MPC Preview: Staying focused on supporting the economy

- **The RBI's Monetary Policy Committee (MPC) is likely to keep the policy rate unchanged and maintain its state-based accommodative forward guidance**
- **The hit to the economy from the second-wave of infections and ongoing concerns about the pandemic are likely to emerge as the primary factors, influencing the monetary policy decision making. The spread into rural areas could emerge as an incremental source of concern, as well**
- **While upside risks to the inflation remain in place, we expect the CPI inflation to remain within the Reserve Bank of India's (RBI's) upper tolerance level, over FY2022. Hence, inflation concerns are unlikely to emerge as an important factor at the current juncture**
- **Although the policy rate is expected to be kept unchanged, we expect the RBI to continue to use its unconventional tools to keep the yields stable, amid a large Government Borrowing programme. We expect a continuance of the GSAP programme into the next quarter (GSAP 2.0). Guidance could also be provided that Operation Twists (OTs) will remain in place, while some tweaks to the HTM limits could also be considered**
- **We expect more support for the rural economy, in terms of more credit to the agricultural sector and additional liquidity measures for the Medium and Small Manufacturing Enterprise (MSME) sector, over and above the support measures announced on May 05**
- **Given these factors, we expect the 10-year benchmark to trade in a broad range of 5.9% to 6.2%, over H1FY2022**

Shivom Chakravarti
shivom.chakravarti@icicibank.com

Jyoti Sharma
jyoti.sharma@icicibank.com

Sarbartho Mukherjee
sarbartho.mukherjee@icicibank.com

June 03, 2021

As the MPC meets amidst the uncertainty created by the second wave of infections, the upcoming monetary policy statement would be observed for the following:

Growth concerns are expected to outweigh inflation concerns: Although the second wave has started to recede, the related economic impact due to the widespread lockdown, re-emphasises the fact that the upcoming policy would be clouded with concerns on durable growth and downside risks to the economic recovery.

Growth: The rapid spread in the infections leading to the 'second wave' of the pandemic has increased its downside risks to the outlook, given the state-wise lockdowns that have been imposed. **Our ultra-frequency indicator (UFI) for the week ending May 23 moved to 66.3 that is the lowest since Jan 2021, indicating a sharp moderation in the economic activity.** However, the weakness in the economic activity has not been as severe as that seen during the first wave in 2020. The Purchasing Managers Index (PMI) manufacturing survey and our Ultra Frequency Index (UFI) print have not fallen by the same degree in 2021 in response to the second wave, as in 2020 in response to the first wave.

Nevertheless, concerns about the outlook will remain in place. The penetration of infection rates into the rural areas will also emerge as an incremental source of concern. The RBI will also have to take into consideration the risks of a third wave of infection that still remains in place, if the pace of vaccinations does not pick-up sharply, going forward. While Q4 FY2021 Gross Domestic Product (GDP) surprised to the upside, Q1 FY2022 GDP could slow on a sequential basis, due to the lockdown that has been imposed. **Hence, we think that the RBI will lower its GDP projections from 10.5% YoY for FY2022 to 9.5%-10% range,** taking into account a weaker than expected Q1 FY2022 performance.

Inflation: Although the headline inflation eased to 4.29% YoY (in April), led by a favourable base effect, the sequential price momentum in certain categories, such as fruits (7.1%MoM), edible oil (3.8% MoM), meat and fish (3.0% MoM) and pulses (1.2% MoM) were higher than expected and will subsequently emerge as a concern. The incoming price data also suggests that the impact of the pandemic could result in supply-side disruptions on food items, leading to an upsurge in perishables, while pulses and edible oils remain elevated in line with the global trends. The elevated core inflation remains a concern (~5.43% YoY in April), as higher commodities and logistics cost feed into the input price that pose an upside risk.

The Wholesale Price Index (WPI) based inflation accelerated quite sharply (~10.49% YoY in April), due to a higher impact of the rising input costs and that could pass on to the Consumer Price Index in the medium-term that will in turn emerge as a source of concern.higher impact of the rising input costs and that could pass on to the Consumer Price Index in the medium-term that will in turn emerge as a source of concern.

Even as concerns about the inflationary pressures remain in place, some comfort can be drawn from the robust *rabi* harvest and expectations of a normal monsoon, along with the favourable base, over the Apr-Dec 2021 period. All of these factors combined are likely to keep the headline CPI inflation under the RBI's tolerance band, in the coming months. Overall, the upside risks to inflation from the elevated global food prices, higher commodity prices and lockdown induced restrictions leading to a supply-side bottleneck could be flagged by the MPC. **While the RBI could raise its inflation projections at the margin, reflecting global commodity price movements, the MPC is unlikely to flag inflation as a substantial concern at the current juncture. We expect headline CPI to average ~5-5.3% YoY over FY2022, with the upside risks from higher oil prices factored in.**

Globally, there has been an acceleration seen in the commodity price inflation that has driven input costs higher. The US inflation pressures have accelerated sharply to levels not seen over the last decade and a similar trend is being seen in other economies. However, none of the major Central Banks have responded to the uptick in inflation pressures, opting instead to ensure that the policy is accommodative to ensure that there is more than adequate support for the real economy. We expect RBI to resort to a similar strategy in downplaying inflation risks at the current juncture.

RBI in its recent annual report made it clear that the monetary policy in 2021-22 would be guided by an evolving macroeconomic condition, with a bias to remain supportive of growth till it gains traction on a durable basis, while ensuring that inflation remains within the target." Given the inflation-growth trade-off, it is expected that the MPC will focus more on growth, while in the background, highlighting that the inflation risks need to be monitored.

Continuation of state based forward guidance: We expect the MPC to continue with its state based forward guidance, given the build-up of uncertainty in the economic recovery. The guidance that the RBI will provide on its accommodative stance is likely to remain unchanged from the previous policy meeting. An emphasis could be placed on keeping the accommodative stance in place, for as long as necessary, to ensure that a durable recovery sets in. Overall, we expect the policy statement to have a dovish underpinning.

Central and State Government borrowing to increase: The Central Government has pegged the gross borrowing for H1 FY2022 at INR 7.24 trillion (~60% of initial FY2022 target of INR 12 trillion). However, the Central Government on May 28th announced that it needs to borrow an additional INR 1.58 trillion, to compensate the states for the Goods and Services Tax (GST) shortfall. The regional lockdowns, due to the massive surge in COVID-19 cases have adversely affected the GST collections. This borrowing will be in addition to INR 12 trillion to bridge the fiscal deficit that is pegged at 6.8% of the GDP for FY2022. The revenue crunch could hurt further, if the third wave hits the country. **Thus, the risks of higher borrowings over the course of FY2022, remain in place.**

In addition to the Central Government borrowing, the transfer of the onus of vaccinating the age group of 18-45 from the Center to the State Governments, can put further strain on an already creaking State Government budget. With 590 million people in the 18-45 age group; assuming 10% go for self-funded private vaccinations, wastage of around 3% and an average cost of a single dose of COVID-19 vaccine at INR 300; the total burden of vaccination for the State is around INR 330 billion for inoculating 100% of the 18-45 age group and about INR 200 billion for inoculating 60% of the age group (herd immunity). Our projections for the overall cost of vaccinations are still fairly tentative.

More use of unconventional tools: The strain on fiscal positions could imply that longer-end bond yields naturally drift higher in the process. Hence, we expect the RBI to continue with its resolve to use unconventional easing through the G-Sec Acquisition Programme (**GSAPs) and OTs to keep borrowing costs moderate for the private and public sector, respectively.** On the GSAP front, we do expect a continuity of bond purchase in the next quarter. Market participants will keenly watch for the finer details of the next GSAP and will cheer a higher quantum of purchase under GSAP 2.0. Additionally, if the State finances get strained further, RBI may also opt for purchase of bonds issued by other States.

The MPC had previously increased its limit under the Held to Maturity (HTM) category for Government Bond holdings to 22% of NTDL up to Mar 31, 2023, after which the limit would go back to 19.5% as on Jun 2023. The holding of G-sec under the Hold to Maturity (HTM) category offers a cushion from valuation changes to the banks. To help banks absorb the heavy G-sec supply and plan their investments in the SLR securities, RBI may increase the HTM limit further or extend the period of the HTM limit increase.

In the Apr 2021 policy meet, MPC has extended the interim Ways and Means Advances (WMAs) limit of INR 515.6 billion to the State Governments till Sep 2021 and increased the limit of aggregate WMA to INR 470.1 billion, per year, for states and Union Territories (UTs). These measures were meant to provide some relief to the State Governments, given their high borrowing requirements, but still they may continue to issue bonds for further borrowing from markets. There could be a possible extension on this front.

The RBI will also continue to commit towards maintaining ample liquidity consistent with the MPC's accommodative guidance and stance provided.

Additional support to MSME and agriculture: Unlike the first wave, the ongoing second wave has affected the rural economy and fragile MSME sector by a greater extent. Hence, the RBI may provide more support for the MSME sector in the form of credit enhancements and more liquidity support to the National Bank for Agriculture and Rural Development (NABARD) and food grain procurement agencies like the Food Corporation of India (FCI) and eNAM-Mandis. This will be over and above the support measures announced on May 05.

To summarise, we expect the MPC focus to remain on supporting the recovery that will result in: (a) keeping the repo rate unchanged and (b) providing a dovish guidance by keeping its state-based forward guidance in place. Additionally, the RBI could continue with its commitment of unconventional easing, with the introduction of GSAP 2.0 and provide more liquidity support to the stressed sectors in the economy.

Hence, we expect the 10-year benchmark to trade between a broad range of 5.9% to 6.2%, over 1HFY2022 supported by RBI's unconventional toolkit.

Over the medium-term, we maintain that the MPC will be on a long pause in the repo rate, possibly over FY2022 and retain its accommodative stance, as long as the risks to the outlook remain in place. Moreover, we expect the RBI/MPC to keep innovating its responses, as per the evolving macroeconomic conditions, while ensuring ample liquidity in the system to promote orderly market conditions and monitoring inflation to ensure that it remains within the tolerance band.

ICICI Bank: ICICI Bank Towers, Bandra Kurla Complex, Mumbai- 400 051. Phone: (+91-22) 2653-1414

Economics Research Group			
Economics Research			
Shivom Chakravarti	Senior Economist— Global markets	(+91-22) 4008-1414 (ext 6273)	shivom.chakravarti@icicibank.com
Sumedha Dasgupta	Economist	(+91-22) 2653-1414 (ext. 7243)	sumedha.dasgupta@icicibank.com
Aniket Gaikwad	Research Analyst	(+91-22) 2653-1414 (ext. 8161)	aniket.gaikwad@icicibank.com
Kaushal Aryan	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	kaushalkumar.aryan@icicibank.com
Asha Sasikumar	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	asha.sasikumar@icicibank.com
Sarbartho Mukherjee	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	sarbartho.mukherjee@icicibank.com
Jyoti Sharma	Research Analyst	(+91-22) 2653-1414 (ext. 7249)	sharma.jyoti@icicibank.com
Tanisha Ladha	Research Analyst	(+91-22) 2653-1414 (ext. 7309)	tanisha.ladha@icicibank.com
Nihal Kumar	Research Analyst	(+91-22) 2653-1414 (ext. 7309)	nihal.kumar@icicibank.com

Treasury Desks			
Treasury Sales	(+91-22) 6188-5000	Currency Desk	(+91-22) 2652-3228-33
Gsec Desk	(+91-22) 2653-1001-05	FX Derivatives	(+91-22) 2653-8941/43
Interest Rate Derivatives	(+91-22) 2653-1011-15	Commodities Desk	(+91-22) 2653-1037-42
Corporate Bonds	(+91-22) 2653-7242		

ICICI Bank (including its branches, and affiliates) is unable to exercise control or ensure or guarantee the integrity of/over the contents of the information contained in the e-mail transmissions and/or attachments and that any views expressed in this e-mail and/or attachments are not endorsed by/binding on ICICI Bank. Before opening any attachments, please check them for viruses and defects and ICICI Bank accepts no liability or responsibility for any damage caused by any virus that may be transmitted by this e-mail and/or attachments thereto.

DISCLAIMER FOR DUBAI INTERNATIONAL FINANCIAL CENTRE ("DIFC") CLIENTS:
This marketing material is distributed by ICICI Bank Limited, Dubai International Financial Centre (DIFC) Branch, a Category 1 Authorised Firm and regulated by the Dubai Financial Services Authority. This marketing material is intended to be issued, distributed and/or offered to a limited number of investors who qualify as 'Professional Clients' pursuant to Rule 2.3.3 of the DFSA Conduct of Business Rulebook, or where applicable a Market Counterparty only and should not be referred to or relied upon by Retail Clients and must not be relied upon by any person other than the original recipients and/or reproduced or used for any other purpose.

DISCLOSURE FOR RESIDENTS IN THE UNITED ARAB EMIRATES ("UAE"):
Any products mentioned in this document, any offering material related, thereto and any interests, therein, have not been approved or licensed by the UAE Central Bank or by any other relevant licensing authority in the UAE and they do not constitute a public offer of products in the UAE in accordance with the Commercial Companies Law, Federal Law No. 8 of 1984 (as amended) or otherwise.

DISCLOSURE FOR RESIDENTS IN HONGKONG
This document has been issued by ICICI Bank Limited in the conduct of its Hong Kong regulated business (i.e. type 1 licence) for the information of its institutional and professional investors (as defined by the Securities and Future Ordinance (Chapter 571 of Laws of Hong Kong) (the "SFO")) customers; it is not intended for and should not be distributed to the retail or individual investors in Hong Kong. Any person who is not a relevant person, should not act or rely on this document or any of its contents. This document has not been reviewed, authorised or approved by any regulatory authority.

ICICI Bank and/or its affiliates are full service financial institutions engaged in various activities, which may include Securities Trading, Commercial and Investment Banking, Financial Advice, Investment Management, Principal Investment, Hedging, Financing and Brokerage Activities. As a result, you should be aware that a conflict of interest may exist. In accordance with the regulatory requirements and its own conflicts of interest policies, ICICI Bank has in place arrangements, internal policies and procedures to manage conflicts of interest that arise between itself and its clients and between its different clients. Where it does not consider that the arrangements under its conflicts of interest policies are sufficient to manage a particular conflict, it will inform you of the nature of the conflict, so that you can decide how to proceed.

DISCLOSURE FOR RESIDENTS IN SINGAPORE
ICICI Bank Limited, India ("ICICI India") is incorporated under the laws of India and is regulated by the Reserve Bank of India. ICICI Bank Limited, Singapore Branch ("ICICI") is regulated by the Monetary Authority of Singapore.

As mentioned, ICICI Bank India is regulated by the Reserve Bank of India. Hence, in relation to your dealing with ICICI Bank India, you understand that your interest will be subject to the protection of local laws and regulations in India, which may offer different or diminished protection, than available under the Singapore laws and regulations. You also understand that the Monetary Authority of Singapore will be unable to force the enforcement of the rules of the local regulators.

For more detailed disclaimer, please visit https://www.icicibank.com/disclaimer/disclaimertnc.html .