Press Release

New Covid variant defers policy normalization further

Status quo on rates, assertion of accommodative stance

8 December 2021

Notwithstanding the steady progress amongst many G-20 economies towards policy normalization amidst price pressures that has catapulted CPI inflation in their economies to multi year highs, India's central bank has continued to persist with its principle of 'gradualism' to nurture the nascent growth recovery and ensure its durability.

As such, the RBI in its bi-monthly policy review, maintained status quo on interest rates in Dec-21, while reiterating its accommodative stance. While the former decision was completely unanimous backed by a 6-0 voting outturn, the latter saw a dissent with 5-1 voting outturn for the third consecutive meeting.

The MPC acknowledged the ongoing advancement in high frequency indicators, including adversely affected contact-intensive services sector leading the RBI to **maintain its growth forecast at 9.5% in FY22**. This was, however, accompanied by a caution on the trajectory owing to the discovery of new Covid variant, elevated commodity prices, persistent supply disruptions and global financial market volatility given that many central banks have initiated an exit from their ultra-accommodative monetary policy.

On inflation front, the RBI did highlight concerns over a flare-up in vegetable prices due to unseasonal rains in the month of Oct-Nov'21 along with consistent pressure on core inflation which has continued to hover around 6.0% in the current fiscal. However, strong progress in rabi sowing, the latest moderation in global crude oil prices and cut in excise/VAT by central as well as some state governments are expected to offset some of the emerging price pressures. This in our view, may have prompted the RBI to maintain a dovish stance on inflation and keep its CPI forecast unchanged at 5.3% for FY22. **"So far, amid relatively weak consumption demand scenario, the input price pressures in the manufacturing or services sector have been only partly passed on to the retail consumers. With compression in firms' profit margins due to elevated commodity prices, further pass-through is expected to continue over the next few quarters. The hike in tariffs by telecom companies to strengthen their balance sheet is one such recent example. Additionally, prolonged supply chain bottlenecks and raw material shortages could keep inflation risks skewed to the upside. Therefore, we attach an upward bias to RBI's inflation forecast with our estimate at 5.5% in FY22 with material upside risks."** says **Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research.**

On the other hand, as widely expected, the RBI has continued to focus on **'rebalancing of liquidity'**. As such, the VRRR (Variable rate reverse repo) will continue to be the primary tool for liquidity management with auction amounts set to go up higher to Rs 6.5 trn – Rs. 7.5 trn in Dec-21. At the same time, the auctions will have a higher proportion of 28 days vis-à-vis the primary tenor of 14 days. In addition, some more steps have been taken to normalize the excess liquidity by reverting to normal dispensation under the MSF (now restored to 2% of NDTL from 3% that was hiked in Mar-20). Further, banks have been given an option to prepay their TLTRO withdrawals to optimize their liquidity position.

"While the calibration of the surplus system liquidity will continue till the next policy meeting, it is difficult to comment on the timing of the reverse repo rate hike. There may be a possibility of such an increase in Feb-22 provided the high frequent economic indicators continue to remain robust and the recent discovery of a new Covid variant "Omicron' doesn't start building up another pandemic wave in the country. Continuing uncertainty on the residual risks of the pandemic can reinforce the 'wait and watch' approach of RBI, thereby slowing down the progress on the policy normalization path." – adds **Suman Chowdhury**.

From the bond yield perspective, the announcement of liquidity calibration in the Oct-21 policy review has already led the 10-year bond yields to inch up with impact on the shorter end of the curve even more pronounced as yields on 1-3 year maturity government bonds jumped by about 10-15 basis points. However, the dovish tone in today's policy review has infused a positive sentiment in the bearish bond market to some extent with 10-year g-sec yields dropping by a few bps. Going forward, while yields at the shorter end of the curve are poised to remain firm amidst policy normalization by the central bank, we also expect 10Y g-sec yields to average towards 6.50% by Mar-22. It may be pertinent to mention that some banks and NBFCs have started to increase their deposit rates albeit marginally. Having said so, the following factors could limit any sharp upward movement in bond yields:

- Expectation with respect to India's inclusion in the global bond indices next year is gaining traction. We believe the upcoming FY23 Union Budget in Feb-22 would shed some light on the policy aspects and preparedness for the same.
- Prospects of modest fiscal consolidation in FY23 and the roadmap ahead on asset monetization that is expected to be announced in the FY23 Union Budget.

Chart 1: Impact of policy normalization more pronounced at shorter end of curve(%)

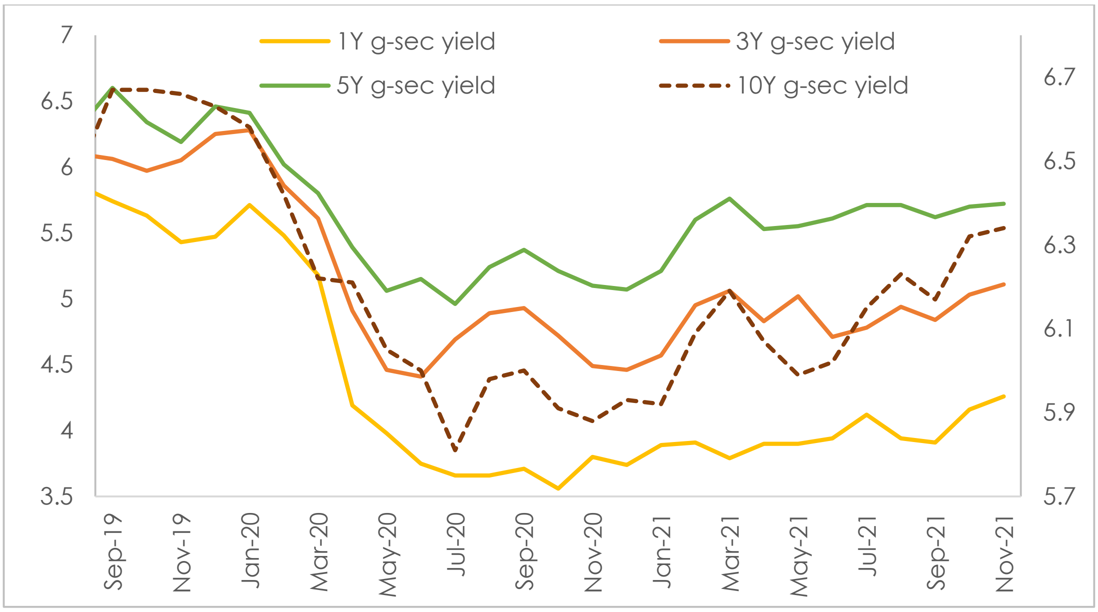
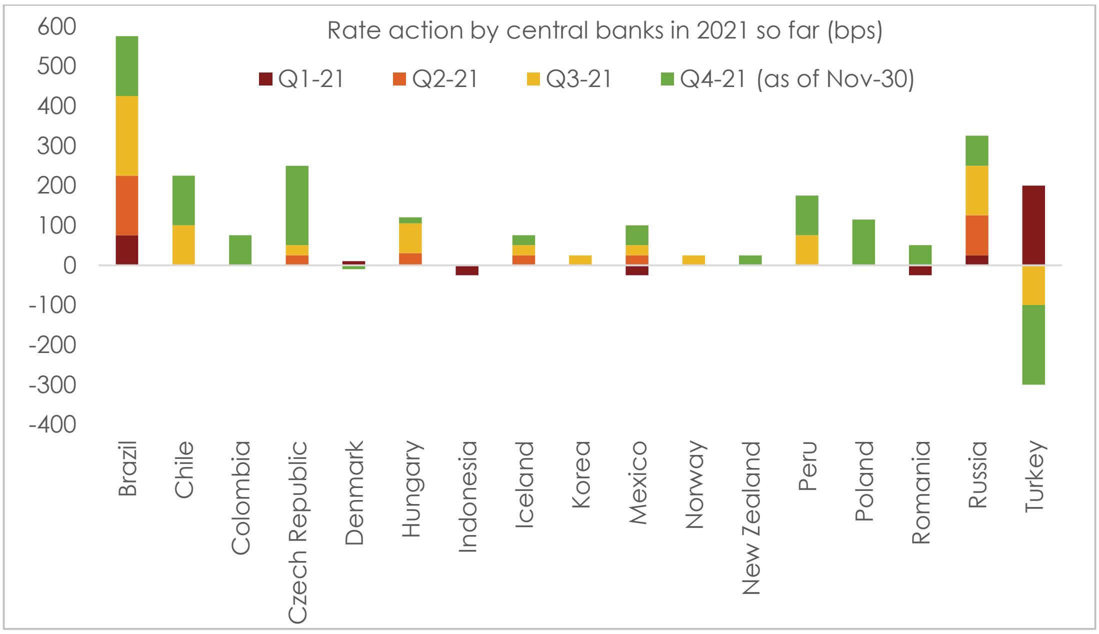


Chart 2: Interest rate normalization gathers momentum in several central banks



About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 8,900 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

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