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RBI POLICY

THE ABSOLUTE QUANTUM OF GSAP AUCTIONS CAN BE REDUCED GRADUALLY OVER THE NEXT FEW MONTHS, SERVING AS A PRELUDE TO REDUCING THE POLICY CORRIDOR DECEMBER ONWARDS

Setting the stage for normalisation

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Views are personal

MUCH HAS CHANGED in the global and domestic context since the MPC's August meeting. The US Fed is close to beginning tapering of the monthly purchases. Inflation in Germany has risen to levels not seen since the time of Helmut Kohl. Energy prices—of gas in particular—have seen unprecedented increase. Supply-side constraints have gotten exacerbated.

On the domestic front, inflation has surprised positively, led by food inflation. The tax collections continue to beat even the most positive estimates, limiting the size of borrowing in second half with disinvestment proceeds, especially from Air India, increasingly seeming like a distinct possibility. Economic recovery is two-paced. On the one hand, the formal sector is performing on a steady footing, led by exports and there is a revival in services because of rising vaccination numbers as well as a revival seen in real estate and related sectors. On the other, the informal sector continues to struggle, with job losses and income cuts.

Given this backdrop, what should the MPC do? The answer lies in how fast the economy reaches its pre-pandemic trajectory and how transitory the supply shocks are. Most importantly, MPC should get comfort from India's constantly rising vaccination. When the MPC met in August, India had clocked 50 crore vaccine-doses delivered. In less than two months, this has increased to over 91 crore. At the current run-rate, India should vaccinate most of its eligible population in the coming months. Rising vaccinations should lead to opening up of contact-intensive services sector, hit hard by the virus. For instance, GVA from trade, hotels and transport is 30% lower than it was two years ago. Even the education sector should see a gradual opening up in the coming months.

ICICI Bank's UFI (Ultra High Frequency Indicators) index is at an all-time high of 109.3, well above pre-Covid levels. At the height of the lockdown, this had fallen to 38.6. Exports are booming, led by engineering goods and software services. Non-oil, non-gold imports, a barometer of domestic demand, have seen a large increase in September ahead of the festival season. In April-September 2021, gold and non-oil, non-gold imports were higher by \$ 8 billion and \$ 10 billion over the same period in 2019.

While the informal sector has borne the brunt of the pandemic, India's startup ecosystem has never had it better. India now has 65 unicorns, of which 29 have been created in 2021 alone. Nasscom believes there will be 76 by end of 2021. The unicorns have been able to generate employment for 3 lakh people.

Corporate India is also increasingly confident of the recovery, as is visible in corporate tax collections that will easily surpass the government's estimates at the beginning of the year. Government policy is supportive, be it in the form of tax compliance (end of retrospective taxation) or the production linked incentive (PLI) schemes. Investments should pick up in the digital economy, 5G and ESG sectors. The Centre's monetisation pipeline and disinvestment will also support private sector investment. This is supportive of a durable recovery in the economy.

> **RBI may look at lowering its inflation estimate from 5.7% in FY22 to 5.5%. A demand-driven rebound and pass-through of costs imply inflation is likely to come in at or above 5% in FY23**

How transitory are supply shocks? Manufacturing PMIs released in the beginning of the month suggest that supply constraints have exacerbated. Factory activity in China, as per official PMI, shrank unexpectedly due to curbs on electricity use in September. Energy shortages are visible in most of Europe and the UK as demand remains unmet. The chip shortage is likely to hurt India's auto production just ahead of the festive season. Global coal prices have risen by 121 % this year. Oil prices are rising as well (up 95 %). So is the case with gas prices (up 81%).

With vaccinations progressing well, the underlying demand will only get stronger. Supply will take time to catch-up. At the very least, inflationary pressures emanating from shortage of energy supply ahead of the winter season in China and Europe will reverberate across the world.

India is much better placed, with a normal monsoon and large surplus food stocks. Food inflation has been benign this year and has surprised positively. A high base also supports lower inflation up to November 2021. However, domestic energy prices continue to see an upward momentum, led by high international prices and domestic taxes. Corporate India will also have to gradually pass on the increase in commodity prices to consumers.

With inflation surprising positively, RBI may look at lowering its inflation estimate from 5.7% in FY22 to 5.5%. A demand-driven rebound and pass-through of costs imply inflation is likely to come in at or above 5% in FY23.

The above growth-inflation dynamic suggests it is perhaps the most optimal time for RBI to let yields nudge a little bit higher. How can it signal this? One, it can absorb a lot more liquidity through longer tenor variable reverse repo auctions rather than fixed rate auctions. This can be achieved by incentivising banks with a higher yield than the overnight rate. Two, the absolute quantum of GSAP auctions, even if it is converted as a liquidity neutral "Operation Twist", can be reduced gradually over the next four months and we can have our own equivalent of the 'Indian Taper'. This will set the stage for RBI to reduce the policy corridor in December 2021 and February 2022, respectively. It will also give the MPC time to look at the evolving growth scenario and any risk emerging from a third wave. MPC members will have time to evaluate how transitory the supply constraints hitting the global economy are.

Last but not the least, this will put RBI ahead of the global monetary policy reversal led by the US Fed. While the Fed taper is unlikely to have an impact on India given India's bullet proof external account (unlike what we saw in 2013), it will give RBI options as to how it wants to pace liquidity and rate cycle in the coming months.