RBI/MPC: As dovish as expected

- **The Monetary Policy Committee (MPC) voted unanimously to maintain a status quo on policy rates and to retain its state-based accommodative forward guidance on expected lines**
- **The main message was that the need of the hour was for the policies to remain accommodative, to combat the hit to the growth from the second-wave of infections**
- **The Reserve Bank of India (RBI) downgraded its Gross Domestic Product (GDP) growth projections for FY2022, taking in to account a weaker than expected growth profile in 1Q**
- **While inflation projections were raised at the margin, they are not expected to overshoot the RBI's upper bound level of 6%. Hence, inflationary concerns are unlikely to influence the monetary policy decision making in the near-term**
- **Even as the RBI has committed to providing ample liquidity, it is looking to 'turning systemic liquidity into equitable distribution' across sectors. Hence, additional support was provided to the stressed sectors of the economy**
- **The RBI announced that it will include State Development Loans (SDL) purchases as a part of the remainder of GSAP 1.0. It also announced plans to implement GSAP 2.0 in Q2 FY2022 that will be to the tune of INR 1.2 trillion, slightly higher than GSAP 1.0 of INR 1 trillion**
- **The upshot is that RBI's continued support through its unconventional tools could ensure that the 10-year benchmark trades in the 5.9% to 6.2% over H1 FY2022**
- **RBI reiterated its call for intervening in the foreign exchange market to stem volatility. We continue to see the USD/INR pair trading in the 72.50-73.50 range in the near-term**
- **Going forward, we see RBI maintaining its accommodative framework for the rest of FY2022. A move towards normalising liquidity conditions could start from Q4 FY2022 only, if there are signs of a durable recovery taking hold**

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The Monetary Policy Committee (MPC) kept the policy rate unchanged today and voted unanimously to maintain an accommodative stance, as long as necessary, to revive and sustain the growth on a durable basis. The policy statement had a dovish underpinning. The MPC noted that the downside risks to its growth have increased due to the rapid spread of the virus and its subsequent adverse impact on both urban and rural demand.

In an attempt to comfort the markets and ensure orderly evolution of the yield curve, a number of measures have been announced for the financial markets and the real economy, reflecting the RBI's commitment to support the recovery. There was also a greater emphasis provided on ensuring that the 'surplus liquidity translates directly into lending into the real economy.

Key takeaways from the policy statement:

Growth remains a priority, over inflation at the current juncture: The RBI lowered its growth expectations for Q1 FY2021, reflecting the impact of the second-wave of infections. The State-wise lockdowns have hurt near-term growth prospects that forced the RBI to lower its GDP growth projections from 10.5% YoY for FY2022 to 9.5%. **There was also a subtle re-wording in the forward guidance provided by stating that the policy will remain accommodative to 'revive and sustain growth' from just 'sustain growth' that was mentioned in the April policy meeting.** Over April-May, the RBI emphasised that there has been a sequential moderation in the urban demand (indicators like electricity consumption, railway freight traffic, port cargo, steel consumption, cement production, e-way bills and toll collections) and in the rural demand (i.e. tractor sales and two-wheeler sales). PMI surveys also capture the sequential moderation. Concerns were also expressed about the spread of infections in the rural areas.

Although inflation projections were raised at the margin over Q2-Q4 FY2021, concerns about the rising price pressures were downplayed. Even with the forecast revisions, CPI inflation is not expected to breach the upper-bound level of 6%. The RBI Deputy Governor Mr Patra, in the press conference, was quick to point out that most of the increase in inflation can be attributed to the supply-side disruptions related to the pandemic and not to the demand-side pressures building up. The global commodity price increases probably also got factored into the CPI projections. On core inflation, the MPC feels that with declining infections, restrictions and lockdowns, the supply side bottlenecks will gradually ease thereby, reducing the input cost pressures. On the other hand, the weaker demand conditions will further playout on the core number. **Hence, inflation concerns are unlikely to play a dominant role in influencing the monetary policy setting, until the pandemic recedes.**

	MPC CPI projections		MPC Real GDP	
	Apr-21	Jun-21	Apr-21	Jun-21
Q1 FY 2022	5.2	5.2	26.2	18.5
Q2 FY 2022	5.2	5.4	8.3	7.9
Q3 FY 2022	4.4	4.7	5.4	7.2
Q4 FY 2022	5.1	5.3	6.2	6.6
FY 2021-22	5.0	5.1	10.5	9.5

Source: RBI, ICICI Bank Research

A change in the liquidity focus: The Governor re-iterated the RBI's commitment to keep ample liquidity in the system to promote orderly market conditions, in line with the accommodative stance of MPC. **A very critical take-away from this round of the policy meeting was that the RBI's focus is shifting to ensure not only that liquidity conditions remain ample but also that there is more equitable distribution of liquidity, across sectors, particularly on the stressed ones.** Hence, several measures, such as an on-tap liquidity window for high contact intensive sectors and a special liquidity facility for Small Industries Development Bank of India (SIDBI), were announced.

Unconventional tools will be used to keep the bond yields stable: The Governor mentioned that RBI has used G-SAP operations, auction cancellations, devolvement and use of greenshoe options in the G-Sec auctions, as a way to convey RBI's views to the market. RBI aims to use these tools to ensure proper orderly evolution of the yield curve, so as to keep borrowing costs of the Government low and yields particularly at the longer-end stable. The Governor downplayed the fact that the RBI was targeting a specific level for the benchmark 10-year yield but instead said that the focus is more on 'stability'. The RBI announced that the remaining auction worth INR 400 billion under GSAP 1.0 would take place on Jun 17. Of that amount, INR 100 billion would constitute purchase of the State Development Loans (SDLs) to ease pressure on the State Governments, who are facing the prospect of higher borrowings. For Q2 FY2022, the total purchases under GSAP 2.0 is expected to be worth INR 1.2 trillion that was higher than INR 1.0 trillion, announced under GSAP 1.0. Even though the quantum of GSAP 2.0 is higher than GSAP 1.0, this could disappoint the Government bond market, as investors were expecting a total purchase in the range of INR 1.2 trillion to INR 1.6 trillion. Additionally, inclusion of SDL purchase under the GSAP programme could mean that there is less quantum of purchases for Government Securities. **The upshot is that with the RBI committing to sticking to its unconventional tools, we see limited upside potential in the benchmark 10-year yield. We maintain our range of 5.9%-6.2% for the 10-year sovereign yield over H1FY2022. Shorter-end yields could continue to trade around the current levels, driven by ample liquidity conditions.**

Range trading in the USD/INR could continue: The RBI reinforced its commitment to managing its exchange rate volatility. Hence, we maintain our call of the USD/INR pair trading in the 72.50-73.50 range in the near-term. Reduced importer demand and a dovish Fed guidance could mean that fund flows continue to enter the local financial system that could in turn limit sharp upside potential emerging at the current juncture.

Policy outlook: The overall outcome was in line with expectations with RBI turning much more cautious on the state of the economy. Uncertainty about the outlook is expected to linger over the next three to four months. A lot will depend on the manner in which the pandemic evolves, the pace of vaccinations and overall mobility trends. Developments in the rural economy will also work as an important input for the Central Bank.

In short, we expect the RBI to stick to its accommodative framework for most of FY2022. The repo rate will likely be kept unchanged, over the course of the fiscal year. More liquidity support measures to specific stressed sectors are also possible to take place. In this regard, more measures can be taken to incentivize banks to increase credit offtake. In our best-case scenario, we see RBI moving towards normalising the policy going into Q4 FY2022, only if there are strong indications that the pandemic has receded.

Annexure: Statement on developmental and regulatory measures:

On-tap liquidity window for Contact-intensive sectors:

- A separate liquidity window of INR 150 billion, to provide fresh lending support to contact-intensive sectors (hotels & restaurants, tourism, aviation, ancillary services and other services) has been announced till Mar 31, 2022, with tenors of up to 3 years at the repo rate, in order to mitigate the adverse impact of the second COVID-19 wave and ease liquidity pressures to revive economic activities. As an incentive, banks have been permitted to park their surplus liquidity up to the size of the loan book created under this scheme with the Reserve Bank, under the reverse repo window at a rate, which is 40 bps higher than the reverse repo rate.

Special liquidity facility to Small Industries Development Bank of India (SIDBI):

- A special liquidity facility of INR 160 billion has been provided to the Small Industries Development Bank of India (SIDBI) at the prevailing repo rate for a period of up to one year, in order to meet the medium-term funding requirements of Micro, Small and Medium Enterprises (MSMEs), with an additional focus on smaller MSMEs and businesses, including those in the credit deficient and aspirational districts. This facility will ensure a continued flow of credit to the MSMEs to kick start the investment cycle and support the ongoing recovery. The facility would be extended for on-lending/refinancing through novel models and structures, including double intermediation, pooled bond/loan issuances, etc.

Enhancement of the Exposure Thresholds under the Resolution Framework 2.0:

- The Resolution Framework 2.0 was announced on May 05 to allow individuals, small businesses and MSMEs, with loans up to INR 0.25 billion and who have not availed restructuring under the Resolution Framework 1.0 and others and were classified as 'Standard' as on Mar 31, 2021-avail one-time restructuring under the proposed framework till Sep 30, 2021. In order to enable a larger set of borrowers to avail the benefits under the Resolution Framework 2.0, the Reserve Bank of India has expanded the coverage of borrowers under the scheme, by increasing the maximum aggregate exposure threshold from INR 0.25 billion to INR 0.5 billion for MSMEs, non-MSME small businesses and loans to individuals for business purposes. It will help the small borrowers and businesses tide over the impact of the second wave of the COVID-19 pandemic and lockdowns.

Placement of Margins for Government Securities Transactions on behalf of Foreign Portfolio Investors (FPI):

- It has been decided to permit the Authorised Dealer Banks to place margins on behalf of their Foreign Portfolio Investor (FPI) clients for their transactions in Government Securities (including State Development Loans and Treasury Bills), to ease operational constraints faced by FPIs and promote the ease of doing business. This will strengthen foreign inflows into the country, thereby increasing the liquidity of domestic capital markets and promoting the development of domestic equity markets.

Facilitating Flexibility in Liquidity Management by issuers of Certificates of Deposit:

- Regional Rural Banks (RRBs) are now permitted to issue Certificates of Deposit (CDs) to eligible investors to ensure efficient liquidity management practices and provide greater flexibility in raising short term funds. Moreover, all issuers of CDs will now be permitted to buy back their CDs before maturity, subject to certain conditions to provide greater flexibility in liquidity management.

Availability of National Automated Clearing House (NACH) on all days of the week:

- NACH has emerged as a prominent digital mode of Direct Benefit Transfer (DBT) to a large number of beneficiaries. It is currently available only on the days when banks are functional. Now, it has been proposed to make it available on all days of the week, throughout the year (effective Aug 01, 2021) in the interest of customer convenience and to take advantage of the availability of RTGS on all days of the year.

Source: RBI

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