Monetary policy | First cut

Steady normalisation

December 8, 2021

RBI keeps policy rates unchanged, takes more steps to mop up liquidity

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept the policy rates and accommodative stance unchanged at its review meeting today. However, as in the previous meeting, it took steps to reduce the extraordinary liquidity injected post the pandemic. The central bank remains supportive of growth, but is trying to manage challenges emerging from inflationary pressures and external risks — including a new unknown in the form of the omicron variant of Covid-19.

The RBI is proceeding cautiously in unwinding the unconventional easing measures, because economic recovery, while steady, remains incomplete, and faces unknown risks from the omicron variant. However, the RBI may not have the leeway to remain as accommodative in the coming months given that the pressure on inflation remains significant. To boot, the Federal Reserve of the United States is also withdrawing accommodation earlier than previously anticipated. We expect a hike in reverse repo rate in February 2022 to narrow the corridor with the repo rate to 25 basis points (bps). This is likely to be followed by a 25 bps hike in repo rate in March 2022.

Key takeaways from the December monetary policy review meeting

- The MPC voted unanimously to keep the repo rate unchanged at 4%. Status quo was also maintained on the reverse repo rate at 3.35% and the marginal standing facility at 4.25%
- It voted 5-1 to continue the accommodative stance
- The MPC maintained forecasts for gross domestic product (GDP) growth at 9.5%, and consumer price index (CPI)-based inflation forecast at 5.3% for this fiscal
- It announced further increase in liquidity absorption under 14-day VRRRs, Rs 6 lakh crore at present to Rs. 7.5 lakh crore by the end of this month. These will be complemented with longer-term VRRRs as well
- An option was provided to banks to pre-pay the funds availed of under the Targeted Long-Term Repo Operations (TLTROs) announced in March-April 2020
- Funding availability under the Marginal Standing Facility (MSF) was reduced to 2% of Net Demand and Time Liabilities (NDTL) from 3%

What weighed on the RBI's decision?

- **Steady but uneven economic recovery**: The MPC noted GDP growth data for the second quarter showed continuing recovery after the second wave of Covid-19 afflictions. This recovery showed signs of gaining momentum in the third quarter, as evidenced by several high-frequency indicators such as the Goods and Services Tax collections, toll collections, air passenger traffic and railway freight movement. While rural demand remains resilient, urban demand has also improved over the past few months. Government investment has been strong, too, and its consumption spending has also picked up from August. On the external front, both exports and imports have crossed pre-Covid levels. The MPC expects the recovery to continue strengthening, on the expectation of resilient rural demand, broad-basing of recovery with expanding vaccination coverage and controlled Covid-19 cases, and investment pickup driven by the government — which could eventually crowd-in private investment.

However, the MPC believes the recovery is far from complete. Private consumption remains below pre-Covid levels. Recovery continues to face headwinds from surging commodity prices, global supply bottlenecks, and volatile global financial conditions. Added to this is the new risk from the new omicron variant, the full implications of which will only be understood in the coming weeks.

Considering the above-mentioned factors, the RBI retained the forecast for GDP growth at 9.5% for this fiscal — moving from 8.4% in the second quarter to an expected 6.6% in the third and 6.0% in the fourth.

- **Inflation dynamics**: Since the last MPC meeting, headline CPI inflation has remained near the mid-point of the RBI's target of 2%-6%. However, the MPC noted that the latest reading for October showed a pick-up to 4.5% from 4.3% previous month, driven by a spike in vegetable prices. Fuel inflation continues to run in double-digits. The MPC was also concerned about the persistence in core inflation, which has stayed close to 6% for the past 6 months.

  The MPC anticipates future inflation trajectory to be subject to a number of factors. To wit, vegetable prices are expected to decline with higher winter arrivals. Current progress on rabi sowing augurs well for agriculture production. The recent fall in crude oil prices, coupled with excise duty cuts on petrol and diesel, could help moderate fuel inflation. It could also indirectly alleviate core inflation through reducing transportation costs. However, input cost pressures remain significant, which the MPC recognises, will get passed on to consumer prices as demand recovers.

  Taking all these factors into account, the RBI kept its CPI forecast unchanged at 5.3%, as in the previous meeting. On a quarterly basis, it expects inflation to move from 5.1% in second quarter to 5.1% in third, and peak at 5.7% in fourth quarter of this fiscal. Next fiscal, it expects it average 5% in both first and second quarters.

- **Changing global market conditions:** The governor noted that global financial conditions are turning volatile. Many central banks across the world, including the systemically important US Fed are moving towards exiting from unconventional stimulus measures announced after the pandemic. Secondly, the omicron variant has brought forth new uncertainties for growth-inflation dynamics. These factors have made the global markets volatile — something that could spill over to the Indian markets as well.

  The RBI maintains domestic factors will remain the primary driver of its policy decisions. However, it feels the need to align liquidity conditions in accordance to evolving market developments to maintain financial stability. It also reaffirmed sticking to its inflation targeting framework in order to maintain credibility in a volatile global environment.

In light of these developments, the RBI took measures to reduce excess liquidity in the system. The auction amount under VRRRs, which had been increased from Rs. 5.4 lakh crore as of September-end to Rs 6 lakh crore on December 3, will be increased further to Rs 7.5 lakh crore by December 31. The RBI has also been conducting longer-tenor VRRRs, which is expected to continue next year. It is aiming for a gradual shift from fixed-rate repo towards VRRRs as the main route of liquidity management.

Among other measures to unwind after the pandemic stimulus, the RBI provided an option to banks to pre-pay funds availed under TLTROs. In addition, the availability of funds for banks under MSF window was reduced to from 3% to 2% of NDTL.

Our view

The RBI remains growth-supportive, and is taking calibrated steps towards unwinding the extraordinary stimulus measures rolled out after the pandemic. However, with economic recovery expected to be on track, the RBI tilt towards managing inflation and external risks.

While headline inflation has come within the RBI's target over the past few months, this has been primarily on account of a high base, especially for food prices. Non-food inflation also remains elevated. Although prices of crude oil, metals and costs of shipping have moderated over the past month, they remain significantly higher than last year. This, coupled with supply disruptions such as semiconductor shortages, has maintained pressure on producer margins. A pass-through of input-cost pressures to consumers, which was already happening in the past months, is likely to continue as domestic demand improves further.

Policy normalisation by the US Fed would be the second factor reducing the leeway for the RBI. Recent minutes of the Federal Open Market Committee, and remarks from Chairman Powell indicate their changing view of inflation not being transitory, and the possibility of increasing the speed of tapering next year. S&P Global expects the Fed to end its bond purchases by March 2022, leaving the year open for at least one rate hike.

Due to these factors, we expect the RBI to continue the calibrated normalisation in the coming months. The process of liquidity absorption is likely to be followed by a hike the reverse repo rate in February 2022 to reduce the gap with the repo rate to 25 basis points. We then expect a 25 bps hike in the repo rate to 4.25% in March 2022. This will still be lower than 5.15% prevailing pre-Covid (i.e. February 2020).

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