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ICRA COMMENTS ON RBI'S FIFTH BI-MONTHLY MONETARY POLICY STATEMENT FOR 2021-22

Omicron uncertainty extends status quo on rates and monetary policy stance

December 2021

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HIGHLIGHTS

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As expected, status quo was maintained on repo and reverse repo rates, and the monetary policy stance

CPI inflation and GDP growth forecasts were retained at 5.3% and 9.5%, respectively, with some recalibration in quarterly projections

The Fifth Bi-Monthly Monetary Policy review for FY2022 maintained a status quo on the repo and reverse repo rates and the monetary policy stance, in line with our expectations, following the renewed uncertainty fuelled by the Omicron variant. The Monetary Policy Committee (MPC) retained its projections for the CPI inflation and real GDP expansion for FY2022 at 5.3% and 9.5%, respectively, while recalibrating the quarterly forecasts. While a subtle shift has been brought in with the comment that price stability remains the cardinal principle of monetary policy, the overarching tone of today's statement and forward guidance is less hawkish than what we had anticipated. With the MPC remarking that the ongoing domestic recovery needs sustained policy support to make it more broad-based, we now foresee a slightly lower likelihood of our base case assessment that the stance will be changed to neutral in the February 2022 policy review.

- In the December 2021 policy review, the MPC voted unanimously to maintain the repo rate unchanged at 4.0%, and retained the accommodative stance by a vote of 5:1. Moreover, the RBI kept the reverse repo rate unchanged at 3.35%, in line with our expectations, following the renewed uncertainty fuelled by the Omicron variant of Covid-19. The Marginal standing facility (MSF) rate and bank rate were also kept unchanged at 4.25% each.
- Taking into account the evolving trends, the MPC retained its October 2021 CPI inflation forecast for FY2022 at 5.3%, with risks broadly balanced, offsetting an upward revision for Q3 FY2022 (to +5.1% from the earlier +4.5%), with a mild downward revision for Q4 FY2022 (to +5.7% from +5.8%). For the subsequent quarters, it has projected the CPI inflation to soften to 5.0% each in Q1-Q2 FY2023.
- The GDP expansion forecast of the MPC for FY2022 has been maintained at 9.5%, despite the actual growth of 8.4% in Q2 FY2022 exceeding its projection (+7.9% made in October 2021). Accordingly, the Committee has now pared the growth forecasts for Q3 FY2022 and Q4 FY2022 to 6.6% (earlier +6.8%) and 6.0% (earlier +6.1%), respectively, compared to its October 2021 projections.

Outlook: Today's policy subtly modified the growth-inflation balance, by commenting that price stability remains the cardinal principle of monetary policy. Based on this, we maintain our base case assessment that the monetary policy stance will be changed to neutral in the February 2022 policy review, as long as no third wave emerges in the interim. We continue to expect a 15 bps hike in the reverse repo rate by the RBI in February 2022, narrowing the policy corridor to 50 bps from the current 65 bps. Thereafter, we foresee hikes of 25 bps each in the repo and reverse repo rates each in the April 2022 and June 2022 reviews, followed by a reassessment of the durability of the growth revival as policy support is withdrawn. Nevertheless, the overarching tone of today's statement and forward guidance is less hawkish than what we had anticipated. With the MPC remarking that the ongoing domestic recovery needs sustained policy support to make it more broad-based, the likelihood of our base case materialising has admittedly moderated.

While today's status quo has reduced the market's nervousness, we expect yields to rise in the next quarter to a range of 6.4-6.7%, as we move closer to the policy lift-off in early 2022.

As Expected, DEC 2021 policy review maintained status quo on the repo and reverse repo rates, while retaining the Accommodative stance by a Vote of 5:1

Today's policy review maintained status quo on the repo and reverse repo rates, and the monetary policy stance, in line with our expectations

In the December 2021 policy review, the MPC voted unanimously to maintain the repo rate unchanged at 4.0% (refer Exhibit 1). In line with previous two policy reviews, five of the six members in the Committee voted to continue with the accommodative stance for as long as necessary to revive and 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. Moreover, the RBI kept the reverse repo rate unchanged at 3.35%, in line with our expectations, following the renewed uncertainty fuelled by the Omicron variant of Covid-19.

The Committee expects the spike in vegetable prices to reverse with the winter arrivals

CPI inflation forecast for FY2022 maintained at 5.3%: After the MPC's last meeting in October 2021, the data released by the National Statistical Office (NSO) had revealed a mild uptick in the headline YoY CPI inflation to 4.5% in October 2021 from the five-month low 4.3% in September 2021 (refer Exhibit 2). This was on account of hardening in the inflation for food and beverages (to +1.8% in Oct 2021 from +1.6% in Sep 2021; led by a spike in vegetable prices), and fuel and light (to a series-high +14.3% from +13.6%; driven by rising global energy prices) in October 2021, relative to the previous month. While the October 2021 CPI print was appreciably below the upper tolerance level of the MPC's 2-6% medium term target, the core-CPI inflation remained elevated at a four-month high 5.8% in October 2021, with a continued uptrend in the inflation for clothing and footwear, health, and transport and communication.

However, cost push pressures such as higher raw material prices, and global logistics and supply chain bottlenecks continue to impinge on core-CPI inflation

Looking ahead, the Committee anticipates that the spike in prices of vegetables following heavy rainfall during October-November 2021 may moderate with the arrival of the winter crop in the market. In addition, the robust start of rabi sowing, as well as the Government of India's (GoI's) supply-side interventions (namely, removing import duties on crude varieties of edible oils until Mar 2022) to contain the pass-through of elevated global edible oil prices, augur well for the domestic retail inflation trajectory. While the international crude oil prices have corrected in the past two weeks following the emergence of the Omicron variant, other cost push pressures related to high industrial raw material prices, transportation costs, and global logistical and supply chain bottlenecks continue to pose risks for the core-CPI inflation trajectory. Nonetheless, the pass-through of rising input costs to the output prices is expected to be contained given the slack in the economy with domestic demand yet to stage a broad-based recovery. While the partial roll-back of Central excise and State VAT rates on petrol and diesel in November 2021 have eased the retail selling prices, the Committee stated that continued normalisation of such levies along with other measures to address input cost pressures are critical to contain the core-CPI inflation, as domestic demand recovers further.

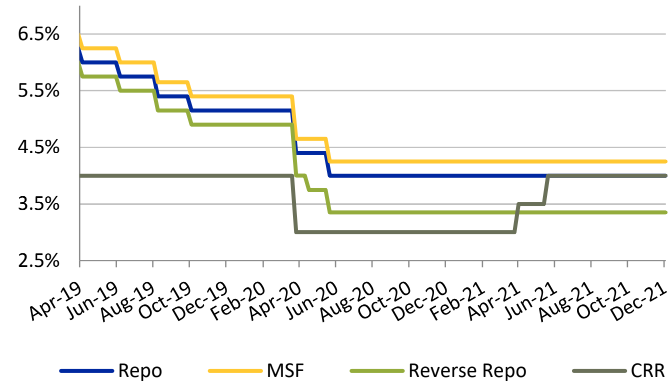
Overall, the MPC retained its October 2021 CPI inflation forecast for FY2022 at 5.3%, with risks broadly balanced. In quarterly terms, this was balanced by an upward revision in the CPI inflation for Q3 FY2022 (to +5.1% from the earlier +4.5%), and a mild downward revision for Q4 FY2022 (to +5.7% from +5.8%; refer Exhibit 3). For subsequent quarters, it has projected the CPI inflation to soften to 5.0% each in Q1 FY2023 (lower than the +5.2% forecast made in October 2021) and Q2 FY2023.

MPC remarked on the need for continued normalisation of cesses on fuels accompanied by measures to address other input cost pressures

The Committee maintained its Oct 2021 CPI inflation forecast for FY2022 at 5.3%

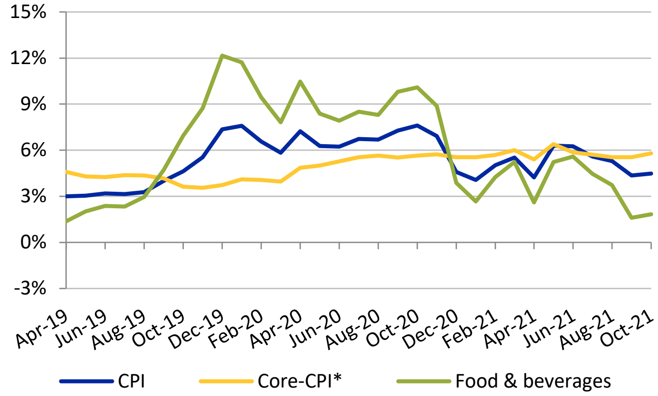
The MPC stated the recovery in domestic economic activity is turning increasingly broad-based, with widening vaccine coverage, subsiding of Covid-19 cases and normalizing mobility

EXHIBIT 1: Movement in Key Rates



Source: *RBI; CEIC; ICRA research*

EXHIBIT 2: CPI Inflation, CPI-food and core-CPI inflation (YoY)



Since detailed data is not available for March-April 2020, we have not excluded prices for petrol and diesel of vehicles in the calculation of the core-CPI index for the YoY inflation rates;* ***Source**: NSO; CEIC; ICRA research*

As the base effect turns adverse, and the pressures related to coal, metals and logistics costs come to the fore, we expect the CPI inflation to rise to an uncomfortable 5.5-6.0% in Dec-Mar FY2022. We maintain our forecast of an average CPI inflation of 5.5% in FY2022, especially given the spate of price increases announced by producers in various sectors in recent weeks.

Real GDP growth forecast for FY2022 retained at 9.5%: On the growth front, the YoY expansion in the GDP (at constant 2011-12 prices) has moderated, albeit to a higher-than-expected 8.4% in Q2 FY2022 (ICRA and MPC exp.: +7.9%; -7.4% in Q2 FY2021) from 20.1% in Q1 FY2022 (-24.4% in Q1 FY2021), on account of base normalisation related to the pick-up in economic activity after the stringent nationwide lockdown in Q1 FY2021.

According to the Committee, the momentum of economic activity is gaining further traction, with resilient rural demand and a pick-up in demand from the urban and contact-intensive sectors, supported by improving optimism with widening vaccine coverage, and rise in demand and mobility during the festive season. The MPC foresees the rural demand to remain robust and rabi sowing in 2021 to exceed the last year's acreage given that about 64% of the 2020 sown area had already been covered up to Dec 3, 2021. Moreover, the Government's infrastructure push, ongoing support from the PLI schemes, recovering capacity utilisation levels, and benign liquidity and financial conditions provide a conducive environment for private investment demand, according to the Committee. Further, the RBI's latest survey revealed improving business outlook and consumer confidence. However, the MPC stated that the volatile commodity prices, renewed uncertainty regarding new mutations of virus, persisting global supply disruptions and financial volatility pose downside risks to its growth outlook.

Volatile commodity prices, renewed uncertainty regarding new virus mutations, persisting global supply disruptions and financial volatility pose downside risks to MPC's growth outlook

Overall, the Committee has retained its October 2021 forecast of the FY2022 real GDP growth at 9.5%, despite the actual growth in Q2 FY2022 being higher-than-expected at 8.4%, and the substantial net cash outgo in the GoI's second supplementary demand for grants. The MPC has now pared its growth forecasts for Q3 FY2022 and Q4 FY2022 to 6.6% (earlier +6.8%) and 6.0% (earlier +6.1%), respectively, compared to its October 2021 projections, suggesting that the outcome in the just-concluded quarter benefitted from an upfronting of pent-up demand. Subsequently, the MPC has retained its October 2021 GDP growth forecast for Q1 FY2023 at 17.2%, in real terms, and projected the Q2 FY2023 growth to moderate to 7.8%, led by the normalising base.

EXHIBIT 3: RBI's earlier and current GDP growth and CPI inflation forecasts

	CPI Inflation		GDP growth (at constant 2011-12 prices)	
MPC policy reviews	**October 2021**	**December 2021**	**October 2021**	**December 2021**
Q3 FY2022	4.5%	5.1%	6.8%	6.6%
Q4 FY2022	5.8%	5.7%	6.1%	6.0%
FY2022	**5.3%**	**5.3%**	**9.5%**	**9.5%**
Q1 FY2023	5.2%	5.0%	17.2%	17.2%
Q2 FY2023		5.0%		7.8%

***Source**: RBI; ICRA Research; Growth forecasts for the GDP are in YoY terms*

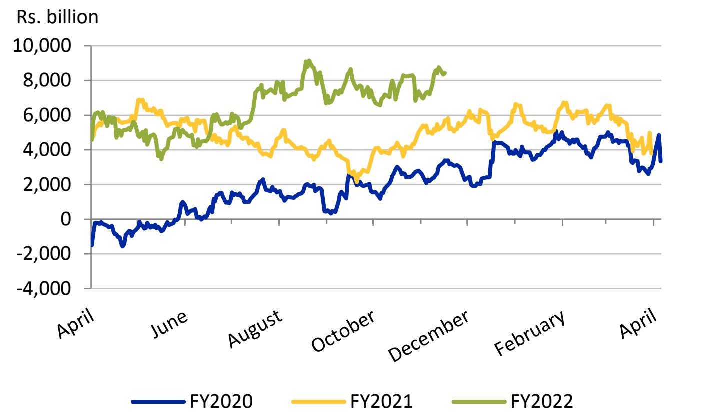
MPC has retained its forecast of FY2022 real GDP growth at 9.5%, despite the actual expansion in Q2 FY2022 exceeding its projection, and the sizeable net cash outgo in the GoI's second supplementary demand for grants

After a broadly healthy festive season, many indicators tracked by ICRA have displayed a flagging momentum in November 2021. Going forward, the rising Covid-19 vaccine coverage will boost confidence and spending towards contact intensive services, enhancing the impact of the duty cuts on fuels. With surging commodity and logistics costs, more sectors are likely to see producers raising prices, which will contain the extent of the overall demand recovery in H2 FY2022, in our view. **With the discovery of the Omicron variant of Covid-19 reigniting uncertainty regarding the strength of global demand and cross-border flows, we are maintaining our estimate of a 9.0% growth in real GDP in FY2022 for now, in the absence of concrete evidence regarding the durability of domestic demand.**

Today's policy subtly modified the growth-inflation balance, by commenting that price stability remains the cardinal principle of monetary policy. Based on this, we maintain our base case assessment that the monetary policy stance will be changed to neutral in the February 2022 policy review, as long as no third wave emerges in the interim. We continue to expect a 15 bps hike in the reverse repo rate by the RBI in February 2022, narrowing the policy corridor to 50 bps from the current 65 bps. Thereafter, we foresee hikes of 25 bps each in the repo and reverse repo rates each in the April 2022 and June 2022 reviews, followed by a reassessment of the durability of the growth revival as policy support is withdrawn. Nevertheless, the overarching tone of today's statement and forward guidance is less hawkish than what we had anticipated. With the MPC remarking that the ongoing domestic recovery needs sustained policy support to make it more broad-based, the likelihood of our base case materialising has admittedly moderated.

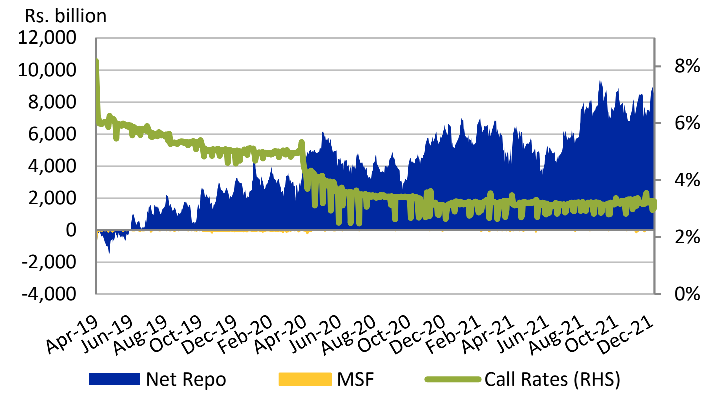
The RBI emphasised the objective to re-establish the 14-day variable rate reverse repo auction as the chief liquidity management operation; from January 2022 onwards, liquidity absorption will be undertaken chiefly through the auction route

EXHIBIT 4: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; MSS)



Data for FY2022 is available upto Dec 7, 2021; **Source: RBI; ICRA Research*

EXHIBIT 5: Call money rates



***Source:** RBI; ICRA Research*

The daily average liquidity surplus under the LAF increased from Rs. 4.9 trillion in Q1 FY2022 to ~Rs. 7.0 trillion in Q2 FY2022, and further to Rs. 7.6 trillion in Q3 FY2022 (till December 7, 2021), following the liquidity operations conducted by the Central Bank. On a monthly basis, it decreased from Rs. 7.8 trillion in September 2021 to Rs. 7.4 trillion in October 2021, after the RBI decided to halt the G-SAP operations in October 2021 policy and conducted mild OMO purchases during the month. Further, the daily average liquidity surplus mildly increased to Rs. 7.6 trillion in November 2021, after the RBI conducted On-Tap TLTRO worth Rs. 2.5 billion on November 15, 2021 and cumulative Rs. 5.1 billion worth of SLTROs for Small Finance Banks (SFBs) during the month (refer Exhibit 4). Subsequently, the daily average liquidity surplus has increased to Rs. 8.5 trillion during first week of December 2021 (till December 7, 2021), with higher reverse repo operations by the banks. With the muted credit growth for large industries and general risk aversion in the system, the surplus liquidity parked by banks under reverse repo window stood at Rs. 9.5 trillion as on December 7, 2021.

The RBI has injected net liquidity of Rs. 2.88 trillion through open market operations (OMO) of Government of India securities (G-secs) during FY2022 till now. Moreover, net OMO purchases of Rs. 2.91 trillion were conducted during H1 FY2022, including Rs. 1.85 trillion under the G-SAP operations and Rs. 1.07 trillion under the outright OMO purchases. Subsequently, in Q3 FY2022, the RBI paused the G-SAP operations and conducted modest OMO purchases of Rs. 3.2 billion each on October 7, 2021 and October 21, 2021, respectively. This was partially offset by outright OMOs sales of Rs. 2.3 billion on October 21, 2021 and Rs. 0.9 billion on October 22, 2021, resulting in lower liquidity injection during the month. Further in November 2021, the RBI conducted cumulative OMO sales worth Rs. 33.1 billion during the month, resulting in net OMO sales of Rs. 30.0 billion during H2 FY2022 till now.

The cut-off yield of 14-day VRRR auction rose gradually from 3.60% on September 24, 2021 to 3.99% on December 3, 2021, close to the repo rate

The RBI had commenced normal liquidity operations, with a resumption of the 14-day VRRR operations from January 15, 2021, for an amount of Rs. 2.0 trillion. Further, in August 2021 and October 2021, the RBI had decided to progressively hike the size of 14-day VRRR auctions from Rs. 2.0 trillion to Rs. 6.0 trillion by December 3, 2021. Moreover, there has been steady rise in both the average and cut off yields in the VRRR auctions in recent months. For instance, the cut-off yield of 14-day VRRR auction rose gradually from 3.60% on September 24, 2021 to 3.99% on December 3, 2021, close to the repo rate. In addition, the RBI also conducted 28-day VRRR auctions worth Rs. 500 billion each on November 2, 2021 and November 30, 2021, respectively. As a result, the average rates for the 91 day Treasury bills (T-bills), 182 day T-bills, and 364 day T-bills rose modestly from 3.37%, 3.49% and 3.69%, respectively, in Q2 FY2022, to 3.52%, 3.77% and 4.03%, respectively, in Q3 FY2022 (till December 7, 2021). Moreover, the daily weighted average call money rate rose from 3.13% in Q2 FY2022 to 3.24% in Q3 FY2022 (refer Exhibit 5), but remained below the reverse repo rate.

The RBI decided to further hike the size of 14-day VRRR auctions from an existing Rs. 6.0 trillion to Rs. 6.5 trillion on December 17, 2021, and further to Rs. 7.5 trillion on December 31, 2021

In today's policy review, the RBI decided to further hike the size of 14-day VRRR auctions from an existing Rs. 6.0 trillion to Rs. 6.5 trillion on December 17, 2021, and further to Rs. 7.5 trillion on December 31, 2021. The Central Bank emphasised the objective of re-establishing the 14-day VRRR auction as the chief liquidity management operation, with liquidity absorption to be predominantly undertaken through the auction route from January 2022 onwards. Moreover, depending upon the evolving liquidity conditions, the RBI will continue to complement the 14-day VRRR auctions with 28-day VRRR auctions. In addition, it retained the flexibility to conduct other liquidity management operations including Operation Twist and regular open market operations.

Conspicuous in their absence from the Governor's remarks, were comments on the orderly evolution of the yield curve being a public good. With the tone of the policy being less hawkish than feared, the benchmark 10-year G-sec (06.10 GS 2031) yield eased by about 5 bps to 6.34%. With no cancellation/devolvement at G-sec auctions since mid-August 2021, the yield for this security has crept up by 25 bps over the last five months, representing a form of stealth tightening. **In Q4 FY2022, both fiscal and monetary policy cues will guide the level to which bond yields rise. The markets are now preparing for faster tapering and rate hikes by the US Fed, with inflation no longer being labelled as transitory. As the Indian markets' views regarding the timing and extent of repo hikes by the MPC crystallise, a further hardening of the G-sec yields is inevitable.**

With the next policy review to be held after the presentation of the Union Budget for FY2023, it will be clearer whether fiscal policy can shoulder the burden of nurturing and broad-basing the nascent domestic recovery, thereby allowing the gradual withdrawal of monetary policy support to commence. Moreover, as hopes fade that meaningful inflows from the transactions in BPCL and LIC will materialise within the current fiscal, there is a growing likelihood that the fiscal deficit will overshoot the target by a considerable margin. As of now, the GoI's H2 FY2022 borrowing calendar is to be completed in Feb 2022. If the disinvestment flows appear set to be significantly below target, the GoI could potentially raise an additional ~Rs. 1.0 trillion through four weekly auctions in March 2022, which will push up yields. However, India's inclusion in the global bond indexes could support the GoI's borrowing programme in the latter part of FY2022, if the actual listing takes place before the end of the fiscal year. Overall, we expect the 10-year G-sec yield to range between 6.4-6.7% in the coming quarter.

The RBI has announced wide-ranging measures including simplification of capital movement between banks and their overseas branches/subsidiaries, besides also deciding to review the prudential norms for investment portfolio of banks. Further, the RBI continues to actively review and facilitate digitalization of payments and related infrastructure and in this regard, has proposed a review of charges on payment systems as well as an increase in transaction limits under UPI.

1) Optionality to pre-pay funds availed under TLRO 1.0 & 2.0

The RBI has allowed banks to repay funding availed under the Targeted Long-Term Repo Operations (TLTRO 1.0 & TLTRO 2.0).

Impact: With banks pre-paying funding of ~Rs. 340 billion availed under TLTRO till date, much of the residual outstanding balances (~Rs. 750 billion), availed at a fixed rate of 4.4% is scheduled to mature after 15-18 months during Q4 FY2023 or Q1 FY2024. While the RBI has opened a pre-payment window for the residual balances, in ICRA's view, banks are unlikely to exercise this option. These outstanding balances could remain effectively low-cost liabilities, given an expected rise in short-term rates close to or beyond levels at which borrowing was done under TLTRO 1.0 & 2.0 as the RBI scales up the VRRR auctions. However, balances of ~Rs.10 billion that were availed by banks at 5.15% under TRLTO, may be prepaid.

2) Reversion of MSF to pre-Covid level of 2% of NDTL

With the onset of Covid-19, the RBI had expanded the MSF borrowing limits to 3% of net demand and time liabilities (NDTL) from the prevailing 2%. However, as the surplus liquidity conditions prevailed for most of the pandemic affected period of FY2021-H1 FY2022, the utilisation of the MSF facility was subdued. The RBI has now decided to revise the MSF limits back to 2% of NDTL.

Impact: Given the surplus liquidity conditions, the MSF utilisation by banks remains limited and hence the RBI's move is unlikely to have any adverse impact on their liquidity. However, as MSF is eligible for inclusion under HQLA for calculation of LCR, a reduction in MSF could lead to moderation in reported LCRs for the banks.

3) Simplification of capital infusion and profit repatriation by overseas branches and subsidiaries

The RBI has allowed banks incorporated in India to infuse capital, retain profit or repatriate profits from overseas branches and subsidiaries without prior approval, subject to the bank meeting regulatory capital requirements, prior authorizations by the board and post facto reporting of such transactions.

Impact: As per a survey on International Trade in Banking Services released by RBI in February 2021, the Indian branches and subsidiaries of Indian banks have extended credit of ~Rs.8.45 trillion and mobilized deposits amounting to ~Rs.5.37 trillion in 2019-20, which roughly accounts for ~8% and ~4% of the domestic credit and deposit outstanding for scheduled commercial banks, respectively. The overseas operations generated a net-income of ~Rs.6-7 billion during 2019-20. On an incremental basis, most of the scheduled commercial banks have been scaling down their overseas operations and hence the incremental capital requirements are likely to remain limited. With freeing up of capital at subsidiaries, it may become operationally easier for banks to repatriate profits on a more frequent basis.

4) Proposed discussion paper to review the prudential norms for investment portfolio of banks

Citing significant developments in global standards on classification, measurement and valuation of investments as well as progress in the domestic financial markets since the prudential norms on investment were last introduced in October 2000, the RBI has proposed to review the same.

Impact: A sizeable portion of the investment book of scheduled commercial banks is classified under the Held To Maturity (HTM) bucket, which is not required to be marked-to-market (MTM). While the implementation or migration to IND-AS has been deferred from time-to-time, an eventual transition to IND-AS in due course would necessitate fair valuation of HTM investments as well. Depending on the MTM position of the HTM books, there could be an impact on banks' profitability and capital. A review of investment norms could pave the way to transition to IND-AS for banks.

5) Facilitation of transition from LIBOR to Alternative Reference Rates (ARR)

In August 2021, the RBI directed banks and other participants in the financial markets to migrate to alternative reference rates (ARR) by December 31, 2021. In continuation of those directives, the Central Bank has announced measures to smoothen transition to ARR. The RBI has taken into consideration the possibility of differences in credit risk and term premia between LIBOR and ARR for ECBs and trade credit, and has accordingly proposed to revise the all-in cost ceiling from 450-500 bps above the selected/chosen ARR from the prevailing 250-300 bps above LIBOR for incremental borrowing, while the all-in cost for existing ECBs and TC is proposed to be increased to 450-550 bps above ARR, as opposed to 250-350 bps above LIBOR.

Impact: In ICRA's view, the term premia structure across currencies/ARR could be different and hence the higher all-in-cost ceiling will provide increased flexibility to the borrowers while transitioning to an alternative benchmark to LIBOR.

6) Proposed discussion paper to review charges in payment systems

Given the increased growth and acceptance of digital payments in the country, the RBI has proposed to review the charges involved under various channels of digital payments. Its discussion paper will solicit feedback from participants with an aim to take steps, if necessary, to improve affordability of transactions to users and make them economically remunerative to providers as well.

Impact: Currently, the payment charges across the various payment systems or platforms vary, thereby influencing their usage. In this regard, smaller ticket payments are preferred on systems with low charges like UPI, while higher ticket payments are preferred on payment systems like credit cards, even at higher charges. While providers of digital payment services incur certain establishment costs, these are usually recovered either from merchants or the customer or both. As acceptance of digital transactions and volumes grow in the country, attempts at lowering or harmonising payment charges, possibly at lower rates across all the payments systems/platforms, could spur overall digital payment volumes further, thereby making it beneficial for users as well as service providers.

7) Increase in UPI transaction limits

The RBI has announced an increase in the transaction limits for payment under UPI for specified categories i.e. investments into G-secs through the Retail Direct Scheme (RDS) and IPOs from Rs.0.2 million to Rs.0.5 million

Impact: In ICRA's view, against the back drop of growing payment throughput under UPI, including application or subscription to IPOs, the decision to increase payment limits for investments/payments by retail investors/individuals into the RDS and IPOs through UPI, will encourage retail participation in the debt and equity markets, while supporting growing UPI volumes in the country.

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