MPC Resolution April 2021– Preview

- **Amid the uncertainty created by a resurgence in infections across the nation signaling a second wave, the Monetary Policy Committee (MPC) is likely to keep policy rates unchanged and continue with accommodative stance in order to aid the ongoing economic recovery**
- **While there is a sequential moderation expected in food and fuel inflation in the coming months, the upside risk due to volatility in energy and commodity prices, and rising global food prices could threaten the future outlook**
- **Meanwhile the central government borrowing programme has pegged the gross borrowing for H1 FY22 at INR 7.24 tn (~ 60% of total target for FY22), in line with expectations, although markets remain concerned over the large borrowing plan and the large supply of bonds in the market**
- **RBI/MPC is expected to continue using unconventional policy tools, such as OMOs and OTs to avoid any untoward surge in yields, as well as to ensure smooth operation of the Government borrowing program**
- **We maintain our view of a long pause on Repo rates. On stance, while we expect the accommodative stance to continue, a future call (forward guidance) on policy normalization could be worded as dependant on momentum in the economy, the damage from the second wave and concerns on underlying inflation pressures. Any change from a time-base to a state-based guidance, if made, will have to be worded cautiously to enable comfort for debt markets**
- **Given these factors we expect the 10-year benchmark to trade in a broad range of 6% to 6.50% this fiscal**

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As the MPC meets amid the uncertainty created by resurgence in infections across the nation, the upcoming monetary policy statement would be watched for the following:

Growth prospects vs. inflationary pressures: While the last policy was dominated by concerns on inflation with emergent risks through the core group, this time, the uncertain near term outlook with rising COVID cases signaling a second wave could garner more attention.

Growth: The resurgence in infections across the nation and the implementation of various measures are likely to delay economic recovery. While real growth rebounded from negative territory in Q3 FY2021, economic recovery is still work in progress. With the ongoing vaccination drive now covering a wider swathe of the population, progress is likely to be much more fast-tracked. However, till a critical mass of inoculated population is achieved, worries on the contagion will keep sentiment subdued. The uncertainty stemming from the second wave is likely to be flagged, and while the growth estimate for FY22 may be retained, a watchful tone is likely to emerge.

Inflation: The recent spike in headline inflation to 5.03% YoY (in February) on account of higher food and fuel prices could see a moderation in the coming prints due to multiple reasons. The bumper harvest and subsequent market arrivals of the *rabi* crop is leading to moderation in food prices, as already seen in the weekly incoming data. A favorable base effect is also likely to play on inflation in the coming months. Elevated core inflation (rising to 5.88% YoY in February) led by higher crude oil prices, rising demand and emergent pricing power as the economy normalizes remains a concern, even though it could see further volatility with demand conditions and volatile crude prices in coming months after OPEC announcement of unwinding unilateral output cuts and subdued demand on account of restricted mobility.

Overall inflation risk remains elevated, while inflation for March is likely to stay within the tolerance band of RBI, major inflationary risks include elevated global food prices, higher commodity prices, imported inflation via strengthening of the Dollar and lockdown induced restrictions hampering interstate mobility of goods. The MPC is expected to flag these risks and could possibly revise their inflation projections slightly upwards for the upcoming quarters.

We expect CPI for Q4 FY21 to average 4.9% YoY, bringing the FY21 average to ~6.2% YoY. Headline CPI inflation is expected to average ~4.9-5.3% YoY over FY22 with the upside risk of higher oil prices factored in. Given the inflation-growth trade-off, it is expected that the MPC will sound concerned on growth stabilising, while highlighting the inflation risks.

Government borrowing plan on expected lines in H1: Keeping its usual practice of front loading market borrowing, the central government borrowing programme has pegged the gross borrowing for H1 FY22 at INR 7.24 tn (~ 60% of total target for FY22), in line with the expectations. However, the market is expected to remain concerned over the large borrowing plan and over supply of bonds in the market (translating to weekly borrowing of INR 260-320 bn with an option to exercise greenshoe of ~ INR 60-80 bn each week), unless supplemented by front-loaded demand inducing measures of OMO purchases and OTs.

Unconventional tools will be key for yield curve management: Despite the substantial borrowing programme over FY2021, yields generally remained stable barring a few auctions that happened in the month of March. Government security yields are expected to remain under pressure in the coming months due to the expected large supply of G-Secs amid a resurgence in inflation and continued sell-off in global bonds.

Meanwhile, the yield on the benchmark 10-year G-Sec has been hardening post the budget, given the concerns on supply and risks such as rising crude oil prices. However, the RBI/MPC is expected to continue using unconventional policy tools at its disposal, such as OMOs and OTs to avoid any untoward surge in yields, as well as ensure smooth transmission while keeping cost of borrowing low and ensure smooth operations of the large Government borrowing program.

Forward guidance and unwinding of accommodation: The Reserve Bank has already taken baby-steps to unwind some monetary accommodation with variable rate reverse repo auctions and a 100 bps phased increase in the cash reserve ratio to reverse last year's cut. The emergent risks due to the second wave along with rising inflationary pressures in the coming months could decide the future path in this direction. The forward guidance will probably be attuned to the present risks surrounding growth, and consequently, any change in guidance, if made, from a time-based to a state-based situation would have to be worded very cautiously to give comfort to markets.

Given these factors we expect the 10-year benchmark to trade in a broad range of 6% to 6.50% this fiscal. Moreover, we maintain our view of a long pause on Repo rates, and expect the status quo to continue till late 2021. While we expect the accommodative stance to continue in this meeting, and a future call on policy normalization could be worded as dependant on momentum in the economy, the damage from the second wave and concern on underlying inflation pressures. Any change from a time-base to a state-based guidance, if made, will have to be worded cautiously to enable comfort for debt markets.

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