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INDUSTRY OUTLOOK

RBI MONETARY POLICY: RIGHT CALL IN UNCERTAIN TIMES

April 2021

RBI'S APRIL 2021 POLICY

In the wake of the nation-wide rapidly rising COVID-19 cases and the consequential imposition of restrictions and lockdown in some States, including Maharashtra, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) unanimously held the rates steady because the MPC wanted to ensure that "the prospects of sustained recovery are well secured". All members of the MPC, viz., Shashanka Bhide, Ashima Goyal, Jayanth R Varma, Mridul K Saggar, Michael Debabrata Patra, along with RBI Governor Das unanimously voted for keeping the policy repo rate unchanged. Accordingly, the benchmark repo rate remained at 4 per cent, while the effective policy rate (reverse repo rate) stood at 3.35 per cent. This status quo ante policy was in conformity with our assessment and the expectations of most well-informed market participants.

What makes it significant is the fact that this was the first bi-monthly MPC meeting of FY22 and was the fifth successive time, when the RBI kept the repo rate unchanged.

STANCE

The Governor Shri Shaktikanta said the MPC "also unanimously decided to continue with the 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, while ensuring that inflation remains within the target going forward".

GDP GROWTH

There is incipient recovery of the global economy but the path remains hazy. The RBI maintained its GDP growth forecast at 10.5 per cent for 2021-22 despite large stimulus in major economies and their likely impact on global growth. The MPC cited the second advance GDP estimates for FY21 of the National Statistical Office (NSO), which placed economic contraction at 8 per cent for FY21.

The quarterly breakup shows that the RBI lowered projected growth in Q3 of FY22 to 5.4 per cent from the 6 per cent announced in February. The economy is now expected to expand 26.2 per cent in Q1, 8.3 per cent in Q2, and 6.2 per cent in Q4.

On the basis of empirical cross-country evidence, Shri Das justifiably maintained "public investment in key infrastructure sectors is a force multiplier with historically proven ability to revive the broader economy by directly enhancing capital stock and productivity, and by attracting private investment". Other supportive factors fostering accelerated growth include fast tracking the vaccination programme, gradual release of pent-up demand, buoyant rural demand and record agriculture production for FY21. The government's plan to increase infrastructure spend, the expansion in the production-linked incentive (PLI) scheme, rising capacity utilisation from 63.3 per cent in the September quarter to 66.6 per cent in the December quarter and improving demand from urban centres as a consequence of the increasing macro-economic traction also augur well.

With growth picking up domestically, the focus must now be two-pronged on containing the spread of the virus and promoting economic revival. Consolidating the gains of the nascent recovery and sustaining the impulses of growth in this financial year must now occupy centre-stage. The Governor held "a key aspect of this strategy will be to strengthen the bedrock of macroeconomic stability that has anchored India's revival from the pandemic. This will help stakeholders in taking efficient spending decisions over longer horizons, thereby improving the investment climate".

The Governor stressed that the RBI is optimistic about a pick-up in demand and expansion of business activity this financial year. With the juxtaposition of high frequency lead and coincident indicators, such as vehicle sales, railway freight traffic, toll collections, goods and services tax (GST) revenue, e-way bills, and steel consumption, the economy is well and truly on the normalising course despite the Coronavirus rearing its ugly head once again. Hence there is the distinct possibility of the economy recording a growth of about 12 per cent in FY22.

Given the macro-economic scenario characterised by the on-going vaccination programme, the gradual release of pent-up demand, the investment-enhancing and growth-supportive reform measures taken by the government, there was evidently no case for any abrupt downward revision in the GDP growth rate at present. This thesis can also be substantiated by the Governor's statement, which pointed out "rural demand remains buoyant and record agriculture production in 2020-21 bodes well for its resilience. Urban demand has gained traction and should get a fillip with the on-going vaccination drive". But the rise in global commodity prices, the volatility in financial markets and the flare in COVID 19, exacerbates risks and lockdowns in certain states and thus could act as headwinds. Besides, consumer confidence has dipped with Covid-19 rising again in some states and in this overarching scenario, a downside risk emanating from the second wave cannot be ruled out.

Hence the Governor did well to temper the optimism because of the recent surge in COVID-19 infections, which clouds the domestic growth outlook together with stringent restrictions by some state governments. There is a real danger that COVID second wave could smother recovery. The focus must therefore now be on containing the spread of Coronavirus and resuscitating the economy. The Governor reassured "in India, we are now better prepared to meet the challenges posed by this resurgence in infections. Fiscal and monetary authorities stand ready to act in a coordinated manner to limit its spill-overs to the economy at large and contain its fallout on the on-going recovery".

INFLATION

The moderate revision in Consumer Price Index (CPI) inflation by the RBI implies FY22 average inflation at 5 per cent. The annual CPI-based retail inflation rate surged to a three-month high of 5.03 per cent in February. The Governor averred "the MPC judged that monetary policy should remain accommodative till prospects of sustained recovery are well secured".

While headline inflation at 5 per cent in February 2021 remained within the tolerance band, some underlying constituents were testing the upper tolerance level. Retail inflation is projected to stay around 5 per cent next year: 5 per cent in the Q4 of FY'21; 5.2 per cent in Q1 and Q2 FY'22; down to 4.4 per cent in Q3 FY'22 and 5.1 per cent in Q4 FY'22, with risks broadly balanced. The MPC held "the evolving CPI inflation trajectory is likely to be subjected to both upside and downside pressures".

While the bumper food-grain production and imports should check food prices, high international commodity prices, increased logistics costs and heightened inflation expectations of households are risk factors. This assessment has been done in the light of the trajectory of food inflation, the temporal and spatial progress of the south-west monsoon in 2021, high international commodity prices and logistics costs.

The RBI tweaked its forecast for the next four quarters because of the recent volatility in crude oil and industrial commodity prices. The RBI reiterated that it remains focused on economic growth as long as inflation remains within the prescribed range. To that extent, the RBI has moved from a time-based guidance to an outcome-based guidance. In view thereof, rising core inflation in the next or the subsequent quarter may not immediately trigger an aggressive, heavy-handed action because of the concern with the growth-inflation dynamics.

CONSUMER CONFIDENCE

A RBI survey brought out that consumer confidence and future expectations in India fell to 53.1 in March 2021 from 55.5 in January 2021. The survey said, "consumer confidence for the current period weakened in March as the current situation index dipped further in negative territory on the back of deteriorating sentiments on general economic situation, income and prices".

Future expectations dipped to 108.8 from 117.1 during the period. The moderation was driven by lower expectations on the economic situation, the employment scenario and income conditions. The survey said, "respondents expressed lower optimism for the year ahead, which was reflected in the future expectations index (FEI); one year ahead sentiments on all major parameters except prices, however, remained in positive terrain".

The survey conducted through field interviews between February 27 and March 8 in 13 cities recorded perceptions and expectations on general economic situation, employment scenario, overall price situation and own income and spending from 5,372 households. With higher essential spending vis-à-vis a year ago, most consumers reported higher overall expenditure, which is expected to increase further in the coming year despite continuing moderation in discretionary spending.

LIQUIDITY AND REGULATORY MEASURES - VRRR AUCTIONS

Despite the recommencement of 14-day variable rate reverse repo (VRRR) auctions since January 15, 2021, liquidity absorbed through the fixed rate reverse repo rose steadily from a fortnightly average of Rs 4.3 lakh crore during January 16-29 to Rs 4.9 lakh crore during January 30-March 31, 2021.

The RBI has decided to conduct Variable Rate Reverse Repo (VRRR) auctions of longer maturity (greater than the existing 14-day) as recommended by its revised liquidity management framework. In view of the success of VRRR and the rising level of surplus liquidity, the RBI will conduct VRRR auctions of longer maturity. The amount and tenor of VRRR auctions will be a function of the evolving liquidity situation. While this may put pressure on the shorter end of the curve, it is not expected to shift the overnight rates above the reverse repo rate of 3.35 per cent at least in the coming six months. The Governor clarified that this measure should not be read as liquidity tightening. In fact, by paying a higher rate of interest on liquidity absorptions through the VRRR auctions, the RBI is indirectly expanding liquidity.

The continuation of VRRRs is contextually significant given the systemic liquidity surplus of almost 4 per cent of NDTL of banks as against 2.3 per cent as of end Mar-20. In a gradual and calibrated process, the liquidity surplus could ease to 2.0-2.5 per cent of NDTL by end Mar-22. This would help to realise the twin objectives of reducing the systemic liquidity surplus and availability of adequate money in the system for hassle-free functioning of money markets.

On the basis of its experience in the previous year, the RBI this year has decided to roll out a secondary market G-sec acquisition programme (G-SAP 1.0) to enable an orderly evolution of yield curve amidst comfortable liquidity conditions. The use of the term G-SAP 1.0 is clearly suggestive of both extension and expansion in due course. In terms of this programme, the RBI will commit upfront to a specific amount of open market purchases of government securities to facilitate a stable and orderly evolution of the yield curve amidst comfortable liquidity conditions, the endeavour being (as Shri Das said) "to ensure congenial financial conditions for the recovery to gain traction". This innovative measure will (a) provide certainty to bond market participants with regard to RBI's commitment of support to bond market in FY22 and (b) help reduce term premiums (spread between Repo Rate and 10Y IGB yield) on the long-end remaining elevated at 215 bps, i.e., almost 100 bps higher than the 5-year average.

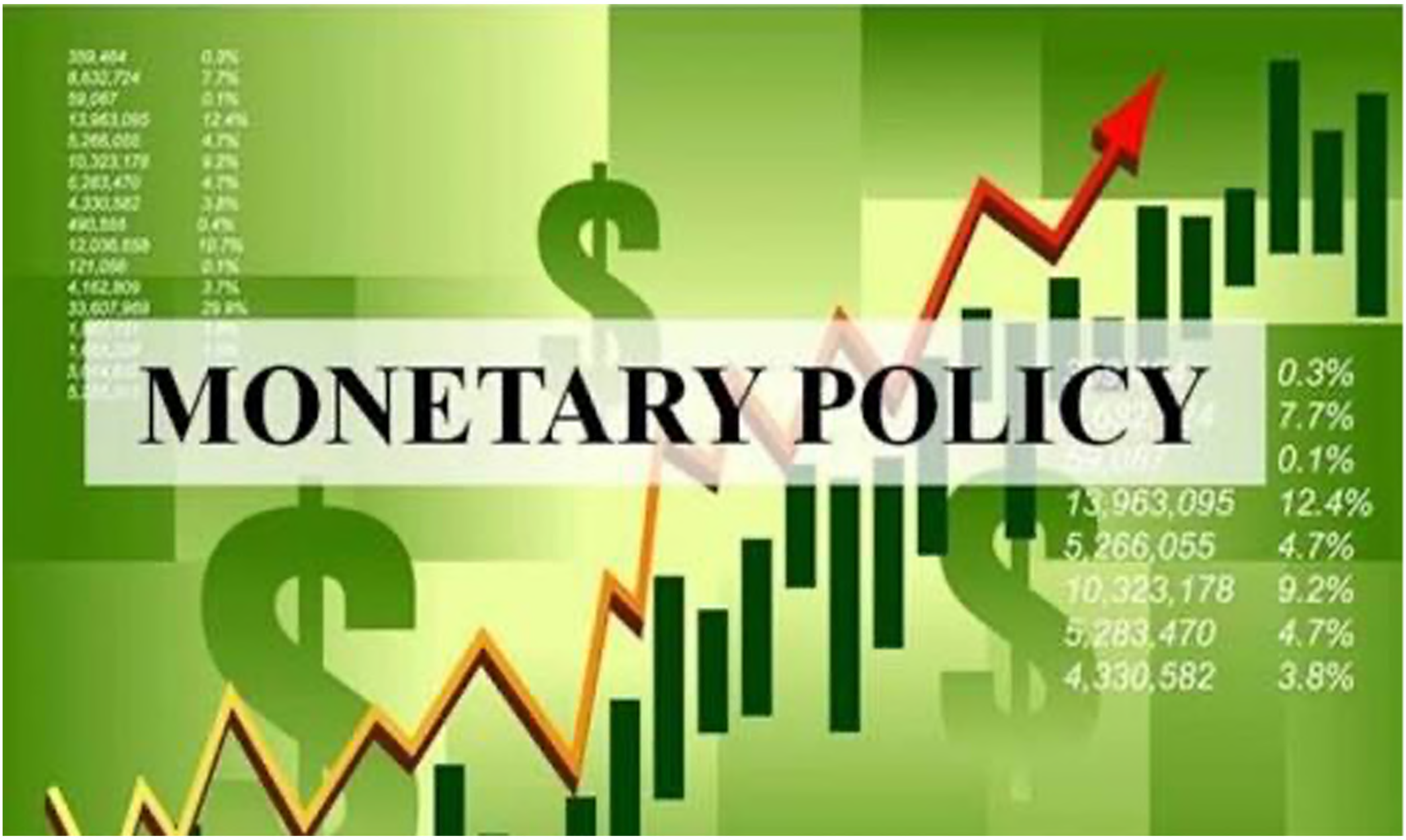
It is instructive that during the global financial meltdown of October 2008, only issuers of reserve currencies deployed quantitative easing to keep financial conditions benign and aid recovery. But in the wake of the dreaded Coronavirus, central banks of several emerging market economies (EMEs) attempted quantitative easing (QE) despite the large associated risks. While no firm estimates are available, market perceptions place the value of the securities to be purchased by the RBI at ₹ 3 trillion during FY22 under the programme. Further, this programme will not replace OMOs and will run alongside its regular liquidity operations, such as, OMOs and Operation Twist.

The RBI will buy bonds worth 1 lakh crore from the secondary market in the three months to June 30, with the first purchase of ₹25,000 crore on April 15. Last year, the RBI bought ₹3.3 lakh crore worth of government securities through open market operations (OMO), which helped it manage a record ₹13.7 lakh crore government borrowing programme. The government plans to borrow ₹12.05 lakh crore this year. But the Governor clearly distinguished this measure from the earlier programme, when he said "this is different from the usual OMO calendar. We have given it a distinct character. This programme will run in addition to normal liquidity adjustment facility (LAF), special open market operations (OMO) and other instruments.

It's for the entire quarter that we announced a specific quantum. Signals from the RBI and action from the RBI have to be weighed together". This would reduce the higher term premiums and enable efficient portfolio decisions for market participants. The 10-year g-sec yield could move towards 6.50 per cent levels by March 2022. This is the first time the RBI is committing its balance sheet for the conduct of monetary policy.

Corporate bond issuance in February at ₹ 45,685 crore moderated from its peak of ₹88,130 crore recorded in December 2020. The surge in bond yields weakened the RBI's easy monetary stance and the RBI's bond purchase calendar makes the bond market participants confident that huge supply of government borrowings will not steeply increase yields. It also supports the easy monetary policy stance.

To be sure, there are some apparent concerns of this measure being inflationary. But a deeper analysis brings out that such concerns are misplaced because the programme was designed by factoring in inflation and growth rate. Some treasury professionals have suggested "the RBI is trying to flatten the yield curve by infusing liquidity at the longer end and re-pricing it at the shorter end. The longer end will therefore hold 6-6.25 per cent, and the shorter end will move towards the repo rate of 4 per cent. With the second lockdown, GST collections may be hit, and this may lead to additional borrowing. So, there is a bit of uncertainty, and that's why the RBI has announced it will do OMO and G-SAP to keep the market at ease".



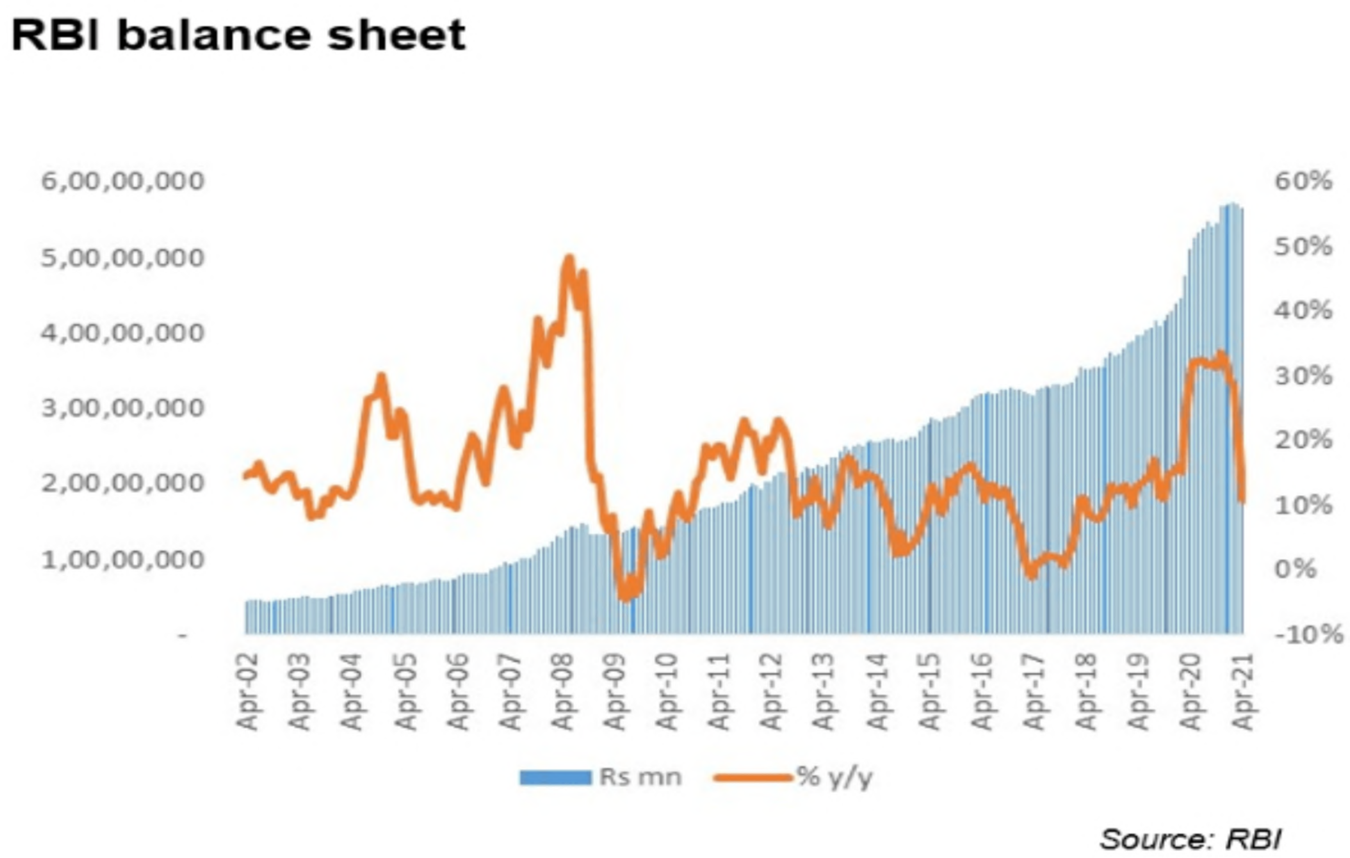
For Q1 of 2021-22, therefore, it has been decided to announce a G-SAP of ₹1 lakh crore buying in the secondary market. The first purchase of government securities for an aggregate amount of ₹25,000 crore under G-SAP 1.0 will be conducted on April 15, 2021.

The RBI's mega bond purchase programme, which was introduced against the background of low credit demand and excess liquidity is, however, fraught with some difficulties. This programme is likely to hamper credit growth because companies would use the bond market to source cheaper capital. Since lending rates are unlikely to rise in a hurry and prices going up in an upward spiral, small savers will face negative returns. Another unintended consequence of large-scale bond-buying and money-printing could be a surfeit of rupees, causing it to depreciate against the dollar.

With $580 billion forex reserves, poor credit off take, danger to financial resilience and the weak position of exporters, letting the Rupee find its own level in these choppy waters may be worthwhile. Our exports, which have been stuck in the $300 billion range for about a decade, will become competitive, IT industry would gain and more job opportunities would be created regardless of high cost of imports. The latter can be better managed by reducing custom tariff. The stock prices will also become a little attractive for foreign investors. But the flip side is that the oil and other imports, which are largely inelastic, would become dearer. The government will need to reduce the tax component on oil.

But with the kind of fiscal crunch both the State and Central Governments are in, tax reduction on oil is almost impossible. There is, however, significant room for improving compliance in GST and this can be done in the short run. There could also be an improvement in consumption taxes as IT sector improves with rupee depreciation.

On 2 April 2021, the RBI's balance sheet stood at Rs 56.7 trillion, up 25 per cent from Rs 45.3 trillion on 28 February 2020. The average monthly increase in RBI's balance sheet in FY21 was 30.4 per cent, higher than the 29.8 per cent and 28.7 per cent increase recorded in FY09 and FY08 respectively, although two thirds of the increase was due to forex interventions.



About 62 per cent of the increase (a little over Rs 7 trillion) on the asset side stemmed from foreign currency assets. This mostly reflects the foreign currency interventions undertaken by the RBI. Purchases of government securities accounted for 31 per cent of the increase in balance sheet during this period.

RBI BALANCE SHEET

Item (Rs mn)	28 Feb 2020	2 Apr 2021	Change (Rs mn)	% share in change
Liabilities	**45318370**	**56708320**	**11389950**	
Notes Issued: Notes in Circulation	23219240	28279910	5060670	44%
Notes Issued: Notes Held in Banking Department	140	120	-20	0%
Deposits: Central Government	1000	1010	10	0%
Deposits: Market Stabilisation Scheme	0	0	0	0%
Deposits: State Governments	420	420	0	0%
Deposits: Scheduled Commercial Banks	5500330	5580140	79810	1%
Deposits: Scheduled State Co-Operative Banks	67390	152210	84820	1%
Deposits: Other Banks	347320	378300	30980	0%
Deposits: Others	3989710	8793120	4803410	42%
Other Liabilities	12192830	13523090	1330260	12%
Assets	**45318380**	**56708310**	**11389930**	
Foreign Currency Assets	32424750	39500520	7075770	62%
Gold Coin and Bullion	2213980	2487670	273690	2%
Rupee Securities including Treasury Bills	9818390	13331760	3513370	31%
Loans and Advances: Central Government	50810	0	-50810	0%
Loans and Advances: State Government	28820	33720	4900	0%
Loans and Advances: National Bank for Agriculture and Rural Development	0	254260	254260	2%
Loans and Advances: Scheduled Commercial Banks	541860	910800	368940	3%
Loans and Advances: Scheduled State Co-Operative Banks	0	0	0	0%
Loans and Advances: Others	121510	152580	31070	0%
Investments	19640	19640	0	0%
Other Assets	98620	17360	-81260	-1%

Source: RBI

LIQUIDITY

During April-August 2020, special refinance facilities of ₹75,000 crore were provided to All India Financial Institutions (AIFIs) like NABARD, SIDBI, NHB and EXIM bank. The RBI Governor further announced liquidity support of ₹ 50,000 crore for fresh lending during 2021-22. The RBI will provide ₹25,000 crore to Nabard (National Bank for Agriculture and Rural Development); ₹10,000 crore to National Housing Bank (NHB); and ₹ 15,000 crore to Sidbi (Small Industries Development Bank of India).

TLTRO SCHEME EXTENSION

The RBI governor announced that On-tap Targeted Long Term Repo Operations (TLTRO) scheme, which was available till March 31, 2021, has now been further extended by a period of six months to September 30, 2021, to ensure adequate liquidity support to the economy.

RTGS, NEFT FACILITIES FOR PAYMENT OPERATORS

The RBI has extended NEFT and RTGS facilities to non-bank payment system operators. Earlier only banks were allowed to use these facilities. Now prepaid payment instrument (PPI) issuers, card networks, White label ATM operators and Trade Receivables Discounting System (TReDS) platforms can also use these facilities.

INTEROPERABILITY OF PPIS, AND INCREASE IN ACCOUNT LIMIT TO ₹ 2 LAKH:- In an attempt to promote digital transaction, the RBI has proposed to hike the limit of the outstanding balance in wallets to ₹ 2 lakh from ₹ 1 lakh.

EXTENSION OF INTERIM WMAS LIMIT

To help state governments tide over the financial stress caused by COVID-19 pandemic, RBI has announced an extension of interim ways and means advances (WMAs) limit of ₹ 51,560 crore. Additionally, RBI has enhanced the aggregate WMA limit of states and Union Territories (UTs) to ₹ 47,010 crore per year. This will facilitate state governments to meet their prior spending commitments in the absence of expected revenue generation and likely increase in their ad hoc spending due to the resurgence of the pandemic.

FUTURE POLICY ACTION

The RBI has slashed the repo rate, i.e., the benchmark lending rate, by 115 basis points (bps) cumulatively since March 2020. This slashing of the repo rate needs to be viewed in conjunction with the 135 bps of cumulative cuts since early 2019. It is expected that policy rates could stay unchanged for some more time and the interest rate could start inching upwards possibly towards the end of the current financial year because of rising input costs, commodity prices and sticky core inflation. The next meeting of the MPC is scheduled during June 2-4, 2021.

CONCLUDING OBSERVATIONS

The rise in second wave of COVID 19 could generate some downside risk to near-term growth prospects stemming from the re-imposition of lockdowns in few states. However, the pick-up in the ongoing vaccination drive, enhanced global growth prospects and adroit liquidity management aimed at containing the costs of borrowings for both the government and the private sector could reduce negative cues. In the ultimate analysis, vaccine distribution and its efficacy is the key to both global and domestic economic recovery.

Important measures, such as, G SAP 1.0, announcement of the OMO calendar and further greater liquidity support to AIFIs like NABARD, SIDBI, NHB and EXIM Bank by ₹ 500 billion for fresh lending during FY22 are well-conceived. These measures together with permission to banks to on-lend through the NBFCs, enhancement of the loan limit under Priority Sector Lending backed by Negotiable Warehouse Receipts and the extension of priority sector tag for the NBFC loans, etc. would provide an impetus to the flow of ground level credit disbursement in India. Measures to inject liquidity in the government securities market and the financial system and the announcement of a bond-buying calendar to help the borrowers benefit from low interest are contextually significant.

The judicious balancing of the conflicting trajectories of inflation (with an upside bias) and economic growth (with a downside bias), effective management of liquidity to keep the costs of borrowings low for both the government and the private sector and the accent on sustained economic recovery makes the first bimonthly monetary policy for the financial year 2021-22 timely and welcome. The Governor’s clear and unequivocal assurance “the Reserve Bank will, of course, continue to do whatever it takes to preserve financial stability and to insulate domestic financial markets from global spillovers and the consequent volatility” is also greatly welcome in this difficult time, when Coronavirus seems to be rearing its ugly and frightening head once again.

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