Press Release

MPC Feb-22 Preview: Policy normalization may not be far away

Moderate hike in reverse repo rate likely in the current policy

4 February 2022

Systemically important central banks have started to scale back their pandemic era accommodative policies amidst high inflationary pressures globally. Fed and BoE are major central banks who have initiated their monetary policy normalization with a rather hawkish pivot in Dec-21 and Jan-22. Notably, the Fed in its last policy meeting also hinted at halting the asset purchases and raise interest rates as soon as March-2022. On the other hand, BoE also raised its interest rates for the second consecutive time in three months to 0.5% in a bid to manage the surging inflation. We believe that most of the central banks are likely to join the normalization bandwagon in the year 2022.

While the RBI has not given indications of any formal monetary policy normalization in its previous meetings, it has already undertaken a liquidity calibration exercise in the system and drain out the excess liquidity through an increased quantum of VRRR auctions. In our opinion, there is an adequately strong rationale for the central bank to initiate changes in its monetary policy stance in 2022 amidst hawkish pivots made by major central banks, limited spill over effect from the spread of Omicron variant, significant drop in Covid infections towards the end of Jan-22 along with persistent inflationary concerns.

Global commodity prices have firmed up sharply in Jan-22, with crude oil prices in particular currently hovering close to USD 91 pb that will lead to continuing input price pressures for both the manufacturing and the services sector. Additionally, progress on vaccinations along with recovery in personal mobility (barring the temporary disruption on account of Omicron) will continue to support pent-up or revenge demand and could keep core inflation elevated.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "As such, we believe RBI could consider moving reverse repo rate up by 20 bps in the Feb-22 policy review to signal the initiation of interest rate normalization cycle while retaining the accommodative stance and the repo rate till the growth signals in the economy become durable. This will also be consistent with its ongoing emphasis on rationalization of liquidity surplus, which has already pushed short term money market rates higher."

Short term rates apart, 10-year yields have also spiked significantly in Jan-22 on fears of potential capital outflows after the US Fed delivered a more hawkish than expected policy outcome. In addition, higher than expected bond yields market borrowings by the government announced in the Union Budget and lack of any clarity on the likelihood of India's inclusion in global bond indices further weighed on the market sentiment pushing 10-year yields sharply higher beyond our expectations. The yields which were at 6.05% as on Feb 5, 2021, has moved up gradually in the last calendar year and sharply of late to 6.87% as on Feb 4, 2022. Clearly, such a rise in bond yields in the backdrop of elevated global commodity prices, higher global inflation and rising interest rates in key economies do make a case for interest rate normalization by the RBI at least in a gradual manner.

Adds Suman Chowdhury "With central bank's proactive balance sheet support with respect to bond purchases likely to get challenging amidst the need for policy normalization, upside pressure on yields could continue to persist. As such, we continue to stick to our call of 10Y g-sec yield drifting higher towards 7.25% by Mar-23."

Chart 1: G-sec yields are back to their pre-pandemic levels

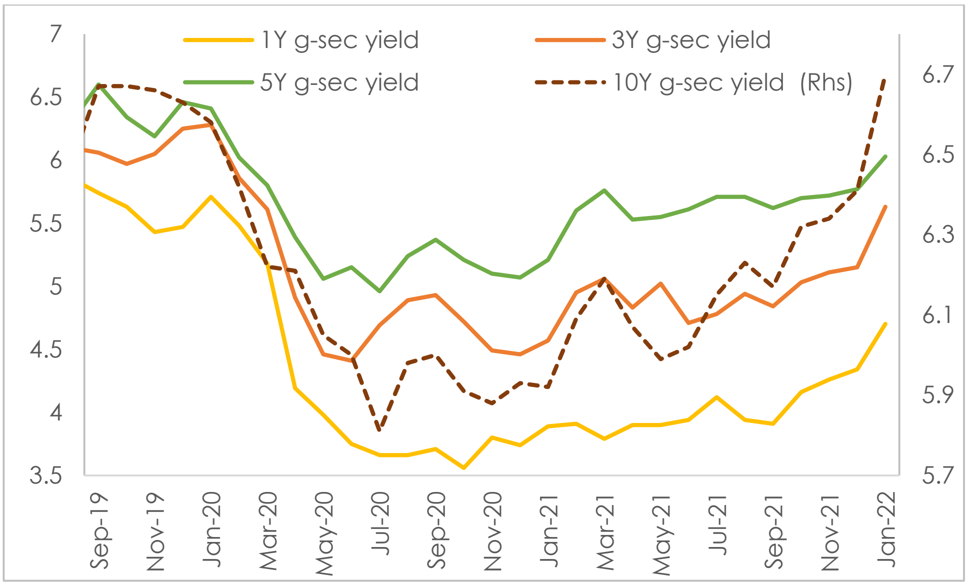
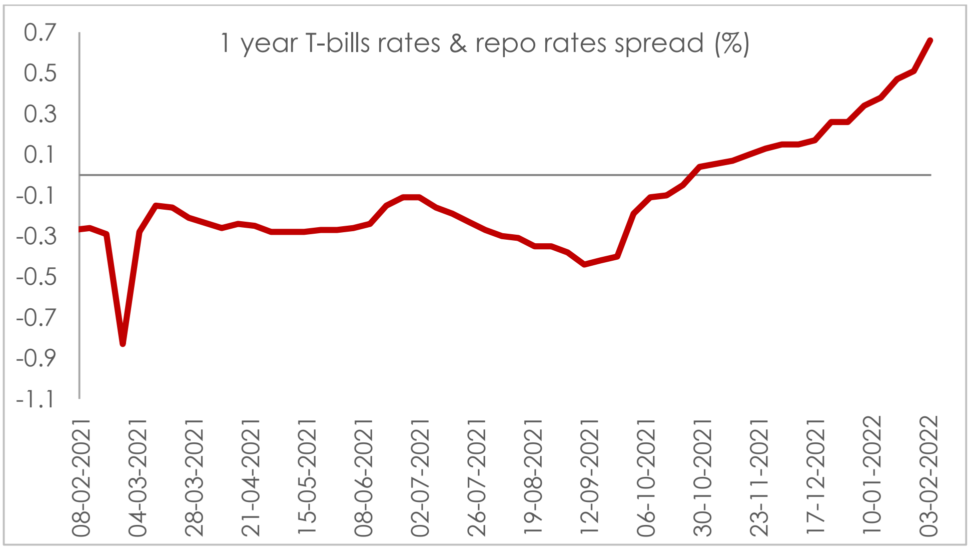


Chart 2: 1 year T-bill rates continue to inch higher



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