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Monetary policy | First cut

Emergency exit

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RBI keeps policy rates unchanged, but halts unconventional measures

The Reserve Bank of India (RBI)'s Monetary Policy Committee (MPC) kept its policy rates and accommodative stance unchanged in today's meeting. It stopped short of announcing a new set of liquidity-enhancing measures for the first time since the onset of the Covid-19 pandemic. It did not extend the government security (G-sec) acquisition programme (GSAP), and announced greater absorption of liquidity under upcoming variable rate reverse repo operations (VRRRs). The RBI is comforted by signs of strengthening economic recovery, while being mindful of supply-driven risks to inflation and the need to maintain financial stability.

Like many other central banks, the RBI is signalling a gradual move towards 'normalising' its monetary policy as the economy emerges from the shadow of the second wave. It is likely to first halt the unconventional easing measures it announced amid the pandemic. We expect this normalisation to continue in the coming months and a hike in the repo rate by 25 basis points by fiscal 2022-end, assuming strengthening economic recovery and elevated inflation risks.

Key takeaways from today's monetary policy meeting

- The MPC voted unanimously to keep the repo rate unchanged at 4%. Status quo was also maintained on the reverse repo at 3.35% and marginal standing facility at 4.25%
- It voted to maintain its accommodative stance, with a 5-1 majority, same as the outcome of the August meeting
- It did not announce any new purchases under GSAP, after the Rs 2 lakh crore of purchases between April and September
- It announced further increase in liquidity absorption under VRRRs, from Rs 4 lakh crore at present to Rs 6 lakh crore by December 2021
- It retained the forecast for gross domestic product (GDP) growth at 9.5% for this fiscal
- It cut the projection for consumer price index (CPI)-based inflation to 5.3% from 5.7% for this fiscal

What weighed on RBI's decision?

- **Pick-up in domestic economy**: Prospects of economic recovery have brightened further with the Covid-19 caseload plunging and vaccinations moving at a healthy pace over the past few weeks. This is evident from continued improvement in high-frequency indicators such as Google mobility, e-way bills, and Goods and

Services Tax collections. The lagging services sector is rebounding from its trough, indicated by expansion in the Purchasing Managers' Index (PMI) for services since August. Manufacturing growth continues to hold up well – the Index of Industrial Production is growing sequentially and the PMI is in expansionary territory since June. The RBI's latest consumer confidence survey also showed improvement in sentiment.

The MPC expects the economic recovery to gather steam as the festive season approaches. A robust pace of vaccinations and controlled Covid-19 caseload should help release pent-up demand especially in urban areas for contact-based services. Normal monsoons and record high kharif production augur well for rural demand. Fiscal-monetary conditions are expected to remain supportive with pick-up in government capital expenditure and the RBI's intent to maintain easy financial conditions. Strong external demand is expected to keep exports healthy. However, headwinds from high commodity prices, global financial market volatility, and a possible third wave need to be monitored.

Considering the above-mentioned factors, the RBI retained the forecast for GDP growth at 9.5% for this fiscal – moving from 20.1% growth in the first quarter to an expected 7.9% in the second, 6.8% in the third and 6.1% in the fourth.

- **Easing headline inflation**: Since the last MPC meeting, CPI inflation has fallen back within the RBI's target of 2%-6%. It was on a downward trend from 6.3% on-year in June to 5.6% in July and 5.3% in August. This was driven by food inflation, which benefited from a high base, and a sequential decline in major items such as cereals and vegetables. The MPC expects food inflation to remain benign in the coming months, assuming (a) record-high kharif production keeps cereal prices soft; (b) vegetable prices are contained by record production and government intervention; and (c) supply-side measures help ease pressures on edible oils and pulses inflation. However, the MPC noted that non-food inflation remains elevated and excise duty cuts for petrol and diesel will lead to a more durable reduction in inflation and anchor inflation expectations.

  On the expectation of easing food inflation and a high base effect, the MPC cut the CPI inflation forecast from 5.7% to 5.3% for this fiscal (5.1% in the second quarter, 4.5% in the third and 5.8% in the fourth), with risks broadly balanced.

- **Financial conditions sufficiently conducive:** Since the last review meeting, the RBI has been taking small steps to reduce excess liquidity, by slowly increasing the absorption under VRRR operations. While open market purchases of G-secs continued under GSAP until September, simple purchases of G-secs were replaced by 'Operation Twist' last month, under which the RBI simultaneously buys long-term G-secs and sells an equivalent amount of short-term G-secs. Hence, Operation Twist does not result in an increase in liquidity.

  Even after these measures, systemic liquidity remains adequate. Benchmark money market rates such as the call money rate and 91-day Treasury bills (T-bills) remained below the repo rate until September. While 10-year G-sec yields have risen slightly of late, they remain lower than pre-pandemic rates. Equity markets remain buoyant, and robust foreign portfolio investor (FPI) inflows have supported the rupee.

  This, coupled with signs of continuing recovery in economic growth, has made the RBI take more steps towards unwinding unconventional easing measures. The RBI Governor stated that a significant liquidity overhang remains to the tune of ~Rs 13 lakh crore. Financial market conditions have been kept conducive as per market expectations and now they need to evolve in line with changing macroeconomic conditions to maintain financial stability.

  Hence, the RBI did not announce any fresh GSAP operations, after conducting them for purchasing Rs 2 lakh crore G-secs during April-September. The RBI maintained that it stands ready to intervene in the bond market with GSAP and other operations as and when needed. Liquidity absorption under 14-day VRRR gradually increased from Rs 2 lakh crore in July to Rs. 5.4 lakh crore by September-end. Today, the RBI announced that the absorption is set to increase further to Rs 6 lakh crore by December 3, 2021. It will also consider introducing 28-day VRRR going forward, depending on evolving liquidity conditions. However, the RBI maintains that liquidity absorption under this window remains voluntary.

Our view

Like other central banks, the RBI is slowly veering towards exit from unconventional policy measures, as risks from the pandemic recede, while inflation remains a significant challenge. Central banks have begun tightening their policies in many emerging markets and some small advanced economies (see table below). The RBI Governor remarked today that "diverging monetary policy stances are not being dictated by country groupings but by country circumstances". Indeed, as the table shows, inflation in India has on average remained within the RBI's target range, unlike in some other emerging markets.

However, this has largely been driven by food inflation, which is the most volatile component. Inflation continues to face pressure from the non-food part. In this fiscal so far (April-August 2021), while food inflation has been benign at 3.8% on average, non-food inflation has been uncomfortable at 6.6%. Commodity prices remain elevated, with Brent crude prices above the $80 per barrel mark, and prices of metals and edible oils remain at decadal highs. This, coupled with surging shipping costs, has resulted in wholesale price index-based inflation being in double digits for the past five months. We expect producers to pass-through rising costs of production as domestic demand recovers in the second half of this fiscal. The RBI's latest surveys on industrial outlook and services and infrastructure outlook confirm firms expect cost pressures and selling prices to rise in the third quarter.

Policy normalisation by other major central banks will further constrain the RBI's policy space. In particular, S&P Global expects the US Fed to begin tapering of its bond purchases by the end of calendar year 2021. The RBI is cognizant of potential global market volatility in the coming months and will move to maintain financial stability.

Taking these factors into account, we expect the MPC to gradually unwind its emergency easing measures in the coming months, and raise the repo rate to 4.25% by the end of this fiscal, if the third wave remains mild. This will still be lower than the 5.15% seen in February 2020, before the Covid-19 outbreak.

Central banks that have already begun tightening monetary policy – how India compares

Country	Monetary policy action 2021	CPI inflation (Apr-Aug 2021)	Inflation target
Brazil	425 bps rate hike	8.4%	3.75% (+/- 1.5%)
Russia	250 bps rate hike	6.2%	4%
Turkey	100 bps rate hike	17.9%	5% (+/- 2%)
Chile	100 bps rate hike	4.0%	3% (+/- 1%)
Mexico	50 bps rate hike	5.9%	3% (+/- 1%)
New Zealand	25 bps rate hike	3.3%	1%-3%
Korea	25 bps rate hike	2.5%	2%
Canada	Tapering of QE since April 2021	3.6%	1%-3%
Australia	Tapering of QE since September 2021	3.8%	2%-3%
India	No change	5.5%	4% (+/-1%)

Source: Central banks and statistical bureaus of respective economies, Trading Economics, CRISIL

Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Ltd.
dharmakirti.joshi@crisil.com

Pankhuri Tandon
Economist, CRISIL Ltd.
pankhuri.tandon@crisil.com

Media Contacts

Saman Khan
Media Relations
CRISIL Limited
D: +91 22 3342 3895
M: +91 95940 60612
B: +91 22 3342 3000
saman.khan@crisil.com

Hiral Jani Vasani
Media Relations
CRISIL Limited
D: +91 22 3342 5916
M: +91 982003 9681
B: +91 22 3342 3000
hiral.vasani@crisil.com

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