Third Bi-monthly Monetary Policy Statement, 2021-22

August 06, 2021

Policy Actions

Keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 4.00 pecent.

Accordingly, the marginal standing facility (MSF) rate and the Bank Rate remains unchanged at 4.25 percent and the reverse repo rate under the LAF remains at 3.35 percent.

The MPC also decided to continue with the accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of coronavirus (COVID-19) on the economy, while ensuring that inflation remains within the target going forward.

These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 percent within a band of +/- 2 percent, while supporting growth.

Policy Assessment

Since the MPC's meeting in June, the pace of global recovery appears to be moderating with the resurgence of infections in several parts of the world, especially from the delta variant of the virus. The growing consensus is that the recovery is occurring on a diverging two-track mode. Countries that are ahead in vaccination and have been able to provide or maintain policy stimulus are rebounding strongly. Growth in other economies remains subdued and vulnerable to new waves of infections.

There has been a considerable hardening of commodity prices, particularly of crude oil. The latest agreement within the Organisation of Petroleum Countries (OPEC) plus to raise oil production for a likely restoration of output to the prepandemic levels by September 2022 imparted transient softening to spot and future crude prices from the recent peak in early July.

On the domestic front, economic activity picked up pace in June-July as some states eased pandemic containment measures. As regards agriculture, the southwest monsoon regained intensity in mid-July after a lull; the cumulative rainfall up to August 1, 2021 was one percent below the long-period average. The pace of sowing of kharif crops picked up in July along with some high frequency indicators of rural demand, notably tractor and fertiliser sales.

Headline CPI inflation plateaued at 6.3 percent in June after having risen by 207 basis points in May 2021. Food inflation increased in June primarily due to an uptick in inflation in edible oils, pulses, eggs, milk and prepared meals and a pick-up in vegetable prices. Fuel inflation moved into double digits during May-June 2021 as inflation in LPG, kerosene, and firewood and chips surged.

System liquidity remained ample, with average daily absorption under the LAF increasing from ₹5.7 lakh crore in June to ₹6.8 lakh crore in July and further to ₹8.5 lakh crore in August so far (up to August 4, 2021). India's foreign exchange reserves increased by US$ 43.1 billion in 2021-22 (up to end-July) to US$ 620.1 billion.

Outlook

Going forward, the revival of south-west monsoon and the pick-up in kharif sowing, buffered by adequate food stocks should help to control cereal price pressures. High frequency indicators suggest some softening of price pressures in edible oils and pulses in July in response to supply side interventions by the Government. With crude oil prices at elevated levels, a calibrated reduction of the indirect tax component of pump prices by the Centre and states can help to substantially lessen cost pressures. Taking into consideration all these factors, CPI inflation is now projected at 5.7 percent during 2021-22: 5.9 percent in Q2; 5.3 percent in Q3; and 5.8 percent in Q4 of 2021-22, with risks broadly balanced. CPI inflation for Q1:2022-23 is projected at 5.1 percent.

Domestic economic activity is starting to recover with the ebbing of the second wave. Looking ahead, agricultural production and rural demand are expected to remain resilient. Urban demand is likely to mend with a lag as manufacturing and non-contact intensive services resume on a stronger pace, and the release of pent up demand acquires a durable character with an accelerated pace of vaccination. Projection for real GDP growth is retained at 9.5 percent in 2021-22 consisting of 21.4 percent in Q1; 7.3 percent in Q2; 6.3 percent in Q3; and 6.1 percent in Q4 of 2021-22. Real GDP growth for Q1:2022-23 is projected at 17.2 percent

The MPC is conscious of its objective of anchoring inflation expectations. The outlook for aggregate demand is improving, but still weak and overcast by the pandemic. There is a large amount of slack in the economy, with output below its pre-pandemic level. The current assessment is that the inflationary pressures during Q1:2021-22 are largely driven by adverse supply shocks which are expected to be transitory. The nascent and hesitant recovery needs to be nurtured through fiscal, monetary and sectoral policy levers.

The MPC decided to keep the policy repo rate unchanged at 4 percent and continue with an accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID19 on the economy, while ensuring that inflation remains within the target going forward

All members of the MPC unanimously voted for keeping the policy repo rate unchanged at percent.

All members of the MPC except Prof. Jayanth R. Varma, voted to continue with the accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward. Prof. Jayanth R. Varma expressed reservations on this part of the resolution.

Statement on Development and Regulatory Policies

This Statement sets out various developmental and regulatory policy that directly address the stress in financial conditions caused by COVID-19.

1). **On-Tap TLTRO Scheme – Extension of Deadline Liquidity:** Given the nascent and fragile economic recovery, the RBI has decided to extend the On Tap TLTRO scheme further by a period of 3 months; till December 31, 2021.

2). **Marginal Standing Facility (MSF) - Extension of Relaxation:** The RBI has decided to continue with the MSF relaxation for a further period of three months; up to December 31, 2021.

Our Views & Conclusion:

MPC as expected kept the policy rate unchanged and continued with its accommodative stance as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy. Even as the RBI holds on to its view that the current inflationary pressures are driven by supply shocks which are likely to be transitory in nature, it has revised upwards the retail inflation outlook for FY22 from 5.1 percent to 5.7 percent. The RBI has retained its GDP growth forecast at 9.5 percent for FY 22. The RBI has also indicated that it would continue to ensure that there is ample surplus liquidity in the banking system to enable lending and thereby stimulate demand in the economy.

We believe that yield will be pressured given the inflationary worries. The upward revision in the inflation targets points towards the strengthening of inflationary pressures. RBI will try and complete the borrowing programme for FY 22 smoothly by using various tools like GSAPs, OMOs and Operation Twist. We will closely monitor the factors discussed above and we will remain invested in the medium term of the yield curve.

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