

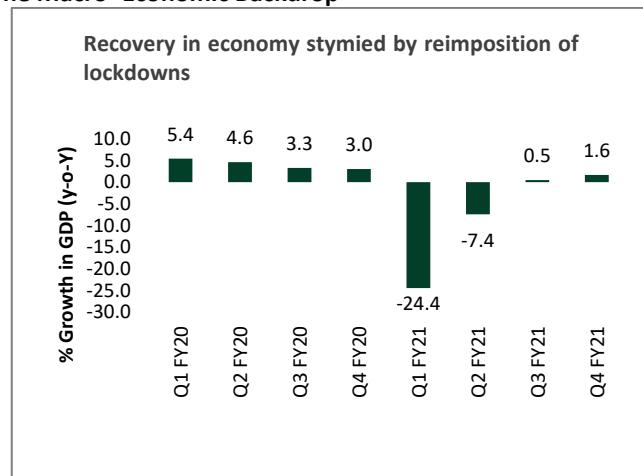
Expectations from RBIs Monetary Policy

August 4, 2021 | Economics

The RBI's Monetary Policy Committee (MPC) will present its third bi-monthly monetary policy for 2021-22 on 6 August'21. This policy comes in the backdrop of the prevailing second wave of the pandemic and the measured easing of region-wise restrictions that have been in place for over four months in most areas, posing a setback to the hoped-for revival of the country's economy. The MPC will also have to reckon with the buildup in inflationary pressures, rising bonds yields, low bank credit-offtake, and mixed signals on the economic front.

We expect the RBI to continue with the accommodative monetary policy stance and retain the policy rate (repo rate) at a record low of 4%. The central bank has kept its stance unchanged in the last six policy meetings i.e., from May'20. The RBI announcements and commentary would however be closely watched to see how it will continue to support economic growth, address concerns over inflation and control the rise in bond yields.

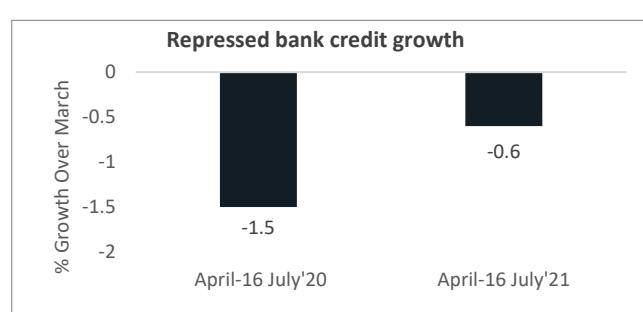
The Macro- Economic Backdrop



Source: MOSPI

The domestic economy's growth momentum of Q3 and Q4 FY21 has been hindered with the reimposition of lockdown/ restriction across regions since the start of FY22. This has effectively pushed forward the timelines for the country's economy attaining the pre-pandemic level of economic activity and output.

Although India's annual economic output/growth in FY22 at 8.8-9% will be high given the sharp contraction in FY21 (-7.3%), it is likely to only be marginally higher than the pre-pandemic period (~1-2% growth over FY20). Some early signals on GST collections, e-way bills, PMIs have shown improvement in July which points to some recovery signs.



Source: RBI

Bank credit offtake though better than a year ago, remains subdued and is reflective of the lack of demand for bank funds by businesses and households alike who are averse to add to their liabilities amid economic and business uncertainties. The wariness of banks to lend to certain segments on concerns over asset quality has also been an inhibiting factor to credit growth. Lower credit offtake has primarily contributed to the substantial liquidity surplus in the banking system since the last 2 years.

Growth in credit has been better for the retail and services segment while that to industry and agriculture continues to be lackluster. Credit disbursal by banks has to an extent been unresponsive to the liquidity infusion measures of the RBI.

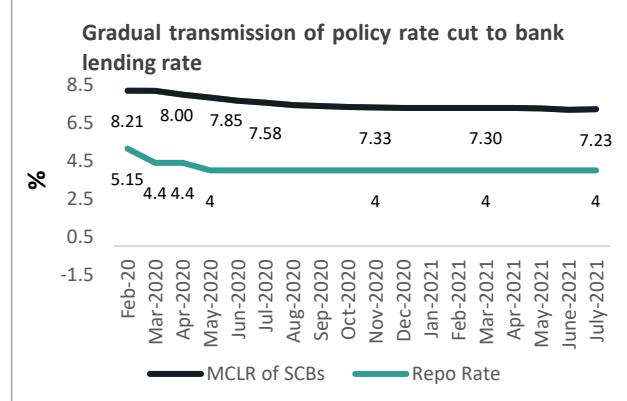
In terms of lending rates, there has been a gradual transmission of the policy rate cuts to bank lending rates. While the RBI has cut rates by 115 bps during Mar- May'20, the median MCLR (marginal cost of funds-based lending rate) of banks has been reduced by 97 bps over a span of 17 months.

Although, the MCLR has fallen to 5-year lows, the cost of bank funds is higher than that from other sources (debt capital markets, public issue, overseas borrowing etc). This has led to corporates with high credit quality to tap alternate sources of funds.

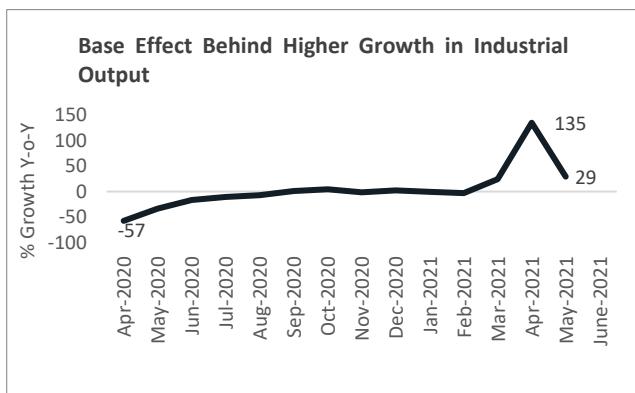
Sector-wise Bank Credit - % Growth Over March

| | Apr-18 Jun FY21 | Apr-18 Jun FY22 |
|-----------------------|-----------------|-----------------|
| Agriculture | -0.4 | -1.2 |
| Industry | -1.0 | -1.7 |
| Services | -2.6 | -1.1 |
| Personal Loans | -2.5 | -1.0 |

Source: RBI



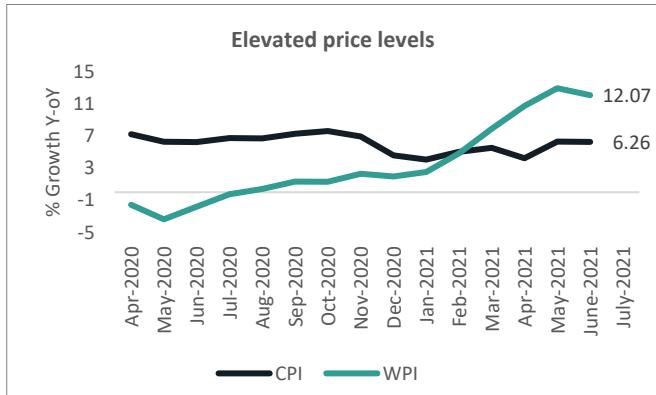
Source: RBI



Source: MOSPI

The high annual growth reading of industrial output since Mar'21 is credited to the sharp contraction in output in the corresponding months of last year. These numbers thus need to be viewed with caution.

The favorable base effect is to prevail for the first half of FY22. The restriction under the second wave of the pandemic has impacted industrial output during Apr-May'21.

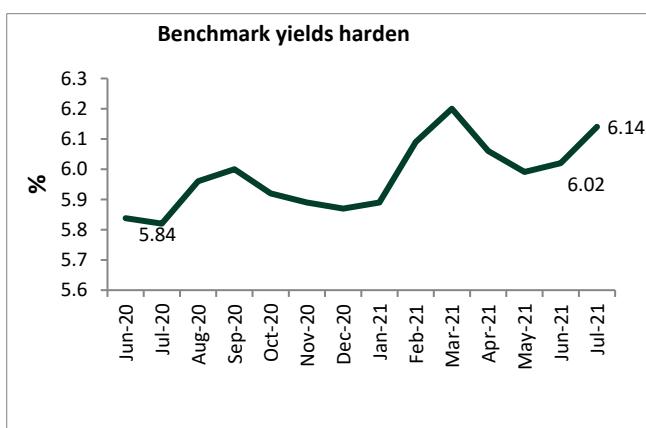


Source: MOSPI

There has been a build up in price pressures in recent months. Retail as well as wholesale inflation has been seen a sharp increase and core inflation has been ruling at elevated levels. Retail inflation has been ruling over the RBI's target (6%) for two months in a row (May-Jun).

The rise in global commodity prices, constrained supply, rising demand and high transportation costs have been bearing down on domestic inflation.

It needs to be seen if the price pressures ease in the coming months. Even if commodity prices soften, services inflation could see an uptick with the unlocking process.



Source: FIMMDA

The Indian benchmark sovereign bond yields have bucked the trend of the decline in yields seen across major economies in recent months.

Concerns over the inflation amid the large supply of government securities have been driving domestic yields. The RBI's bond purchases and the surplus liquidity in the banking system have to an extent curtailed the rise in yields.

The RBI has been working towards anchoring bond yields with the underlying aim of smoothly facilitating the large borrowing programme of the government and to keep the cost of funds low when the economy is moving towards higher levels of activity.

What has the RBI done so far?

The RBI in its response to the pandemic energy has used a host of policy tools and announced measures during scheduled and unscheduled monetary policy meets since March'20. These have included

- **Reduction in repo rates** to a record low of 4% through a rate cut of 75 bps in March'20 and 40 bps in May'20
- **Liquidity schemes** to make available funds to banks for lending. Targeted Long Term Repo Operations (TLTRO 1.0 and 2.0, Special TLTRO, on-tap TLTRO) have been announced to the tune of Rs. 2.75 lakh crore.
- **Cut the CRR** (cash reserve ratio) for banks by 100 bps to 3% with a phased normalization (to 3.5% from 27 March'21 and 4% from 22 May'21)
- Undertook higher quantum of **open market operations** (OMO) purchase and sale of central government securities to manage bond yields. In FY21, the RBI has undertaken OMO purchases of G-Secs to the tune of Rs 5.04 lakh crore and in the first five months of FY22 the purchases have totalled Rs. 1.9 lakh crore. A special government securities acquisition programme (GSAP) was introduced with a commitment to purchase sizeable government securities.
- OMOs were also introduced for **state development loans** (SDLs). Rs. 30,000 crore of SDLs were purchased in FY21 and Rs. 5,425 crore so far in FY22.
- **Increased the Ways and Means Advances** (WMA) limit for states to meet their liquidity shortfalls.
- Relaxation under the Marginal Standing Facility (MSF) to enable banks to avail funds under the MSF facility by dipping into the SLR up to additional 1% of the NDTL till 30 Sep'21.
- 6 months **moratorium** (April-August'20) in respect on all term loans of commercial banks, all India financial institutions and NBFCs outstanding as on 1 March 2020.
- **Increase in limit of SLR holding in HTM category** (to 22% of NDTL) till 31 March'21.
- Liquidity Coverage Ratio (LCR) requirement for Scheduled Commercial Banks reduced to 80% from 100%

- Interest on working capital facilities deferred for 6 months (April-August'20) without downgrade of asset classification.
- The RBI has permitted to increase bank's exposure to a group of connected counterparties from 25% to 30% till June 30, 2021.

Predominant Concerns for the RBI

- **Economic recovery:** The second wave of the pandemic has led to the tempering of economic growth expectations for FY22. With the first four months of FY22 being subject to pandemic lockdowns/ restriction, economic output has been impacted. With the pandemic not yet being contained and with emerging worries over new variants of the virus, there exists significant downside risk to the domestic economy's recovery. The RBI has revised downwards its growth outlook for FY22 to 9.5% in June from 10.5% in April. However, most recent leading indicators indicate that the worst may be over. Hence the view of the RBI here would be important.
- **Inflationary pressure:** The rise in global prices across commodities and the elevated levels of the non-food, non-fuel components of the domestic price index (core inflation) if sustained can pose a challenge to the RBI in maintaining an accommodative policy stance.
- **Rise in bond yields:** The recent surge in bond yields raises the cost of funds for the government and businesses alike. This would have adverse implications for the planned government borrowing program for the year and for business whose fund requirement would increase with the easing of the lockdown restrictions.

CARE Ratings Expectations

- Key policy rates i.e., repo and reverse repo rate to be retained at historical lows. The accommodative monetary policy stance would be maintained as the RBI stays focused on economic revival. With the domestic economic landscape being fraught with uncertainties, there is a strong case for continued policy support.
- No new liquidity measures expected. The existing measures can be extended in terms of duration and coverage of segments.
- The inflation outlook for FY22 could see a revision from the forecasted 5.1%. The RBI assessment and outlook on inflation would be keenly watched for signals on the continuation of its loose monetary policy stance.
- The GDP growth outlook for FY22 is unlikely to be revised (from 9.5%).
- There could be an increase in the quantum of OMO purchases under the GSAP programme for the remainder of the year (to more than Rs. 1 lakh crores in each of the remaining three quarters) aimed at cooling down bond yields.

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