# RBI Monetary Policy Review

L&T Financial Services
Mutual Fund

**December, 2021**

The Monetary Policy Committee (MPC) came out with their bi-monthly policy statement today. Some of the key announcements are as follows:

- 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 for FY2022 have been retained, with real GDP growth for FY2022 expected to be 9.5%. The growth numbers for Q3 FY2022 and Q4 FY2022 have been marginally revised downwards to 6.6% and 6.0% respectively, while Q1 FY2023 and Q2 FY2023 growth numbers are projected at 17.2% and 7.8%
- The projection for CPI inflation for FY022 has been retained at 5.3%, with an estimate of 5.1% for Q3 FY2022 and 5.7% for Q4 FY2022. Inflation is expected to be at 5.0% during H1 FY2023

**Although markets were expecting a hike in Reverse Repo Rate, there was no such announcement. The Governor mentioned that Variable Rate Reverse Repo (VRRR) auctions have been used as an effective tool to manage liquidity and the endeavour is to establish a 14-day VRRR auction as the main liquidity management operation. The amount of the 14-day VRRR auctions will be increased from currently at INR 6 Lakh Crs to INR 7.5 Lakh Crs by the end of December 2021.**

**In the absence of any announcements pertaining to a Reverse Repo hike, markets reacted positively, with money market and 1-3 year corporate bond yields rallying by 5-10 bps. Correspondingly, on the 3-year and beyond segment, both G-Sec and corporate bonds moved down by 3-5 bps.**

## Our take on the Policy

The MPC surprised the markets positively with its dovish tilt, by not hiking the reverse repo rate or even preparing the market for a future increase. Majority of the markets had priced in a partial 15-20bps reverse repo hike. Also, the MPC document as well as the post-policy press conference downplayed inflation worries, by projecting slightly lower inflation readings in Q4 FY22 and Q1 FY23 than in the previous policy, while introducing a 5% forecast for Q2 FY23, all surprising on the downside. Core inflation although elevated is expected to trend lower given the fuel tax cut and other supply-side measures. Overall, contrary to market expectations, the MPC retained its clear focus on supporting a durable growth recovery, compared to any undue worries about inflation risks. Without any hint of future reverse repo hike or change in stance, markets are now left guessing as to the timing of the eventual lift-off. Expectedly, all of this has led to a small relief rally of 3-10 bps across various segments of the yield curve.

However, we would like to highlight a couple of points which make us somewhat cautious of not over interpreting the dovishness of today's policy.

Firstly, liquidity normalisation is expected to continue progressing at a good clip, with a majority of the surplus likely to be absorbed by the 14 day VRRR over the coming weeks. Such a shift, wherein the overnight fixed-rate reverse repo amounts reduce further from 2.5lk cr currently towards less than 1 lakh cr, could potentially lead to overnight rates heading higher towards the 3.6-3.75% level over the next few months, which would put pressure on the short to medium end of the curve to gradually move higher from current levels. As far as pushing up short rates is concerned, this could achieve more than any reverse repo hike that the RBI could have announced in its policy today. Thus, we would caution investors from interpreting too much on the dovish tilt of the MPC in not announcing a reverse repo hike today.

Secondly, despite the confidence exuded by the RBI MPC with regard to inflation trajectory, we believe risks of a meaningful overshoot of CPI readings over the coming 3-4 months are non-trivial and could make the RBI appear somewhat behind the curve by the time of the next MPC meeting in February. With a rising current account deficit and volatile global flows environment, maintaining RBI policy credibility with regard to Flexible inflation targeting becomes that much more crucial and may force RBI to start the process of policy normalisation somewhat faster than currently telegraphed by them.

Accordingly, we would continue to be somewhat cautious in the positioning of our funds and advise investors to do the same. Carry is indeed attractive for going longer on the yield curve – however, it needs to be clearly synchronised with the investment horizon of investors.

While Covid worries are likely to wax and wane over the coming months and quarters, leading to high levels of uncertainty around future projections of growth and inflation, today's MPC has once again stressed on a gradual, well-calibrated and telegraphed manner of any future policy normalisation, which should provide debt investors with much-needed comfort against any abrupt sharp movements of interest rates.

**Source:** RBI Press Release, internal