RBI Monetary Policy Review

L&T Financial Services
Mutual Fund

February, 2021

The Monetary Policy Committee (MPC) came out with its bi-monthly policy statement on February 5, 2021. Some of the key announcements are as follows:

- The MPC members unanimously voted for keeping the policy rates unchanged
- The MPC also unanimously decided to continue with an accommodative stance as long as necessary (at least during FY2021 and into FY2022) to revive growth on a durable basis and mitigate the impact of the pandemic on the economy, while ensuring that inflation remains within the mandated target band going forward
- With a growth-driven Budget announced by the Government, the RBI expects real GDP to grow at 10.5% in FY2022, with a range of 26.2% to 8.3% in H1 FY2022 and 6% in Q3 FY2022
- The projection for CPI inflation has been revised to 5.2% for Q4 FY2021 (from 5.8% earlier), 5.2% to 5% in H1 FY2022 (from 5.2% to 4.6% earlier) and 4.3% in Q3 FY2022

Some of the other non-policy related announcements are as follows:

- The CRR cut of 100 bps which was effective till March 26, 2021, will now be gradually restored in a phased manner. Banks will have to maintain 3.5% CRR from March 27, 2021, to May 21, 2021 and 4% thereafter
- In September 2020, RBI increased the HTM category for Banks from 19.5% to 22% of NDTL in respect to SLR securities. This dispensation was earlier till March 2022, but has now been pushed to March 2023, providing greater flexibility to Banks to plan their investments
- Retail investors will now be allowed to participate in the G-Sec market, both in primary and in the secondary market
- FPIs will now be allowed to invest in defaulted bonds which will be exempted from short term limits

The Governor emphasized that the RBI stands committed to ensure ample liquidity in the system in consonance with the monetary policy stance. Additionally, the Governor also reiterated that the RBI will ensure that the market borrowing goes through in a non-disruptive manner

Although, the RBI Governor tried to comfort the market on liquidity and yield movements, market participants were expecting more clarity on the calendar, quantum and schedule of open market operations which the RBI would conduct to absorb the increased supply of dated securities both in this financial year and the next one. However, in absence of any such announcements, yields shot up across the G-Sec and Corporate bonds.

Outlook

We believe the RBI will have to offer much clearer guidance and support to the bond markets, given the huge government bond supply, that's pending in rest of FY21 and the whole of FY22. If the market's confidence in RBI's intent get shaken, these worries can manifest themselves in a sudden sharp spike in yields across the curve, making it that much harder for the central bank to control later. We expect the RBI to comfort the markets over the coming weeks through appropriate signaling, which we expect will lead to stabilization of interest rates post the sell-off over the past few weeks.

Following the upward move in interest rates, the carry in the 2-5 year part of the G-Sec and AAA curve is a lot more attractive and offers good value and buffer to absorb the gradual normalization of rates that is likely over the coming few years. The 10-year G-Sec benchmark, which had been trading in a 5.75-6% range for the past many months, has now convincingly broken past the 6% barrier. With the economy now picking up, core inflation likely to remain above 5% and the huge borrowing program announced in the budget, we believe yields are likely to now trade in a higher range of 6-6.5% range, with RBI being forced to take aggressive supportive measures to ensure that rates remain in the lower end of that range.

Source: RBI Press Release, internal

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