Sixth Bi-monthly Monetary Policy Statement, 2021-22

February 10, 2022

Policy Actions

MPC in its 6th MPC decided to 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 December 2021, the rapid spread of the highly transmissible Omicron variant and the associated restrictions have dampened global economic activity. The global composite purchasing managers' index (PMI) slipped to an 18-month low of 51.4 in January 2022, with weakness in both services and manufacturing. World merchandise trade continues to grow. There are, however, headwinds emanating from persistent container and labour shortages, and elevated freight rates. In its January 2022 update of the World Economic Outlook, the International Monetary Fund (IMF) revised global output and trade growth projections for 2022 downward to 4.4 percent and 6.0 percent from its earlier forecasts of 4.9 percent and 6.7 percent, respectively. After reversing the transient correction that had occurred towards end November, commodity prices resumed hardening and accentuated inflationary pressures. With several central banks focused on policy normalization, including ending asset purchases and earlier than expected hikes in policy rates, financial markets have turned volatile. Sovereign bond yields firmed up across maturities and equity markets entered correction territory. Currency markets in emerging market economies (EMEs) have exhibited two-way movements in recent weeks, driven by strong capital outflows from equities with elevated uncertainty on the pace and quantum of US rate hikes. The latter also led to an increasing and volatile movement in US bond yields. The first advance estimates (FAE) of national income released by the National Statistical Office (NSO) on January 7, 2022 placed India's real gross domestic product (GDP) growth at 9.2 percent for 2021-22, surpassing its pre-pandemic (2019-20) level. The manufacturing PMI stayed in expansion zone in January at 54.0, though it moderated from 55.5 in the preceding month. Among services sector indicators, railway freight traffic, e-way bills, and toll collections posted y-o-y growth in December- Headline CPI inflation edged up to 5.6 percent y-o-y in December from 4.9 percent in November due to large adverse base effects. Core inflation or CPI inflation excluding food and fuel stayed elevated, Overall system liquidity continued to be in large surplus, although average absorption (through both the fixed and variable rate reverse repos) under the LAF declined from ₹8.6 lakh crore during October-November 2021 to ₹7.6 lakh crore in January 2022. Reserve money (adjusted for the first-round impact of the change in the cash reserve ratio) expanded by 8.4 per cent (y-o-y) on February 4, 2022. Money 3 supply (M3) and bank credit by commercial banks rose (y-o-y) by 8.4 percent and 8.2 percent, respectively, as on January 28, 2022. India's foreign exchange reserves increased by US$ 55 billion in 2021-22 (up to February 4, 2022) to US$ 632 billion.

Outlook

The inflation trajectory, going forward, will be conditioned by a number of factors. The flare-up in vegetables prices due to heavy rains in October and November is likely to reverse with the winter arrivals. Rabi sowing is progressing well and is set to exceed last year's acreage. Recent pro-active supply side interventions by the Government continue to restrain the pass-through of elevated international edible oil prices to domestic retail inflation. Crude prices have seen a significant correction in recent period. Cost-push pressures from high industrial raw material prices, transportation costs, and global logistics and supply chain bottlenecks continue to impinge on core inflation. The slack in the economy is muting the passthrough of rising input costs to output prices. Taking into consideration all these factors, CPI inflation is projected at 5.3 percent for 2021-22; 5.1 percent in Q3; 5.7 percent in Q4:2021-22, with risks broadly balanced. CPI inflation for Q1:2022-23 is projected at 5.0 percent and for Q2 at 5.0 percent.

The recovery in domestic economic activity is turning increasingly broad based, with the expanding vaccination coverage, slump in fresh COVID-19 cases and rapid normalization of mobility. Rural demand is expected to remain resilient. The spurt in contact-intensive activities and pent-up demand will continue to bolster urban demand. The government's infrastructure push, the widening of the performance linked incentive scheme, structural reforms, recovering capacity utilization and benign liquidity and financial conditions provide conducive conditions for private investment demand. The Reserve Bank's surveys point to improving business outlook and consumer confidence. On the other hand, volatile commodity prices, persisting global supply disruptions, new mutations of the virus and financial market volatility pose downside risks to the outlook. Taking all these factors into consideration and assuming no resurgence in COVID-19 infections in India, the projection for real GDP growth is retained at 9.5 percent in 2021-22 consisting of 6.6 percent in Q3; and 6.0 percent in Q4:2021-22. Real GDP growth is projected at 17.2 percent for Q1:2022- 23 and at 7.8 percent for Q2.

The impact of the recent spike in vegetables prices on food inflation prints is expected to dissipate as the usual softening of prices in the winter sets in. The partial roll back of Central excise and State Value Added Taxes (VAT) on petrol and diesel in November have eased retail selling prices and will have second round effects over a period of time.

Crude oil has seen some correction but remains volatile. Core inflation will need to be closely monitored and held in check. For a sustained lowering of core inflation, continuing the normalisation of excise duties and VATs alongside measures to address other input cost pressures assume critical importance, more so as demand improves.

All members of the MPC – Dr. Shashanka Bhide, Dr. Ashima Goyal, Prof. Jayanth R. Varma, Dr. Mridul K. Saggar, Dr. Michael Debabrata Patra and Shri Shaktikanta Das – unanimously voted to keep the policy repo rate unchanged at 4.0 percent.

All members, namely, Dr. Shashanka Bhide, Dr. Ashima Goyal, Dr. Mridul K. Saggar, Dr. Michael Debabrata Patra and Shri Shaktikanta Das, 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

1. Voluntary Retention Route (VRR) – Enhancement of Limits

A dedicated investment limit of ₹1,50,000 crore was set for investments under the VRR. Given the positive response to the VRR as evident from the near exhaustion of the current limit, it is proposed to increase the investment limit under VRR by ₹1,00,000 crore to ₹2,50,000 crore with effect from April 1, 2022. The revised investment limits are being notified today.

2. Review of Credit Default Swaps (CDS) Guidelines

Guidelines for Credit Default Swaps (CDS) were last issued in January 2013. Given the importance of the CDS market for the development of a liquid market for corporate bonds, especially for the bonds of lower rated issuers, it was announced in the Statement on Developmental and Regulatory Policies of December 4, 2020 that these guidelines would be reviewed. Accordingly, draft guidelines were issued on 3 February 16, 2021 for public consultation. Taking into account the feedback received, the final Directions are being issued today.

3. Extension of Term Liquidity Facility of ₹50,000 crore to Emergency Health Services:

In view of the response to the scheme, it is proposed to extend this window up to June 30, 2022 from March 31, 2022 as announced earlier.

4. Extension of On-tap Liquidity Window for Contact-intensive Sectors:

Banks have deployed their own funds to the tune of ₹5,041 crore (up to February 4, 2022) to the entities under contact intensive sector. In view of the response to the scheme, it is now proposed to extend this window up to June 30, 2022.

5. Permitting Banks to Deal in offshore Foreign Currency Settled Rupee Derivatives Market

With a view to providing a further fillip to the interest rate derivative market in the country, removing the segmentation between onshore and offshore markets and improving the efficiency of price discovery, it has been decided to allow banks in India to undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) market with non-residents and other market makers. Banks may participate through their branches in India, their foreign branches or through their IFSC Banking Units. Necessary directions are being issued today.

Our Views & Conclusion:

The Policy decision remains highly dovish as against market expectation of a tilt towards normalization. The RBI is seen to be cautious on growth given its projection of 7.8 percent for the next year. On inflation side, its projection of CPI is seen to be softer than expected, given the elevated levels of commodity prices. We expect the yield curve to remain steeper with the shorter end expected to rally more than the longer end. Owing to this, we shall remain invested in the medium-term duration of the yield curve.