RBI Monetary Policy Review

L&T Financial Services
Mutual Fund

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Monetary Policy – Remains dovish despite high inflation

- The MPC members unanimously voted for keeping the policy rates unchanged
- The MPC decided with a 5 to 1 majority to continue with the accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remained within the target going forward
- Growth projections have been retained, with real GP growth expected to be 9.5% in FY2022 (21.4% in Q1, 7.3% in Q2, 6.3% in Q3 and 6.1% in Q4 FY2022). Real GDP growth for Q1 FY2023 is projected at 17.2%
- The projection for CPI inflation has been revised upwards to 5.7% for FY2022 (5.9% in Q2, 5.3% in Q3 and 5.8% in Q4 FY2022), with risks broadly balanced. CPI inflation for Q1 FY2023 is projected at 5.1%

The Governor mentioned that ample surplus liquidity has been maintained to ensure easing of financial conditions. The absorption of liquidity by RBI through Reverse Repo auctions has gone up substantially over the last couple of months. Given, that appetite for the 14 days VRRR auctions has gone up (evident through bid-cover ratio), the RBI has decided to increase the amount of fortnightly 14 days VRRR auction in a staggered manner (currently at INR 2 Lakh Crs to INR 4 Lakh Crs by the end Sep 2021; i.e., an increase of INR 50,000 Crs every fortnight). However, the Governor reiterated that enhancement in amounts under VRRR auction should not be misconstrued as reversal of accommodative stance.

The Governor announced two auctions under G-SAP 2.0 worth INR 25,000 Crs each to be conducted in August. Other operations vis-à-vis OMOs and OTs will be conducted alongside G-SAP, as when required. The Governor also indicated that G-SAP auctions can include both off-the-run and on-the-run securities.

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

- On-tap TLTRO scheme extended by 3 months till Dec 2021
- MSF window relaxation extended by 3 months till Dec 2021
- Deferral of deadline for achievement of financial parameters under Resolution Framework

The Governor reiterated that RBI stands committed to act through various measures to ensure that growth trajectory is back on track and stability in financial markets is preserved.

Market impact

Yields moved slightly higher post the MPC announcement. Short end rates (money market instruments and 2-3 year Corporate bonds) moved up by 5-8 bps owing to the increased quantum in VRRR auction. The 5-year segment also moved up a similar magnitude and the 10-year benchmark G-Sec saw a move up by 4 bps.

Our take on the Policy

While the overall tone of the Governor's messaging remained as dovish as earlier, however, a few signals from the policy does raise a few questions regarding a potential change in bias.

Firstly, the accommodative stance was not unanimous, but a 5-1 vote, with Prof J R Verma voicing his dissent probably with the open-ended state-based forward guidance of the stance. Secondly, the inflation forecast was moved up markedly higher to 5.7% (vs 5.1% earlier), and the Q1 FY23 CPI projection has been pegged at 5.1%. While the upward adjustment could be interpreted as slightly hawkish, it could also be seen as building in a lot more tolerance into the MPC projections for higher inflation over the coming quarters if CPI prints remain elevated, rather than being seen as an upside surprise. And finally, the much awaited announcement on the variable rate reverse repo (VRRR), with a gradual increase in the amount from Rs 2 lakh cr to Rs. 4 lakh cr by September. In our view, this -in fact- makes it clear that the RBI is not planning on elongating the tenor of the VRRRs for now (which would have been more negative for short end rates), and is happy with just increasing the total amount in the 14 days VRRR gradually, in an environment where the total excess liquidity is upwards of Rs. 8 lakh cr.

As confirmed by the slight increase in the GSAP amount for August, RBI continues to signal to the market that it stands committed to ensuring that yields don't move up sharply, and any adjustment is 'controlled' and 'managed' in a calibrated manner.

Overall, the MPC continued to show a growth focus, without being too worried about the recent inflation prints. The normalisation path of interest rates is likely to be very gradual with potential reverse repo hikes a Jan-Mar phenomenon, instead of Oct-Dec as feared by the markets earlier.

Source: RBI Press Release, internal