



October 11, 2021

Monetary Policy Review

Rates Unchanged, but gradual liquidity withdrawal

The RBI monetary policy committee (MPC) met in the backdrop of global central banks indicating taper. While the rates were expected to remain unchanged, which they did, eyes were on RBI's liquidity stance. The RBI reaffirmed its commitment towards a gradual, calibrated withdrawal of excess liquidity by increasing the variable rate reserve repo VRRR auction size and pausing the G-Sec acquisition programme (GSAP).

Growth Outlook

- The MPC highlighted that the demand recovery has gathered pace in August-September in line with their August assessment.
- The MPC expects urban and rural demand to be strong going forward as well, supported by pent-up demand, festive season, and strong agriculture production.

- With the pick-up in government capex and favourable financial conditions, a virtuous investment cycle could also be around the corner.
- Elevated input costs, global financial and commodity market volatility, and a resurgence of Covid are some risks according to the MPC.
- Overall, the MPC kept its GDP growth forecasts for FY22 unchanged at 9.5%.

Inflation Outlook

- The MPC noted that CPI inflation during July-August has turned out to be lower than anticipated. This was driven by moderation in food inflation even as fuel inflation edged up. Core inflation remains elevated.
- Going forward, the MPC expects food inflation momentum to be muted given record Kharif production and adequate buffer stocks.
- The MPC believes the CPI will moderate led by a favourable base effect and lower food inflation. Hence, the MPC revised its CPI forecast downwards to 5.3% for FY22 from 5.7% in August.

Liquidity Measures

- **GSAP Paused**- The RBI recited an overhang of liquidity, absence of additional borrowing for GST compensation and the expected increase in government spending as reasons to pause GSAP.
- **Absorbing excess liquidity**- the RBI will increase the quantum of VRRR to INR 6 lakh crores by December from INR 4 lakh crores currently.
- **Extended SLTRO for Small Finance Banks**- the special long term repo operation (SLTRO) for small finance banks which was available till 31st October 2021, has been extended till 31st December 2021.

Other Major Announcements

- A framework for retail digital payments in offline mode to be introduced.
- Limit on IMPS increased to INR 5 lakhs from the current limit of INR 2 Lakhs.
- A framework for geo-tagging all payment acceptance infrastructures (POS, QR codes, etc) to be introduced.
- The ways and means advances (WMA) limits and relaxation in overdraft (OD) facility for the State Governments / UTs extend further by six months to 31st March 2022.
- Lending by banks to NBFCs for onward lending to the priority sector was permitted by the RBI till 30th September 2021. This has been extended till 31st March 2022.
- An internal ombudsman scheme for certain categories of NBFCs with higher customer interface to be introduced.

Outlook

Global central banks across the world have indicated taper over the last month. Many central banks in the emerging market, especially in countries that are commodity exporters have already started raising rates given the sharp rise in commodity prices. While almost nobody expected the RBI to announce a rate hike yet, there was some concern on whether the RBI would rein in liquidity too quickly. Those fears seem to have been alleviated. Systemic liquidity had increased significantly hence using the VRRR to normalize liquidity is a logical step. While GSAP has been paused, RBI can conduct open market operations (OMOs), if required.

As expected, the RBI is beginning to rein in liquidity gradually which could be the first step in the long runway towards rate hikes. We had recommended investing in the 5–7-year bucket in March 2021. This strategy has resulted in an annualised return of 7.3% since then compared to 6% delivered by the Crisil Composite Bond

Fund Index. This bucket of maturity offers a meaningful yield pick-up due to the steepness of the curve. Hence, for a holding period of three years, we continue to like this part of the curve, in spite of our expectation of some volatility. As economic recovery strengthens, our conviction on carefully curated structured credit deepens further. Overall, we continue to recommend to investors that they barbell portfolios.

We also believe that volatility often throws up good risk-reward opportunities and since we anticipate volatility in the coming quarters, we will keenly watch for such trades. Only the execution window of such trades tends to be short and hence swift decision making would be the key ingredient to make the most of these opportunities.

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