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The RBI continues to prioritize growth revival despite inflationary pressures

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- The Reserve Bank of India (RBI) in a unanimous decision, maintained status quo on key policy rates, as expected, and retained its accommodative stance "as long as necessary to revive and sustain growth on a durable basis", with a 5:1 majority.
- The RBI continued to prioritise growth revival over building inflationary concerns that it perceives as primarily supply-side driven. The RBI revised its Consumer Price Index (CPI) projection to 5.7% YoY for FY22 from 5.1% earlier.
- Economic recovery has picked up from the setback of the second COVID wave. However, the RBI sees the recovery as nascent and hesitant with underlying factors remaining weak.
- The central bank continues to see the need for policy support to nurture economic recovery and remains cautious of a pre-emptive withdrawal of policy support which could be fatal to the fragile recovery.
- The RBI maintained its growth forecast for FY22 at 9.5% YoY, which stands close to our own forecast of 9.9% YoY. However, it revised its quarterly projections to reflect a better recovery in Q1 FY22.
- On liquidity management, the RBI announced an increase in the variable rate reverse repo (VRRR) auction amount, given the surge in liquidity recently.
- The absorption of liquidity is expected to create more space for the RBI to sterilize capital flows in the forex market, conduct more open market operations (OMOs), and also balance flows from government spending that is expected to pick up in coming months.
- The RBI governor also managed to dissect liquidity normalization from policy normalization, assuaging any concerns of a move away from its accommodative stance.
- The RBI proposed to conduct two more G-SAP auctions of Rs 25,000 crore each on August 12, 2021, and August 26, 2021.
- In response to the impact from the second COVID wave, the RBI also extended previous measures such as the on-tap Targeted longer-term repo operations (TLTRO) scheme for stressed sectors, relaxation on the marginal standing facility (MSF) to banks, and the deferral of the deadline for achieving financial parameters under the resolution framework 1.0.
- We maintain our call for a change in the accommodative stance that could come in the form of a reverse repo rate hike in Q4 FY22. However, we do not rule out an earlier move in Q3 FY22 on the back of a faster recovery and further increase in inflationary pressures. We expect the first repo rate hike to take place in the next fiscal year (FY 2023).

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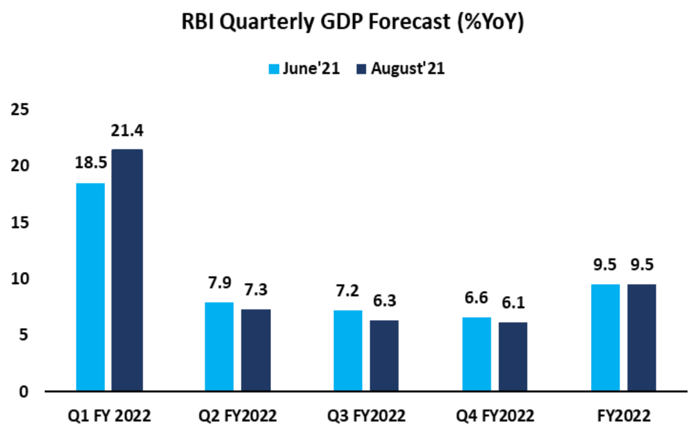
RBI remains accommodative; continues to prioritize growth revival despite inflationary concerns

The RBI August policy was on expected lines as the Monetary Policy Committee (MPC) maintained status quo on its policy rate decisions and its accommodative stance. The RBI continued to prioritize growth revival over building inflationary pressures that it perceives as largely temporary and supply driven. Although recovery has picked up from the setback of the second COVID wave, the central bank continues to see the need for policy support to nurture recovery that remains nascent and hesitant and rests on weak underlying factors. It also remains cautious of a pre-emptive withdrawal to policy support that could be fatal to the fragile recovery. On liquidity management, the RBI announced an increase in the VRRR auction amount, given the surge in liquidity recently. The absorption of liquidity is expected to create more space for the RBI to sterilize capital flows in the forex market, conduct more OMOs (the RBI announced fresh G-SAP auctions of Rs 50,000 crore in August) and also balance flows from government spending that is expected to pick up in the coming months. The RBI governor also managed to dissect liquidity normalization from policy normalization, assuaging any concerns of a move away from its accommodative stance. In response to the impact from the second COVID wave, the RBI also extended previous measures such as the on-tap TLTRO scheme for stressed sectors, relaxation on MSF facility to banks, and the deferral of deadline for achieving financial parameters under the resolution framework 1.0. The RBI also announced new guidelines for a smooth transitioning from London Interbank offered rate (LIBOR).

RBI retains growth projection for FY22 with revisions to quarterly growth forecasts



Source: RBI

RBI maintains status quo despite building inflationary pressures

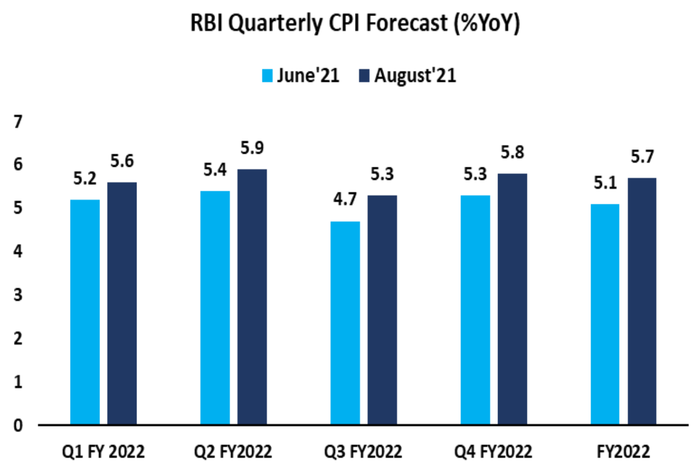
In line with our expectations, the MPC kept policy rates unchanged at their respective levels - Repo rate at 4%, Reverse repo rate at 3.35%, Marginal Standing Facility rate, and Bank rate at 4.25%. The MPC also decided to maintain its accommodative stance *"as long as necessary to revive and sustain growth on a durable basis…while ensuring inflation remains within the target",* although the decision was not unanimous with one member dissenting (Prof. Jayanth Varma) and resulting in a 5:1 vote. ***The RBI continued to tilt the balance in favor of growth revival despite building inflationary pressures in recent months (over its threshold of 6%), as it saw the growth recovery as still nascent and hesitant.***

Economic recovery from the setback of the second COVID wave has been relatively faster as noted in the evolving high-frequency indicators of June and July. This is reflected in the upward revision of RBI's growth forecast for Q1 FY22 that has been revised higher to 21.4% YoY (from 18.5% earlier). However, the growth forecasts for the remaining three quarters (Q2-Q4 FY22) have been revised lower (please refer to chart), which possibly reflects a delayed recovery in certain sectors still impacted by the pandemic. As such, the RBI maintained its overall growth projections for FY22 at 9.5% YoY which sits close to our own estimates of 9.9% YoY. Domestic economic activity has started treading towards normalcy, with both facets of consumption and investment demand noting a sequential increase. This has been facilitated with the easing of state-led restrictions that is further bolstered by the ongoing vaccination drive. Encouragingly, the RBI's consumer confidence survey for the July round noted a turnaround in its 'one year ahead' expectations that returned to optimistic territory from its historic lows in May 2021. Tailwinds from the external sector also remain robust with exports rising to record highs in FY22 so far (April-July) even as import recovery remains strong. Considering these factors, we see upsides to our growth projections of ~16% YoY in Q1 FY22. However, we still expect growth to be sub 20% (lower than the RBI's forecast of 21.4%) given muted government spending in Q1 FY22 (0.7% YoY in Q1 FY22). Nevertheless, given robust revenue receipts of the government, we expect government spending to increase, as we move into festive season months, and support growth in the following quarters.

On the inflation outlook, the MPC revised its CPI projections higher to 5.7% YoY for FY22 from 5.1% earlier. Implicit in this was the overshooting of actual CPI prints for Q1 FY22 to 5.6% YoY (due to over 6% prints in May and June respectively) against the RBI's forecast of 5.2%. The RBI also raised its projections for the following three quarters from Q2-Q4 FY22 to 5.9%, 5.3%, and 5.8% respectively from 5.4%, 4.7%, and 5.3% respectively, acknowledging adverse supply shocks, elevated logistic costs, rising global commodity prices and domestic fuel taxes for upside price pressures. However, the RBI continues to see these building price pressures as transient and largely supply side driven while demand remains subdued. Inflation prints are likely to ease in the interim (Q3 FY22), as supply pressures fade with the reopening of the economy; kharif harvest arrivals that are likely to ease food inflation, and also a favourable base effect in coming months, which will provide more space for the MPC to continue remaining accommodative.

Overall, the RBI's focus on reviving growth remains starkly clear, which is evident in its current guidance even as it pushes its inflation projections to the edge of its comfort level at 5.7% YoY for FY 2022. In fact, according to deputy governor Michael Patra, the RBI is spreading disinflation over 2-3 years to reduce losses on output. Moreover, the path of inflation is being calibrated downwards, which had increased to 6.2% on average in the pandemic year (FY 2021) and is expected to trend lower to 5.7% in FY 2022 before finally moving to 4%. Additionally, a statement from the RBI governor's speech - "The MPC continues to be conscious of its mandate of anchoring inflation expectations as soon as the prospects for strong and sustainable growth are assured" – further quells any doubts on inflation taking precedence over growth revival in the near term. In this light, it is important to note that while economic recovery continues to take place, it is still incomplete, and the underlying factors remain weak. Meanwhile, downside risks to growth from a possible third wave continue to remain alive. Daily COVID cases, after bottoming out around the 40,000 -mark have started to inch higher, although the spread continues to remain concentrated in a few regions. Moreover, India's vaccination coverage also remains low at present (~28% of the population inoculated with a single dose and ~8% inoculated with both doses).

RBI CPI projections revised higher in FY 2022



Source: RBI

RBI dissects liquidity normalization from policy normalization

The RBI has been injecting abundant liquidity in the system to ensure congenial financial conditions and boost demand to cushion the impact from the pandemic since last year. In addition to cutting interest rates, the RBI has employed both conventional and unconventional tools such as OMOs, special open market operations (SOMOs), G-SAP auctions, etc., to ease financial conditions. In addition to the liquidity injected from the RBI, robust capital flows have further added to the abundance of liquidity. As such, systemic liquidity remained elevated at Rs 5.7 lakh crore in June which increased to Rs 6.8 lakh crore in July and has further increased to ~Rs 8.5 lakh crore in August (upto August 4, 2021).

With the intent of continuing normal liquidity operations, the RBI announced an increase of the fortnightly VRRR auction amount from Rs 2 lakh crore currently to Rs 4 lakh crore. The RBI undertook a calibrated approach - with the VRRR auction amount increasing to Rs 2.5 lakh crore on August 13, 2021; Rs 3 lakh crore on August 27, 2021; Rs 3.5 lakh crore on September 9, 2021, and Rs 4 lakh crore on September 24, 2021. While we, along with market participants, were expecting the first signs of policy normalization to begin from H2 FY22 onward (which could take the form of a VRRR auction increase), this step came in earlier than expected. However, it is important to acknowledge that the governor managed to dissect the process of liquidity normalization from policy normalization as he reiterated that this step does not tantamount to and should not be misread as a reversal of the accommodative stance. This is evident in the bond yield reaction for the 10-year which has increased modestly by ~3-4 basis points following the announcement. Bond yields also remained supported as the RBI announced a G-SAP auction of Rs 50,000 crore in August. As such, we maintain our call for a change in the accommodative stance that could come in the form of a reverse repo rate hike in Q4 FY22. However, we do not rule out an earlier move in Q3 FY22 on the back of faster recovery along with a further increase in inflation pressures. We expect the first repo rate hike to take place in the next fiscal year (FY 2023).

The increase in the VRRR auction amount should also help RBI in managing liquidity by creating more space to conduct OMOs and intervene in the forex market with capital flows expected to remain robust. Moreover, this would also balance the flows expected from the increase in government spending as we move towards festive season months. Core liquidity (adjusted for government balance) stood at nearly Rs 10 lakh crore as on July 16, 2021.

RBI extends support in response to the second wave

The RBI has remained proactive since the onset of the pandemic and introduced various measures to extend liquidity and credit support while undertaking additional steps to ensure penetration of the benefits of its measures to last-mile recipients. The RBI announced the extension of existing measures and also announced new measures, as listed below -

On-tap TLTRO Scheme: Extension of Deadline

- The operating period of on-tap TLTROs has been further extended by a period of 3 months i.e., till December 31, 2021. The scope of the on-tap TLTROs scheme which initially started with 5 sectors i.e., 1) Agriculture, 2) Agri-Infrastructure, 3) Secured Retail, 4) Micro, Small and Medium Enterprises (MSMEs), and 5) Drugs, Pharmaceuticals, and Healthcare, was further extended to 26 stressed sectors identified by the Kamath Committee in December 2020 and bank lending to NBFCs in February 2021.

Marginal Standing Facility (MSF): Extension in Period of Relaxation

- Banks have been provided a further relaxation of 3 months under MSF till December 31, 2021, wherein they are allowed to avail of funds by dipping into the Statutory Liquidity Ratio (SLR) up to an additional 1% of their net demand and time liabilities (NDTL). This dispensation provides increased access to funds to the extent of Rs 1.62 lakh crore and qualifies as high-quality liquid assets (HQLA) for the Liquidity Coverage Ratio (LCR).

LIBOR Transition - Review of Guidelines – Export Credit in Foreign Currency and Restructuring of Derivative Contracts

- Regarding the transition away from LIBOR, the RBI has decided to amend the guidelines related to (i) export credit in foreign currency and (ii) restructuring of derivative contracts.
- Banks will be permitted to extend export credit in foreign currency using any other widely accepted Alternative Reference Rate (ARR) in the currency concerned. Since the change in reference rate from LIBOR is a ‘force majeure’ event, banks are also being advised that change in reference rate from LIBOR/LIBOR-related benchmarks to an ARR will not be treated as restructuring.

Deferral of Deadline for Achievement of Financial Parameters under Resolution Framework 1.0

- Under resolution framework 1.0, entities are required to meet sector-specific thresholds in respect of five financial parameters, four of which relate to operational performance, i.e., Total Debt to EBIDTA ratio, Current Ratio, Debt Service Coverage Ratio, and Average Debt Service Coverage Ratio.
- Recognizing the continued stress from the second COVID wave, the RBI has decided to defer the target date for meeting the specified thresholds for the above four parameters to October 1, 2022, (from March 1, 2022, earlier).
- In regard to the debt-equity mix parameter i.e., Total Outside Liabilities/Adjusted Total Net Worth (TOL/ATNW), the date for achieving the specified threshold remains unchanged: March 1, 2022.

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