Press Release

Visible signs of monetary policy normalization in India

Short term rates rise but new pandemic risks can slow down speed of execution

30 November 2021

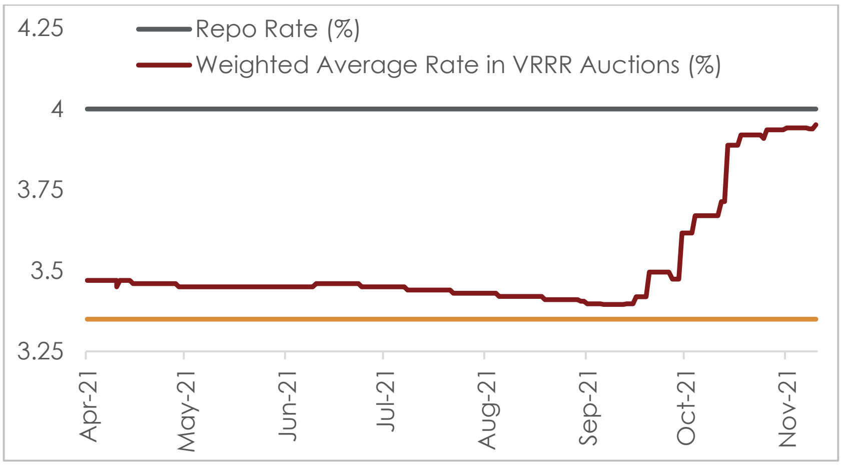
After bottoming out at 5.97% in May-21, India's 10Y g-sec yield has been gradually creeping up with bond yields averaging at 6.35% in Nov-21, the highest since the beginning of the pandemic. Since the start of H2 FY22, the 10Y g-sec yield has moved up by a cumulative 18 bps. The impact on the shorter end of the curve has been more pronounced as yields on 1-3 year maturity government bonds jumped by about 20-50 basis points during the same period. While there has been relief from concerns over additional government borrowing in H2 FY22 along with the moderation in inflation trajectory, the firmness in the yields is largely a reflection of a steep rise in global commodity and crude oil prices along with commencement of liquidity normalization by the RBI since the last MPC.

"Acuité believes that monetary policy normalization will continue in the major global economies given the extended period of higher inflation but the speed may vary across the central banks, depending upon their assessment of the residual pandemic risks. India is also expected to continue with the gradual approach to normalization and a phase-wise increase in the reverse repo rate can be envisaged in the current fiscal." – **says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research**

The rise in short term g-sec yield has been in focus as this is an outcome of active calibration of money market liquidity by the RBI. To recall, the central bank in its last MPC meeting had augmented its liquidity calibration effort through the expansion of the scope of VRRR (variable reverse repo rate) auctions along with discontinuation of the government bond acquisition programme (G-SAP). While the monthly average surplus in money market liquidity has continued to remain above INR 7.0 trn past 3 months with liquidity surplus in Nov-21 currently standing at around Rs 7.6 trn so far and proves the VRRR tool to be liquidity neutral, the absorption of surplus liquidity via all forms of VRRR has been gradually inching up with outstanding amount under the same increasing from Rs 5.4 tn prior to Oct-21 policy review to Rs 6.4 tn currently.

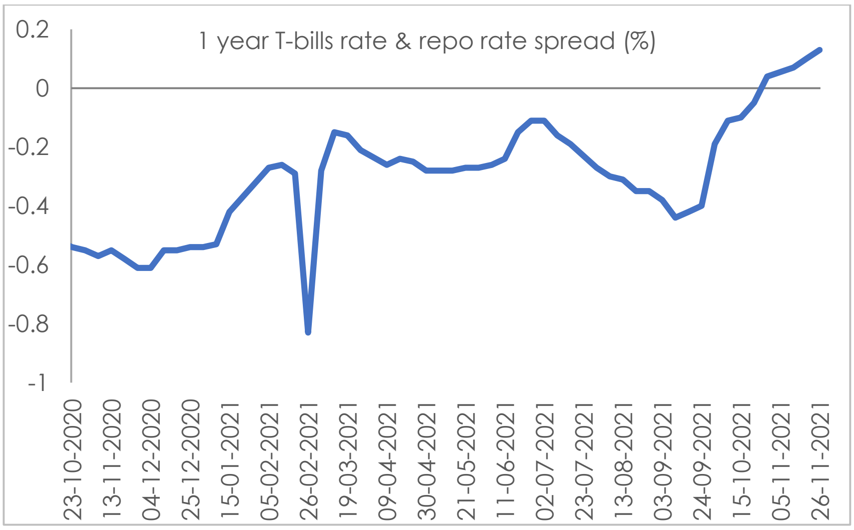
We expect the magnitude of liquidity absorption to potentially move up further as the central bank has also started to use longer tenors like the 28-day other than the standard 14-day auction. Importantly, the weighted average rate under these VRRR auctions has also hardened from pre Oct-21 policy level of 3.47% to 3.95% currently, close to the repo rate that has been maintained at 4.00% by the MPC since May-20.

Chart 1: In recent VRRR auctions, the cut-offs have moved towards repo rate



There has also been some spillover to the overnight rates with monthly average weighted call rate moving up from 3.12% in Sep-21 to 3.24% currently. While the call rate continues to be marginally lower than the reverse repo rate (the current effective policy rate) of 3.35%, the impact, in comparison, is relatively higher in case of term money segment, T-Bills, CDs, and CPs. It is important to highlight that the average spread of 1Y T-Bill rate over repo rate has turned positive (currently averaging around +10 bps in the month of Nov-21 so far as compared to average -41 bps in Sep-21) for the first time since the beginning of the pandemic.

Chart 2: Average spread of 1Y T-bill and repo rate has turned positive in Nov-21



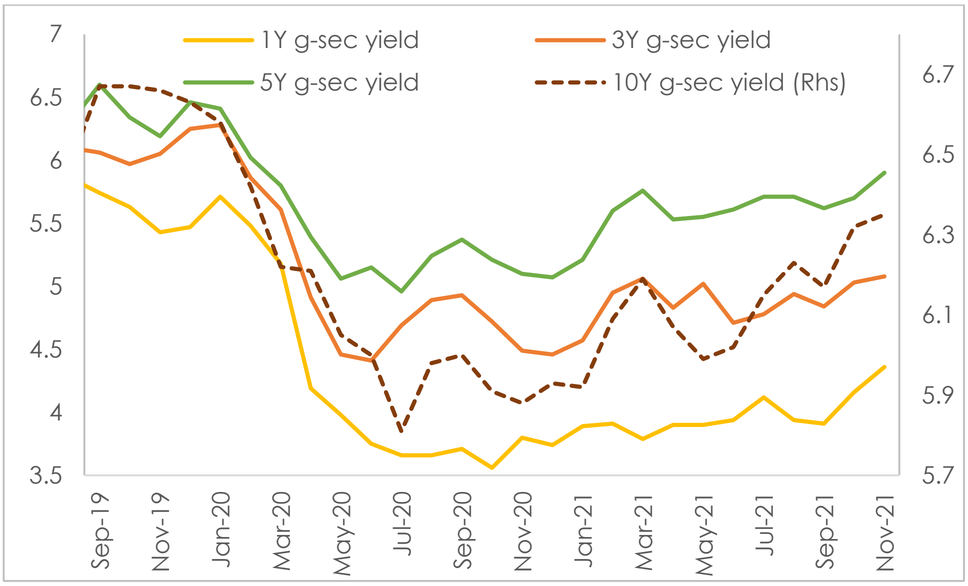
With ongoing calibration of liquidity surplus acting as a precursor, we expect a hike in the reverse repo rate which is likely to be split between Dec-21 and Feb-22 policy reviews. The anticipated move in reverse repo rate from 3.35% currently to 3.75% by Feb-22 would help restore the width of the policy rate corridor to its normal level of 25 bps (with repo rate being maintained at 4.00%) from the current spread of 65 bps.

Having said that, we remain watchful of the risks emerging from the fresh resurgence of Covid cases in Europe and Africa along with the uncertainty on the impact of the new variant (Omicron). This has the potential to reverse the ongoing travel liberalisation and can possibly dampen global growth prospects. This can also reinforce the "wait and watch" approach of RBI, thereby slowing down the progress on its policy normalization path.

From the bond yield perspective, while yields at the shorter end of the curve are poised to remain firm amidst growing expectations of central bank accelerating its policy normalization, we also expect 10Y g-sec yields to average towards 6.50% by Mar-22. Having said so, the following factors could limit any sharp upward movement in bond yields:

- India's CPI inflation is likely to average under 5% in Q3 FY22 on account of kharif output led support to food inflation along with trickle down impact of recent cut in fuel taxes. Lower inflation print expectations in the near term and the perceived risks of the new Covid variant have the potential to defer the first reverse repo rate hike to Feb-22.
- 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.

Chart 3: Impact of policy normalization more pronounced at shorter end of curve (%)



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.

Media Contacts:

Roshni Rohira Ph: + 91-9769383310 roshnirohira@eminenceonline.in	Neelam Naik Ph: + 91-9619699906 neelam@eminenceonline.in

Investor Outreach: **Analytical Contact:**

Rituparna Roy Deputy Vice President Ph: + 91-7506948108 rituparna.roy@acuite.in	Suman Chowdhury Chief Analytical Officer Ph: + 91-9930831560 suman.chowdhury@acuite.in