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How Reserve Bank's Actions Speak Louder Than Words

Expert Take

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While the monetary policy action was very much on expected lines with policy rates unchanged, the language and tone turned out to be a little more growth supportive than the median expectations of the market. "To revive and sustain growth on a durable basis" continues to be present in the guidance.

The Monetary Policy Committee and the RBI are now increasingly confident of growth with visible recovery in a number of high-frequency indicators and tremendous improvement in vaccination. However, what explains the gradual approach to policy normalisation would be the poor recovery in contact-intensive services contributing about 40% of economic activity which are yet to attain pre-pandemic levels.

What has materially changed in the latest policy, as explained by deputy governor Michael Patra's post policy quip, is the shift in active liquidity management to a passive style wherein market determines the rate at which liquidity will be absorbed by RBI in the 14 day Variable Rate Reverse Repo. VRRR is the rates at which RBI absorbs excess liquidity from the system through auctions. This accompanied by management of liquidity using multiple tenor VRRR means that the RBI is unlikely to leave more than ₹2 to 3 lakh crore of surplus in the overnight fixed rate Liquidity Adjustment Facility (LAF) reverse repo window. The step-up in 14-day VRRR sizes and likely reduction in system liquidity on account of increase in currency in circulation during the festive season implies that the bid to cover ratio for the 14-day VRRR auctions could stay low.

This implies that the banks will seek higher returns in these auctions, thus keeping both the weighted average rate and the cut-off rate elevated, which in turn will have a rub-off effect on short end of the yield curve. So, in other words, action does speak louder than the words in this policy.

YIELD CURVE

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The other significant development was the decision to do away with Government Securities Acquisition Programme (G-SAP) purchases completely with the implicit admission that the current state of the economy does not require these emergency measures anymore, which we agree with. While this also likely signals that the RBI is less worried about bond yields going up, we do believe that the RBI will be ready to intervene to curb excessive up moves in yields and will make up for any bond demand-supply mismatch on an ad-hoc basis.

What does all this mean for interest rates in the economy?

In a nutshell, the yield curve should flatten from here on with short-end rates likely to normalise faster than long-end yields. Long-end yields, too, will have to contend with volatile oil prices, higher global bond yields and a strength in the dollar even as near-term domestic inflation worries, higher tax collections and the presence of RBI as a merchant banker to the Government might give some comfort.

So, the RBI has set the pace for policy normalisation in coming months. The first step was actually fired in this policy. The next step will be in the form of a formal reduction in the policy corridor to 25 bps by increasing the reverse repo rate and then followed by a change in stance in April preceding an eventual repo rate hike a little later.

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