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CANARA ROBECO Mutual Fund

RBI Policy Update

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Assessment of Monetary Policy Committee's (MPC) August 6, 2021 Bi-Monthly Monetary Policy, FY 2021-22

RBI's Policy Stance:

The MPC, for the 7th consecutive meeting, decided to keep the benchmark interest rate unchanged and continued to maintain its stance as "accommodative" to recover from the disruptions caused by the second wave of the COVID-19 pandemic to the economy. The MPC noted that the economy has started to recover from the shocks of the second wave as the number of cases and casualties have come down significantly. To support a full economic recovery and growth, it was decided to maintain the benchmark interest rate and maintain accommodative stance for as long as necessary, to revive growth on a durable basis, while ensuring that inflation remains within the MPC's target. **As the CPI inflation has shown stability in Jun'21 after a rise in May'21, the MPC noted that it would continue within the policy of 4+/-2% in FY2022 as well and decided to**:

- **keep** the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4%;
- maintain the monetary policy stance as **accommodative**

Variable	Stands at
Repo	4.00%
Reverse Repo	3.35%
CRR	4.00%
MSF	4.25%
SLR	18.00%

Source: www.rbi.org.in

Policy Stance & Rationale:

- In the third bi-monthly policy meeting of FY22, chaired by RBI governor Mr. Shaktikanta Das, the MPC members voted unanimously to keep its benchmark interest rate unchanged. The MPC also decided on a 5 to 1 majority to continue to remain accommodative with an aim to aid the recovery of the economy and support growth, while ensuring that inflation remains within the target going forward. The focus is on providing policy support required to gain momentum in the economic growth and its recovery. **The MPC kept the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.0%. The reverse repo rate under the LAF too continues to stand at 3.35%, and the marginal standing facility (MSF) rate and the Bank Rate at 4.25%.**

- Globally, the economic recovery is picking up; however, the resurgence of the Delta variant of coronavirus in many countries poses danger of disrupting the pace of recovery. Countries that have vaccinated majority of their population and have been able to provide or maintain policy stimulus are recovering faster. The other economies are still struggling to grow due to new waves of infections. Commodity prices continue to be elevated, especially crude oil. Inflation, too, have hardened in many advanced economies (AEs) and emerging markets economies (EMEs). Sovereign bond yields have softened in most AEs compared to EMEs, as inflation is thought to be transient and the demand for sovereign bonds have gone up due to rising concern over resurged infections. The US dollar has continued to strengthen at the backdrop of higher growth expectations, resulting in the weakening of EME currencies.

- Domestically, the economic recovery is gaining momentum as the infections are coming down and restrictions have been eased in most states. The pace of vaccinations has picked up, which is supporting the opening of economy and normalising businesses. The monsoon has recovered after a brief interruption and kharif sowing is gaining momentum from the earlier slow pace. Aggregate demand, too, is improving with the revival of economy but aggregate supply is yet to reach pre-pandemic levels. External demand remained buoyant during Q1 FY2021-22 and was reflected in increasing exports, lending critical support to aggregate demand.

- CPI inflation remained stable in Jun'21 at 6.26% after a sharp rise to 6.30% in May'21. While fuel inflation surged, food inflation too increased due to a rise in prices of edible oils, pulses, milk and vegetables. Core inflation remained elevated due to the increased price pressures. Inflation in transport and communication, housing, health softened in Jun'21. The RBI Governor highlighted reasons like supply disruptions, elevated logistic costs, high global commodity prices and high local fuel taxes for current inflation trend. He pointed to moderation on core inflation in recent months as sign of comfort. **CPI inflation is projected at 5.7% during 2021-22 with 5.9% in Q2, 5.3% in Q3 and 5.8% in Q4 of 2021-22, with risks broadly balanced. The projection for next year is lower at 5.1% for FY2023.**

- System liquidity remained sufficient in Jul'21 with an average daily absorption under the LAF increasing from INR 5.7 lakh crs in Jun'21 to INR 6.8 lakh crs in Jul'21. Auctions for a cumulative amount of INR 40,000 crs in Q2 FY2021-22 so far under the G-SAP programme, evened liquidity across illiquid segments of the yield curve. Reserve money (adjusted for the first-round impact of the change in the cash reserve ratio) expanded by 11.0% (Y-o-Y) on July 30, 2021, driven by currency demand. Money supply (M3) and bank credit grew by 10.8% and 6.5%, respectively, as on July 16, 2021. India's foreign exchange reserves increased by USD 43.1 billion in 2021-22 (up to end of Jul'21) to USD 620.1 bn.

  Source: RBI

Outlook:

- The policy was on expected lines with the MPC holding fire and maintaining status quo on rates with a unanimous decision. The stance was also maintained at "accommodative", albeit with one member expressing reservations on continuing with the stance in the wake of persistently high inflation. Nevertheless, the RBI raised the CPI inflation target for FY2022 to 5.7% from 5.1%, reflecting higher input prices. **Growth projections were maintained at 9.5% for FY2022. On liquidity front, RBI is increasing the variable reverse rate repo (VRRR) auctions amount from current INR 2 lakh crs to INR 4 lakh crs by the end of September, by an amount of INR 50,000 crs every fortnight.** This is to take care of excess durable liquidity in the system which is currently close to INR 10 lakh crs.

- The MPC seems to be taking a leaf out of global central banks' playbook wherein the major central banks are comfortable running over inflation targets temporarily, citing the current inflation trajectories, in their own respective countries, as transitory. Despite high inflation prints in countries like US, UK and EU, central banks have stuck to their guns and continued with near zero rates and bond buying programmes. Majority of central banks believe that inflation is likely to come down by next year as supply chains ease and economic activity increases. The RBI too believes that current inflation trend is in transitory and should trend lower in rest of FY2022.

- In the home ground, the revival of south-west monsoon and the improvement in kharif sowing should help to control cereal price pressures. Urban demand is likely to restore with a lag as manufacturing and non-contact intensive services resume at a stronger pace, and the accelerated pace of vaccination will help in increasing stifled demand. The robust outlook for agriculture and rural demand would continue to support private consumption. Global commodity prices and financial market volatility, coupled with the possibility of new waves of infections are, however, downside risks to economic activity.

- **Market reacted negatively on account of: (1) Increase in CPI inflation projections, (2) Increase in VRRR amount which may be a first step towards policy normalisation and lastly, (3) reservations by one of the MPC members on the continuation of the accommodative stance.** However, announcement of G-SAP of INR 25000 crs each for next week and the end of August should keep markets steady. Further, CPI inflation is likely to drop below 6% in July 2021 and may continue to drop in the coming months. This may give some comfort to markets. Global crude prices have further retraced from highs, which may give short term relief on local prices. The **10 Year G-Sec yield has risen to 6.25%, which may not be comfortable for RBI. RBI may further intervene via Operation Twist, auction cancellations, etc. to ensure any sharp rise in yields is avoided.**

  Source: RBI, Bloomberg

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