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Monetary policy | First cut

Steady as she goes

June 4, 2021

Status quo on rates, liquidity support extended

Caught between slowing growth and inflationary pressures, the Reserve Bank of India (RBI)'s Monetary Policy Committee (MPC) stayed put on policy rates in today's meeting. It also continued with its accommodative stance "as long as necessary" to support growth. Deploying an expanded set of tools to support financial conditions in the economy, including interventions in bond and foreign exchange markets, it continued with its targeted support approach to the most stressed segments. The current policy extends help to a greater number of vulnerable services.

Monetary policy space to support growth has become more limited, given the persisting risks to inflation from surging commodity prices. While consumer price index (CPI)-based inflation remains within the target range for now, the MPC will remain watchful of pass-through from rising input costs. While this will restrain the RBI from making major policy changes, it is likely to continue using targeted instruments to maintain conducive financial conditions.

Key takeaways from the June 4 meet

- The MPC unanimously voted to keep policy rates unchanged, with the repo rate at 4%, reverse repo at 3.35%, and marginal standing facility at 4.25%
- It also maintained its accommodative stance, also unanimously, *"as long as necessary to sustain growth on a durable basis and continue to mitigate the impact of Covid-19 on the economy, while ensuring inflation remains within the target going forward"*
- The need to continue monetary support was felt, given the economy faces another blow from the second Covid-19 wave
- The MPC cut the GDP growth forecast by 100 basis points (bps) to 9.5% in fiscal 2022
- It acknowledged the pressures on CPI inflation from rising commodity prices, and revised up its forecast to 5.1% for fiscal 2022 from 5% previously
- The RBI announced more bond purchases under the government securities acquisition program (GSAP), one tranche for the current quarter, and higher purchases for the second quarter of this fiscal
- On-tap window of liquidity for contact-based services was announced as an attempt to address rising dichotomies in the economy

What weighed on the RBI's decision

- **Second wave's impact on growth**: The MPC noted that the second pandemic wave has hit short-term growth outlook. This has been visible in slowdown in high frequency indicators in April-May 2021 such as mobility, purchasing manager's indices (PMIs), e-way bills generation, railway freight traffic, steel consumption, and tractor sales. In addition to urban demand, rural demand also faces downside risks from the spread of Covid-19, unlike last year. However, it is hoped that a normal monsoon will support rural demand, going forward. Segments of urban demand that are not contact-intensive are expected to gain from adoption of Covid-compatible occupation models. The pace of vaccination is also expected to increase in the coming months. Finally, strong global recovery is expected to augur well for export demand.

  Factoring in the hit from the second wave, the MPC revised down GDP growth forecast to 9.5% for fiscal 2022 from 10.5% estimated earlier. On a quarterly basis, it has projected 18.5% growth in the first quarter (Q1) of fiscal 2022, 7.9% in the second quarter (Q2), 7.2% in the third (Q3) and 6.6% in the fourth (Q4).

- **Inflation risks**: The MPC acknowledged the upside risks on CPI inflation from rising international commodity prices and logistics costs. It reiterated the need for central and state governments to reduce the impact of rising crude oil prices on consumers through reducing excise duties, cess and taxes on petrol and diesel. It further called for supply measures to ease the impact of edible oil prices, which have surged to a decadal high.

  However, it expected that the rise in overall CPI will be controlled with: (1) normal monsoons: expected to keep cereal prices in check, which accounts for the largest share in food CPI inflation; (2) recent supply side interventions in pulses - one of the commodities putting pressure on inflation; and (3) weak demand conditions: expected to hinder pass-through of rising input costs to retail prices.

  Overall, the MPC has revised up its CPI inflation by 10 basis points (bps) to 5.1%. The revisions have been done for Q2-Q4 of this fiscal. Projections now stand at 5.2% in Q1, 5.4% in Q2, 4.7% in Q3, and 5.3% in Q4.

- **Need for financial sector support to aid economic recovery**: The RBI is of the view that conducive financial conditions are critical to mitigate the impact of disruptions to economic activity. Besides maintaining repo rate at decadal lows and an accommodative stance, it is using targeted instruments to ease financial conditions across different market segments.

  For the bond market, it announced additional GSAP operations, under which the RBI commits in advance the open market purchase of G-secs. After two GSAP operations aggregating to Rs 60,000 crore in April-May, another tranche of Rs 40,000 crore was announced for June. A higher amount for a total of Rs 1.2 lakh crore has been announced for Q2.

  The RBI has also been intervening actively in foreign exchange markets to stabilise the rupee, at a time of unbalanced global recovery leading to higher volatility in foreign capital flows.

  Among other targeted measures, liquidity facilities were announced for contact-intensive sectors and Small Industries Development Bank of India (SIDBI), while coverage of borrowers was expanded under the micro, small and medium enterprises (MSME) resolution scheme.

Our view

The RBI has broadly managed to maintain conducive financial conditions, despite rising headwinds from the second wave, inflation, and faster recovery in advanced economies. Benchmark 10-year G-sec yields remain at decadal lows, money market rates below the repo rate, and bank lending rates lower than last fiscal. The rupee has also stabilised on account of RBI's forex interventions, and should receive comfort from the fact that foreign exchange reserves remain at a record high.

However, the worry remains on the rising risks to CPI inflation. International prices have surged for critical inputs imported by India: crude oil prices have crossed $70 per barrel, the highest since 2019, while edible oils, metals and minerals are at decadal high. Surge in transportation costs have further added to cost pressures. While producers are bearing a greater brunt of rising input costs for now, these could get passed on to consumers once demand recovers. In our recent report[1], we find that rising crude and edible oil prices are already getting passed on to consumer prices, while core inflation has started feeling some impact of rising metal prices through consumer durables. Moreover, food inflation – the prime mover of CPI – faces upside pressure from disruptions in rural economy due to the second wave, and rising global prices.

Within the limited policy space, we believe the MPC will keep policy rates unchanged and the stance accommodative in the foreseeable future, and use other innovative tools to support financial conditions. Fiscal policy now needs to take the wheel, as it better positioned to drive last mile interventions to help a number of flailing segments.

[1] CRISIL Quickonomics: *Why inflation is back to haunt*. May 26, 2021

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