Second Bi-monthly Monetary Policy Statement, 2021-22

June 04, 2021

Policy Actions

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

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 in April, the global economic recovery has been gaining momentum, driven mainly by major advanced economies (AEs) and powered by massive vaccination programmes and stimulus packages. Activity remains uneven in major emerging market economies (EMEs), with downside risks from renewed waves of infections due to contagious mutants of the virus and the relatively slow progress in vaccination.

CPI inflation is firming up in most AEs, driven by release of pent-up demand, elevated input prices and unfavourable base effects. Inflation in major EMEs has been generally close to or above official targets in recent months, pushed up by the sustained rise in global food and commodity prices.

India's real gross domestic product (GDP) contracted by 7.3 percent in 2020-21. On June 1, the India Meteorological Department (IMD) has forecast a normal south-west monsoon, with rainfall at 101 percent of the long period average (LPA). This augurs well for agriculture.

Industrial production registered a broad-based improvement in March 2021. While mining and electricity output surpassed March 2019 (pre-pandemic) levels, manufacturing did not catch up. GST collections were at their highest during April 2021, there are indications of moderation in May as reflected in lower E-way bills generation.

Headline inflation registered a moderation to 4.3 percent in April from 5.5 percent in March, largely on favourable base effects. Food inflation fell to 2.7 percent in April from 5.2 percent in March, with prices of cereals, vegetables and sugar continuing to decline on a y-o-y basis. While fuel inflation surged, core (CPI excluding food and fuel) inflation moderated in April across most sub-groups barring housing and health, mainly due to base effects.

System liquidity remained in large surplus in April and May 2021, with average daily net absorption under the liquidity adjustment facility (LAF) amounting to ₹5.2 lakh crore. India's foreign exchange reserves increased by US$ 21.2 billion in 2021-22 (up to May 28) to US$ 598.2 billion.

Outlook

Going forward, the inflation trajectory is likely to be shaped by uncertainties impinging on the upside and the downside. The rising trajectory of international commodity prices, especially of crude, together with logistics costs, pose upside risks to the inflation outlook. A normal south-west monsoon along with comfortable buffer stocks should help to keep cereal price pressures in check. CPI inflation is projected at 5.1 percent during 2021-22: 5.2 percent in Q1; 5.4 percent in Q2; 4.7 percent in Q3; and 5.3 percent in Q4:2021- 22; with risks broadly balanced.

Turning to the growth outlook, rural demand remains strong and the expected normal monsoon bodes well for sustaining its buoyancy, going forward. The increased spread of COVID-19 infections in rural areas, however, poses downside risks. Urban demand has been dented by the second wave, but adoption of new COVID-compatible occupational models by businesses for an appropriate working environment may cushion the hit to economic activity, especially in manufacturing and services sectors that are not contact intensive. Real GDP growth is now projected at 9.5 percent in 2021-22, consisting of 18.5 percent in Q1; 7.9 percent in Q2; 7.2 percent in Q3; and 6.6 percent in Q4:2021-22.

The MPC notes that the second wave of COVID-19 has altered the near-term outlook, necessitating urgent policy interventions, active monitoring and further timely measures to prevent emergence of supply chain bottlenecks and build-up of retail margins. A hastened pace of the vaccination drive and quick ramping up of healthcare infrastructure across both urban and rural areas are critical to preserve lives and livelihoods and prevent a resurgence in new waves of infections.

The MPC decided to retain the prevailing repo rate at 4 percent and 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

All members of the MPC unanimously voted for keeping the policy repo rate unchanged at 4 percent. Further, all members of the MPC voted unanimously to continue with the accommodative stance as long as necessary to revive growth 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.

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 Liquidity Window for Contact-intensive sectors – On-TAP liquidity window of ₹ 15,000 crs at repo rate i.e 4 percent for a tenor of three years to contact intensive sectors in hospitality, aviation, tourism and other services. Banks will be incentivized by permitting to park surplus liquidity (size of loan book under this scheme) at 40 bps higher than reverse repo rate i.e 3.75 percent.

2). Special Liquidity Facility to SIDBI – ₹15,000 crs liquidity line was provided to SIDBI in the April policy to meet the funding requirements of micro, small and medium enterprises (MSMEs). In order to meet MSMEs' short and medium-term credit needs to kick start the investment cycle (with additional focus on smaller MSMEs and businesses, including those in credit deficient and aspirational districts), it has been decided to provide a further special liquidity facility of ₹16,000 crs to SIDBI.

3). Resolution Framework 2.0 to cover wider borrowers: The framework was expanded to cover larger set of borrowers, maximum aggregate exposure threshold enhanced to ₹ 50 crs from ₹ 25 crs for MSMEs, Non-MSME small businesses and business loan to individuals.

4). Regional Rural Banks permitted to issue Certificate of Deposits (CDs) to eligible investors. All issuers of CDs will be permitted to buy back their CDs before maturity (subject to conditions).

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. The RBI has revised up its inflation estimate for FY 22 from 5 percent to 5.1 percent. The RBI has revised down its GDP growth forecast to 9.5 percent from 10.5 percent earlier for FY 22. It expects rural demand to get support from a normal monsoon. However, increased spread of COVID-19 infections in rural areas poses downside risk.

We believe that yield will remain rangebound and the market will continue to get liquidity support from the RBI. The RBI has already announced GSAP 2.0 for Q2FY22 for ₹ 1.20 Lakh crs (GSAP 1.0 was for 1.0 Lakh crs). The RBI will continue to deploy its arsenal via OMOs and GSAPs this fiscal to manage yield curve and keep the Gsec yields close to 6 percent to ensure smooth large borrowing programme. We will closely monitor the factors discussed above and we will remain invested in the medium term of the yield curve.