October, 2021

Monetary Policy: Gradual start to the tilt

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

- 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 for FY22 have been retained, with real GDP growth for FY22 expected to be 9.5%. The Q1FY22 growth number was slightly below RBI's earlier estimate, however the growth numbers for the next two quarters have been revised upwards to 7.9% in Q2 and 6.8% in Q3, and the growth numbers for Q4FY22 and Q1FY23 retained at 6.1% and 17.2% respectively
- The projection for CPI inflation has been revised downward to 5.3% (from 5.7% in August policy) for FY22. The inflation projection for Q2 and Q3 have also been revised downwards to 5.1% and 4.5% respectively, while Q4 number is retained at 5.8%. CPI inflation for Q1FY23 is projected at 5.2%

Although, markets were a little wary that there could possibly be a Reverse Repo hike announced, however, there was no such announcement. The Governor mentioned that Variable Rate Reverse Repo (VRRR) auctions have been used as an effective tool to manage high surplus liquidity and RBI will continue to use this tool going forward. The amount of the 14-day VRRR auctions have been increased in a staggered manner (currently at INR 4 Lakh Cr to INR 6 Lakh Cr by early Dec'21; i.e., an increase of INR 50,000 Cr every fortnight). The RBI might also complement the 14-day VRRR auction with other fine-tuning instruments and 28-day VRRR auctionbasis evolving liquidity conditions. However, the Governor reiterated that enhancement in amounts under VRRR auction should not be misconstrued as reversal of accommodative stance and RBI stands committed to provide ample liquidity to support economic recovery.

The other important announcement was pertaining to G-SAP auctions. The Governor mentioned that G-SAP has been used by RBI as an effective tool in anchoring yield expectations in the backdrop of Government's large borrowing program. The RBI has injected liquidity to the tune of INR 2.37 Lakh Cr through open market operations during H1FY22. Given the high liquidity currently prevailing, no additional borrowing by the Government towards GST compensation and Government expenditure expected to release further liquidity, the Governor mentioned that there was no requirement for undertaking G-SAP auctions currently. However, the RBI would be ready to conduct G-SAP/OMO/OT auctions whenever the need arises.

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

- On-tap Special Long Term Repo Operations (SLTRO) for SFBs
- Review of WMA Limits and Relaxation in OD Facility for the State Governments and UTs
- Priority Sector Lending - Permitting Banks to On-lend through NBFCs

Market impact

In absence of any announcements pertaining to a Reverse Repo hike or any longer tenor VRRR auctions, markets reacted positively, with money market and 2-3 year Corporate Bond yields rallying by 5-10 bps. Correspondingly, the 4-5 year segment also moved down by 3-4 bps. However, the longer tenor G-Sec and Corporate bonds moved up by 3-4 bps, as no G-SAP auctions were announced. Post the 14-day VRRR auction cut-off which came in at 3.99% (with weighted average yield of 3.65%), part of the gains in both short end G-Sec and Corporate bonds reversed.

While bond markets were nervously worried about a faster pace of policy normalisation (with a possible reverse repo hike in this policy itself), the RBI Governor has once again spelt out his more dovish stance focussed more on growth recovery. While monetary policy normalisation has kick-started, the process is likely to be a very gradual one, with RBI keen to avoid a sharp repricing of bond yields. With the enhanced 14 day VRRRs doing the job of raising overnight rates and yields at the shorter end of the curve, the markets are better prepared for a partial reverse repo hike in the December policy, with the LAF corridor narrowing back to 25bps i.e. reverse repo at 3.75% by February. Given the 20-30bps upward move in 1-3 year segment over the past few weeks, we believe such a path of normalisation is priced into that part of the curve. The 5-7 year segment is likely to benefit from lower supply of GOI bonds and should stay relatively better protected, compared to the 8 year+ segment, where bond markets are likely to re-engage in a cat-and-mouse game with the RBI with regard to OMO support, especially given the backdrop of surging oil prices and higher US Treasury yields.

Source: RBI Press Release, internal