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Monetary Policy Likely to Normalise in Q4

Expert Take

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The Reserve Bank of India's monetary policy outcome was less about rates and more about the policy language, rate stance, forward guidance and liquidity infusion through the Government Securities Acquisition Programme (GSAP). The stance remained unchanged while the forward guidance continued to be unequivocally dovish.

To nurture its revised state-based forward guidance, the Monetary Policy Committee (MPC) added the word 'revive' to acknowledge the scar of the second wave of the Covid-19 pandemic while continuing with its accommodative stance of sustaining growth on a durable basis. Also, the MPC did not go the full length in acknowledging higher inflationary risks, but modestly increased its average inflation forecast for FY22 to 5.1% (from 5%).

The post-policy comments from the RBI dismissed current inflationary pressures as transient and as a supply-side problem rather than as a demand-pull that might have required some action. Overall, the message was to focus on growth being the policy priority — best amplified by Governor Das in his own words: "there has been no thinking about a normalisation of policy" as it was "too early" and "too premature".

Though the policy spoke of an opening up of policy elbow room due to lower-than-expected April inflation, Das' comments did not allude to the space being available on the rates side even while acknowledging liquidity. With the policy rate space no longer being available, the RBI has increasingly shifted to regulatory and unconventional measures to deal with the pandemic fallout. While highlighting the role of liquidity being the primary vehicle of transmission, the governor mentioned the need for equitable distribution of surplus liquidity.

As far as the markets are concerned, the RBI reemphasised that it will maintain financial stability and congenial financing conditions. The step-up of GSAP for the second quarter with a higher commitment of ₹1.2 lakh crore (against ₹1 lakh crore in Q1) and the inclusion of State Development Loans (SDLs) will continue to alleviate the demand issue in the bond market.

BENIGN REGIME

There is sufficient clarity and patience to comfort markets on the growth-inflation tradeoff

The injection of additional liquidity to the tune of ₹36,000 crore (up to May 31) besides the ₹60,000 crore under GSAP remains a testimony to RBI's regular operations.

To drive its message louder on the orderly evolution of the yield curve, the governor said that RBI's liquidity measures and operational decisions on the cancellation, devolvement and exercise of green-shoe options in primary auctions "conveys the Reserve Bank's view to the market".

However, the governor added that the "6% yield on 10-year benchmark bond is not sacrosanct" and the RBI remains focused on the entire term structure as evidenced through its purchases in the GSAP.

To augment further the demand-side measures, the RBI has allowed authorised dealer banks to place margins on behalf of their FPI clients for transactions in GSecs. Such debt market reform along with reports of RBI evaluating a proposal to make GSecs eligible for settlement through Euroclear will accelerate the channelling of foreign savings in the local fixed income market.

The post-policy conference addressed a lot of issues about its foreign exchange operations, balance sheet growth and dividend policy. The RBI defended its two-sided intervention in the forex markets given its objective to contain volatility in the rupee exchange rate, liquidity conditions and the need for emerging market economies to build a war chest against external exigencies.

On the heightened two-way volatility in the forex forward premium market, the RBI ascribed it to the market outcome but conveyed that it stands ready to take countervailing measures to cool it down. This narrative alongside the governor's statement on easing inflation providing elbow room on liquidity measures suggests that RBI may start rolling down its forward book. Das also ruled out the deployment of additional tools to sterilise liquidity inflows.

Overall, there seems to be sufficient clarity and patience embedded in the guidance to comfort the markets on the growth-inflation tradeoff. Moreover, the RBI's use of conventional and unconventional tools to drive MPC resolution in pursuit of sustainable durable recovery will keep the policy environment benign.

The first sign of normalisation could come in the form of longer tenor VRRR (variable-rate reverse repo) followed by a narrowing of the policy rate corridor which at best may come in Q4-FY22.

Till then, the markets need to remain guided by Das' concluding remarks: "continue to think and act out of the box, planning for the worst and hoping for the best".

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