RBI/MPC: Inescapable re-pricing of yields

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- **The MPC left rates unchanged as per expectations, while continuing with its forward guidance of accommodative stance for the current fiscal year and into the next financial year**

- **Walking a tight rope on inflation and growth the Governor and the MPC highlighted that while inflation had stabilised recently, emergent risks through core group remained (leading to an increase in Q2FY22 forecast for headline CPI). On the other hand, growth impulses have improved but recovery is yet to find a strong footing. These two forces justified the current stance and pause on rates to bolster growth till a sustained recovery is underway while keeping a close watch on inflation dynamics**

- **The Governor briefly highlighted the efficacy of the current inflation targeting program in ensuring price stability, leading us to believe that the current framework (due for review by March 2021) will be maintained**

- **On the Government borrowing program and liquidity normalisation steps, the Governor tried to assuage markets 1) by caveating the CRR reversal to open up space for other liquidity enhancing operations without impacting financial stability and also conducting it in two tranches to ensure a non-disruptive transition 2) HTM hike extension to FY23 and retail participation in bond markets, aimed at improving demand conditions of government paper 3) re-iteration of the yield curve being a public good and calling for cooperation from markets to ensure smooth rollout of the government borrowing program**

- **In our view, adverse reaction from the bond markets was on account of 1) no OMO purchase announcement 2) increased inflationary outlook for Q2 and risks through core inflation 3) expectations of a sustained growth recovery**

- **Overall the large supply of paper that looms in front of market participants leads us to believe that repricing of the yield curve has happened and the low rate environment seen last year is behind us. The borrowing program, increase in crude prices, global yield environment will all lead to an upside in domestic yields with our view of 10-year benchmark trading ~6.25% by March-end 2021 and a 6.0-6.50% range in FY22**

- **On Repo rate, we maintain our view of a long pause for the calendar year. The possibility of reverse repo hikes in two tranches and a shift in stance to neutral in August/October policy, as growth recovery gains a firmer footing, also cannot be ruled out**

Other salient points from the Governor's speech and policy statement:

Risks to inflation from the core basket: As expected, the MPC revised its near term Q4FY21 forecast downwards by 60 bps given the recent fall in vegetable prices, as well as sharper than expected fall in egg and poultry prices due to avian flu. However, it pointed out this fall in food prices is not broad-based with certain segments like pulses, edible oil continuing to see upside. On core inflation the committee seems less sanguine, with risks through higher crude prices translating to higher pump prices, increasing cost-push pressures and resurgence in pricing powers as the economy revives, despite some downside as COVID induced supply side constraints get removed. Given these concerns H1FY22 inflation was revised to 5.2 - 5.0% YoY from 5.2 – 4.6% YoY. The upward revision of 40 bps for Q2FY22, could be on account of pressures on the core group. Q3FY22 inflation is projected at 4.3% YoY which is similar to our expectations. With these numbers, while the trajectory of inflation is moving lower, H1FY22 is expected to remain above the target 4% mark. **These numbers are in line with our projections, with our FY22 inflation expected to average lower than 5% YoY vs. FY21 expectations of 6.2% YoY.**

Growth – Encouraged by successful vaccine rollout so far, the Union Budget, resilience shown in rural demand and optimism shown in business and consumer confidence, FY22 growth projections were of 10.5% YoY, which is slightly lower than the numbers shared in the Economic Survey but overall indicate the confidence of the RBI/MPC on continuation of growth impulses as we move into the next fiscal. However, the MPC was of the view that growth recovery is yet to garner a firm holding and that is why it would be advisable to remain on a long pause on rates as well as maintain the accommodation stance as long as "the prospects of a sustained recovery are well secured", while closely monitoring inflation dynamics.

MPC inflation targeting framework – the Governor briefly mentioned that the framework is up for review by March 2021 while pointing out its success in maintaining price stability (apart from the COVID-19 period). He went on to highlight the importance of price stability in reducing uncertainty and encouraging investment and savings decisions, reduced term and risk premia in financial markets and increased credibility in the external markets. **Given these indications and the recent commentary from Government officials, we think that the current framework of a 4% target with 2-6% band, will be maintained.**

Liquidity guidance – "yield curve a public good" – The Governor re-iterated that the yield curve is a public good and the RBI/MPC has ensured that the government borrowing program for FY21 went through in a non-disruptive manner through a combination of policy rate cuts, explicit forward guidance, liquidity management and regulatory forbearance. He went on to say that the announcement of the variable reverse repo auctions led to the markets misinterpreting it as a reversal in accommodative stance, and tried to assuage market participants by mentioning that the liquidity stance will be in line with the accommodative stance, with continued provisioning of ample liquidity and easy financial conditions. He also mentioned that large global inflows into the Indian markets led by global risk-on sentiment have resulted in increased financial market volatility, leading the RBI to act accordingly to mitigate any impact on domestic markets and liquidity. Laying the above background, the Governor announced CRR normalisation in two tranches. This, he mentioned, is important to open up space for other liquidity enhancing operations without impacting financial stability. He ended the guidance by **ensuring markets of conducting the government borrowing program in a non-disruptive manner as has been done in the current fiscal, and called for cooperation and collective responsibility from all stakeholders.**

Additional measures – In continuation to previous announcements made in the last few policies directed towards providing liquidity support to targeted sectors, deepening of the financial markets and ensuring smooth functioning of the markets, additional measures were announced. These included: 1) inclusion of NBFCs under the on-tap TLTRO scheme announced in October 2020 2) restoration of CRR in two phases (as mentioned earlier) which would create space for other liquidity enhancing operations 3) extension of MSF relaxation by an additional 6 months up to September 2021 4) extension of HTM hike up till March 2023 given the backdrop of market borrowings for FY22, along with a glide path to restore the limits in a phased manner starting from quarter ending June 30, 2023 5) incentivising credit flow to MSME sector by allowing banks to "deduct credit disbursed to 'New MSME borrowers' from their net demand and time liabilities (NDTL) for calculation of CRR" 6) allowing retail participation in Government bond markets which could widen the investor base for government securities.

To conclude, while the policy was on expected lines the adverse reaction from the bond markets was on account of 1) no OMO purchase announcement 2) increased inflationary outlook for Q2 and risks through core inflation 3) expectations of a sustained growth recovery. Overall the large supply of paper that looms in front of market participants leads us to believe that repricing of the yield curve has happened and the low rate environment seen last year is behind us. The borrowing program, increase in crude prices, global yield environment will all lead to an upside in domestic yields with our view of 10-year benchmark trading ~6.25% by March-end 2021 and a 6.0-6.50% range in FY22. On Repo rate, we maintain our view of a long pause for the calendar year. The possibility of reverse repo hikes in two tranches and a shift in stance to neutral in August/October policy, as growth recovery gains firmer footing, also cannot be ruled out.

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