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RBI MONETARY POLICY EXPECTATIONS

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POLICY EXPECTATIONS

The RBI's December Monetary Policy would be formulated against a mixed economic backdrop.

GDP GROWTH

The Indian economy was already in a stage of pronounced downturn when the pandemic devastated lives and livelihoods on a large scale. The GDP shrank 24.4 per cent in the first quarter after the pandemic struck and contracted by 7.3 per cent for the whole year with a negative output gap. Strong fiscal and monetary support and rising vaccination has helped nurture a swift economic recovery.

The Indian economy is projected to grow at 9.5 per cent in FY22. There is a clear uptick in the GDP growth of 8.4 per cent in the second quarter of 2021-22 as may be seen from the detailed data set given below:

GDP Growth rate (per cent) (2018-19 to 2021-22)

Year & Quarter	Growth (per cent)
2018-19	
Q1 (Apr-June)	7.6
Q2(Jul-Sept)	6.5
Q3(Oct-Dec)	6.3
Q4(Jan-March)	5.8
2019-20	
Q1 (Apr-June)	5.4
Q2(Jul-Sept)	4.6
Q3(Oct-Dec)	3.3
Q4(Jan-March)	3.0
2020-21	
Q1 (Apr-June)	-24.4
Q2(Jul-Sept)	-7.4
Q3(Oct-Dec)	0.5
Q4(Jan-March)	1.6
2021-22	
Q1(Apr-June)	20.1
Q2(July-September)	8.4

Sequential Growth in Real GDP (per cent)

Quarter/Year	Sequential Real GDP Growth(per cent)
Q1 2020-21	-29.69
Q2 2020-21	22.31
Q3 2020-21	9.94
Q4 2020-21	7.51
Q1 2021-22	-16.90
Q2 2021-22	10.36

Quarterly GDP Growth at Constant Prices (yoy per cent)

	Q2FY20	Q2FY21	Q2FY22
Real GDP	4.6 per cent	-7.4 per cent	8.4 per cent
Nominal GDP	5.9 per cent	-4.0 per cent	17.6 per cent

All these broad macro numbers are welcome, which augur well for sustained economic growth. Some clear signs of reviving growth include robust GST collection in November of around ₹1,30,000 crores; India's manufacturing sector strengthening in November on robust production and sales; the seasonally adjusted IHS Markit India manufacturing (PMI) rose from 55.9 in October to 57.6 in November; and India's merchants exports rose 26 per cent in November, 2021 to 29.88 Billion Dollar in comparison to November, 2020 at 23.6 Billion US Dollar. The healthy level of forex reserves is also a stabilizing factor in the movement of the Indian Rupee.

Taken together-individually and collectively- these events and developments are clearly suggestive of a strengthening of the growth impulses and likely double digit growth for the FY 22, despite uneven and nascent recovery and dipping corporate profitability because of surging costs. Thus, India will be the fastest growing economy of the world. Accordingly institutions across the board justifiably maintain that the resuscitation of the Indian growth process is here to stay.

India's GDP Growth Revised Upwards

Institution	Initial Estimate for FY 22	Revised Estimate for FY 22
SBI Research	8.5-9per cent	9.3-9.6per cent
IMF	8.5per cent	9.5per cent
UBS Securities	8.9per cent	9.5per cent
DBS Group	8per cent	9.5per cent

However, the emergence of the new virus Omnicorn version, languishing recovery of the informal, non-agricultural sector of the economy, sluggish recovery in private consumption, low consumer confidence, declining trend in rural non-agricultural to agricultural wage, and persisting inflationary pressures powered by supply side disruptions cause concern.

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EMPLOYMENT

While the quarterly GDP data reveals that the economy is now well past the pre-Covid benchmark, India's employment scenario is yet to recover from the debilitating COVID hit. The GoI's urban employment data for January-March 2021 showed that between January-March 2020 (pre-Covid quarter) and January-March 2021, the proportion of salaried jobs in the total shrank from 50.5 per cent to 48.1 per cent. The proportion of jobs in casual labour and the self-employed rose to make up most of the jobs. Both the proportion of population in the job market and workers with jobs in the first quarters of 2020 and 2021 were level.

BANKING SECTOR

Aggregate deposits slumped by ₹2.7-lakh crore during the fortnight ended Nov. 19 after a record ₹3.3-lakh crore fortnightly increase during the Diwali week. The abrupt increase and subsequent slump in deposits of all scheduled commercial banks (ASCBs) in the fortnight ended November 5, and the preceding fortnight ended November 19, respectively, are contrarian trends, as brought out by the State Bank of India's economic research report, Ecowrap.

"While it may be exactly difficult to decipher the increase and subsequent decline, it does pose questions on liquidity management, financial stability, or a shift in behavioural trend in customer payment habits through digitisation and hence, lower currency leakage and concomitant deposit bulge or both," said Soumya Kanti Ghosh, Group Chief Economic Adviser at SBI.

An increase of ₹3.3-lakh crore in deposits in the fortnight ended November 5 never occurred during a Diwali week as there is always a currency leakage and concomitant deposit decline. This is also the fifth largest increase in any fortnight in the last 24 years.

While fiscal policy is certainly important, monetary policy must work in tandem to support the process. Since the banking sector is a microcosm of the Indian economy, the stress in the economy will be reflect on the balance sheet of the banks. The GNPAs were estimated to be 7.48 percent in March 2021. The RBI's Financial Stability Report (FSR) showed that in March 2022, the NPAs are expected to be 9.80 percent in case of baseline scenario and 11.22 percent in March 2022 in severe shock scenario. However, the stress levels are certainly lower than the previous years and banks are buffered well with reserves.

Sectoral deployment of bank credit showed that credit to agriculture and allied activities performed well with a growth of 10.2 percent in October 2021 as compared to 7.2 percent in October 2020. Credit growth to industry picked up to 4.1 percent in October 2021 from a contraction of 0.7 percent in October 2020. Medium industries saw a growth of 48.6 percent in October 2021 as compared to 20.8 percent last year.

Retail and MSME segments, which constitute 40 per cent of bank credit, could face higher accretion of NPAs and stressed assets.

INFLATION

Goldman Sach has forecasted headline CPI inflation to increase to 5.8 per cent (year of year average) in 2022 from 5.2 per cent in 2021. The RBI has been mandated by the central government to ensure that the retail inflation based on the Consumer Price Index (CPI) remains at 4 per cent with a margin of 2 per cent on either side. The RBI had kept the key interest rate unchanged in its after monetary policy review in August citing inflationary concerns.

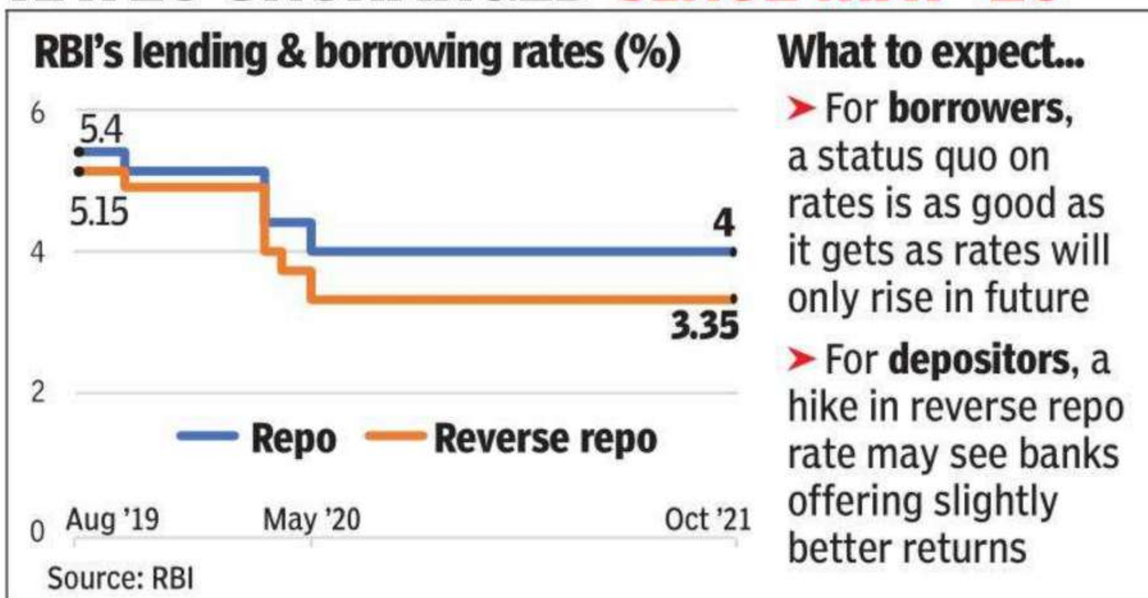
In its October MPC meeting, the RBI had projected the CPI inflation at 5.3 per cent for 2021-22: 5.1 per cent in the second quarter, 4.5 per cent in third quarter; 5.8 per cent in the final quarter of 2021-22, with risks broadly balanced. CPI inflation for the first quarter of 2022-23 is projected at 5.2 per cent.

Despite the inflationary price spiral caused by high commodity prices and supply bottlenecks, the near-term retail inflation is likely to remain within the MPC target band of 4 to 6 per cent. Despite the threat posed by the new Covid variant —Omicron, the near-term retail inflation is likely to remain within the MPC's targeted band of 4 to 6 per cent. This, in turn, should give the Monetary Policy Committee (MPC) a window of opportunity to evaluate the medium-term implications of Omicron by continuing to maintain an accommodative pause in policy rates in December.

The Wholesale Price Index (WPI) rose from October 2020 to October 2021 where at present the WPI for all commodities is high at 12.54 percent, Fuel & Power at 37.18 percent, and Manufactured Products at 12.04 percent. The food price index is comfortable at 3.06 percent.

POLICY ACTION

We expect the RBI to retain the Repo rate at 4 per cent and the accommodative stance to continue. However, the reverse repo rate could be hiked from the present level of 3.35 per cent by 20 basis points because of resurgent macro-economic growth and the cutting of taxes on fuel last month.



The RBI pumped ₹13.6 lakh crore of excess liquidity since March 2020 through its various measures which equals 6.3 per cent of GDP. A much greater infusion of funds a la Brazil could have caused financial stability concerns. Liquidity should stay in surplus but there should be some reversal in the excessively high surplus that it is right now.

The consumers, especially the retired people, have suffered due to the negative rates of returns they earn amid the interest rates going southwards and inflation rising. This causes concern and puts a floor level on the rate of interest on deposits. The financial sector in the country is diverse and policy prescriptions of a mature market like the US may not work in India because of grossly inadequate financial literacy.

FUTURE POLICY CONTOURS

The RBI may start hiking rates from 2022. There could be repo rate and reverse repo rate hike of 50 basis point by the end of FY 2022. The RBI will also narrow the corridor between repo and reverse repo rate, with sharper hike in reverse repo rate. The quantum of rate hike will be a function of the Covid spread and its impact on economic growth,

The RBI has already initiated a policy normalisation path with the introduction of variable reverse repo rate (VRRR) auctions. We expect a further 20 bps hike in the reverse repo rate at the December 8 policy meeting, followed by 20bps more in February. Repo rate hikes are likely to follow in mid-2022i.

The RBI had responded to the Covid pandemic by releasing vast amounts of money into the banking system, resulting in a surplus of close to ₹11 lakh crore earlier this year. Liquidity remains in the surplus mode with the average daily net absorption under the liquidity adjustment facility (LAF) at ₹ 7.6 lakh crore as of November. The RBI is likely to support the growth momentum while managing risk. It may extend the Targeted Long-Term Repo Operations to infrastructure and ESG (Environmental Social Governance) projects to support growth. In a gradual and calibrated manner, the RBI has been rowing back slightly on liquidity without overtly admitting that this is part of a normalisation process.

The RBI could also provide commentary aimed at reining in bond yields and suggest a shift to normalise monetary conditions to avoid a future price spiral.

CONCLUDING OBSERVATIONS

Indications of the US Fed removing policy support at a faster pace, to keep inflation under check, are visible. This could complete the taper faster with a concomitant rise in interest rates. This can impact future strategies of central banks. Covid is also making a comeback in Europe and the new variant from South Africa causes not headwinds to the global economy with possibilities of lockdowns with a crippling impact on both domestic and the world economy.

Inflation has been sticky, primarily through input cost rise. With the Omicron scare, oil prices fell $10 per barrel, but could recover if the threat from the new coronavirus variant subsides. While the OPEC has not altered its monthly production increase schedule, the US Fed is likely to accelerate withdrawal from its extra-accommodative monetary policy because of persistent inflation. In the US, unemployment is falling even as the number of fresh jobs created recedes, suggesting withdrawal of labour from the workforce, probably due to Covid concerns. The resultant rise in wages is feeding into persistent inflation, and the yield on US treasuries has been rising. The dollar has been strengthening against other currencies.

The MPC will have to weigh the trade-off between the inflationary effect of pricier imports, should the rupee fall on account of a reallocation of capital away from emerging markets and the dampening effect on growth from any policy rate action. Rising yields in India, and a further rise in the reverse repo rate and absorption of greater volumes of surplus liquidity could compensate for the effects of US Fed action.

Given the evolving order, there has to be a clearly communicated medium-term fiscal consolidation strategy to facilitate private investments. The RBI must continue with the accommodative monetary policy stance but also give clear indications that things are changing on the banking and monetary front. Towards this end, there could be hawkish guidance to prepare markets for policy corridor normalisation in the next policy, particularly since the RBI pumped ₹13.6 Lakhs Crore of excess liquidity since March 2020 through its various measures. The high surplus liquidity in the banking system needs to be gradually reduced.

Given the compelling necessity of broad-basing the process and pattern of development bot for considerations of growth and distributive equity, India's focus for the medium term would be to reiterate jobs (construction and education) and trade (improves competitiveness and market share). Financial inclusion, MSMEs, skilling and focus on increasing education for the girl child and gaining share of women in the labor force must be prioritized to meet the rising expectations.