 lakhs.
- The RBI will allow cash withdrawals for full KYC PPIs of non-bank PPI issuers

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