Monetary Policy Review – Gradual withdrawal of accommodative stance continues; G-SAP 1.0 need to go upto at least 5.0

RBI kept its key policy rates unchanged through a unanimous vote of the Monetary Policy Committee (MPC). Thus Repo, Reverse Repo rate & MSF rate stands at 4.00%, 3.35% and 4.25%. The MPC also decided to continue with the accommodative stance 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 that inflation remains within the target going forward. The projection of real GDP growth for 2021-22 is retained at 10.5 per cent consisting of 26.2 per cent in Q1, 8.3 per cent in Q2, 5.4 per cent in Q3 and 6.2 per cent in Q4. CPI inflation is now projected as 5.0 per cent in Q4:2020-21; 5.2 per cent in Q1:2021-22, 5.2 per cent in Q2, 4.4 per cent in Q3 and 5.1 per cent in Q4, with risks broadly balanced.

- **Variable rate reverse repo (VRRR) auctions of longer maturity:** As indicated in the Revised Liquidity Management Framework announced on February 06, 2020 longer tenure VRRR auctions to be conducted the amount and tenor of which will be decided based on the evolving liquidity and financial conditions.
- **G-SAP 1.0**: RBI has put in place as a secondary market G-sec acquisition programme (G-SAP) whereby RBI will commit upfront to a specific amount of open market purchases of government securities with a view to enabling a stable and orderly evolution of the yield curve amidst comfortable liquidity conditions. For Q1 of 2021-22, therefore, it has been decided to announce a G-SAP of ₹1 lakh crore. The first purchase of government securities for an aggregate amount of ₹25,000 crore under G-SAP 1.0 will be conducted on April 15, 2021.
- **TLTRO on Tap Scheme – Extension of the deadline**: The TLTRO on Tap Scheme announced on October 9, 2020 which was made available up to March 31, 2021, is now being further extended by a period of six months i.e., upto September 30, 2021.
- **Liquidity Facility for All India Financial Institutions**: Special refinance facilities of ₹75,000 crore were provided to All India Financial Institutions (AIFIs) like NABARD, SIDBI, NHB and EXIM bank during April-August 2020. Additionally, , liquidity support of ₹50,000 crore for fresh lending during 2021-22 will be provided to AIFIs: ₹25,000 crore toNABARD; ₹10,000 crore to NHB; and ₹15,000 crore to SIDBI.
- **Enhancement of Limit of Maximum Balance for Payments Banks**: the current limit on maximum end of day balance of ₹1 lakh per individual customer is being increased to ₹2 lakh with immediate effect.
- **Permitting Banks to On-lend through NBFCs**: Bank lending to registered NBFCs (other than MFIs) for on-lending to Agriculture, MSME and Housing was permitted to be classified as Priority Sector lending (PSL). This dispensation which was available from August 13, 2019 till March 31, 2021 is being further extended for another six months up to September 30, 2021.
- **Priority Sector Lending (PSL) - Enhancement of Loan Limit against eNWR/NWR:** To encourage farm credit to individual farmers against pledge/hypothecation of agricultural produce, RBI decided to enhance the loan limit under priority sector lending (PSL) from ₹50 lakh to ₹75 lakh per borrower against the pledge/hypothecation of agricultural produce backed by Negotiable Warehouse 9 Receipts (NWRs)/electronic-NWRs (e-NWRs) issued by warehouses registered with the Warehousing Development and Regulatory Authority (WDRA).
- **WMA limit for States/UTs**: RBI decided to enhance the aggregate WMA limit of states and UTs to ₹47,010 crore, an increase of about 46 per cent from the current limit of ₹32,225 crore which was fixed in February 2016. Further, it has also been decided to continue the enhanced interim WMA limit of ₹51,560 crore granted by RBI due to the pandemic for a further period of six months i.e., up to September 30, 2021.

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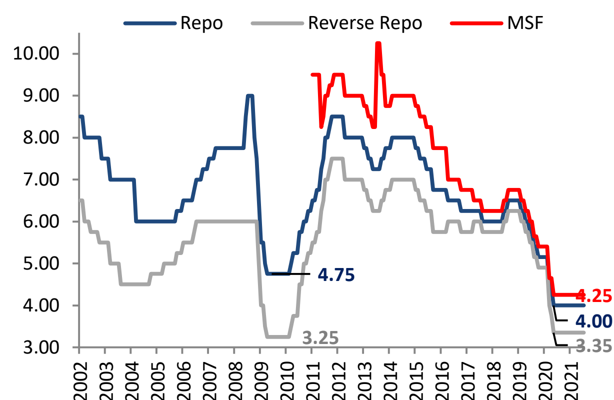
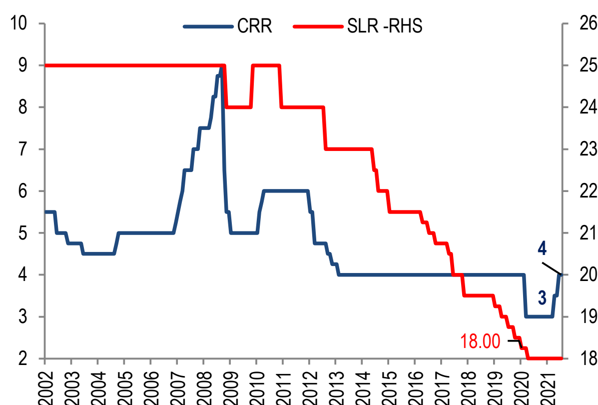
RBI kept rates unchanged since May-20

Exhibit 1: RBI keeps policy rates unchanged for the time being in accordance with accommodative stance



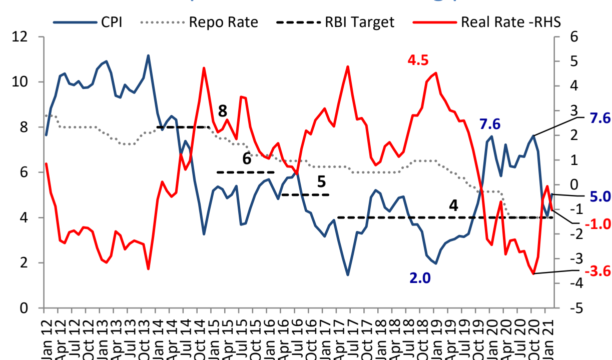
Source: RBI, ASKWA Research

Exhibit 2: CRR being restored back to 4% level in two phases



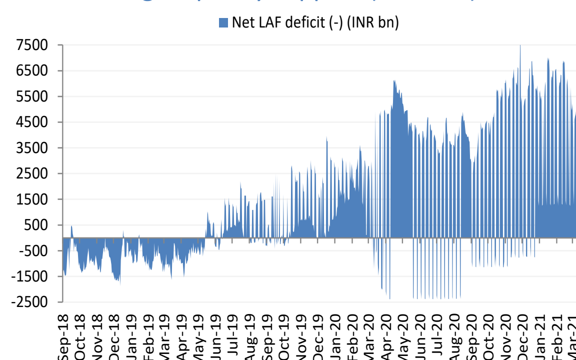
Real policy rate closer to positive; liquidity support continues but have seen early signs of normalisation

Exhibit 3: Real Repo rate closer to being positive



Source: CMIE, RBI, ASKWA Research

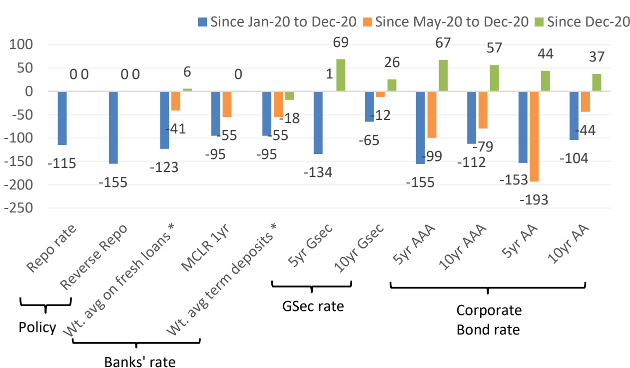
Exhibit 4: Huge liquidity support (INR7tn+) continues



Source: CMIE, RBI, ASKWA Research

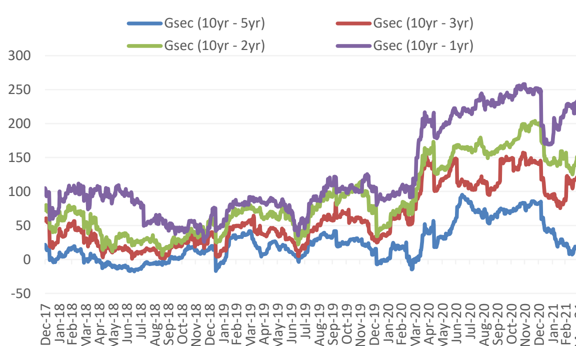
Market rates have started rising, term spreads show volatility

Exhibit 5: Transmission and reversal; even when RBI left policy rate unchanged



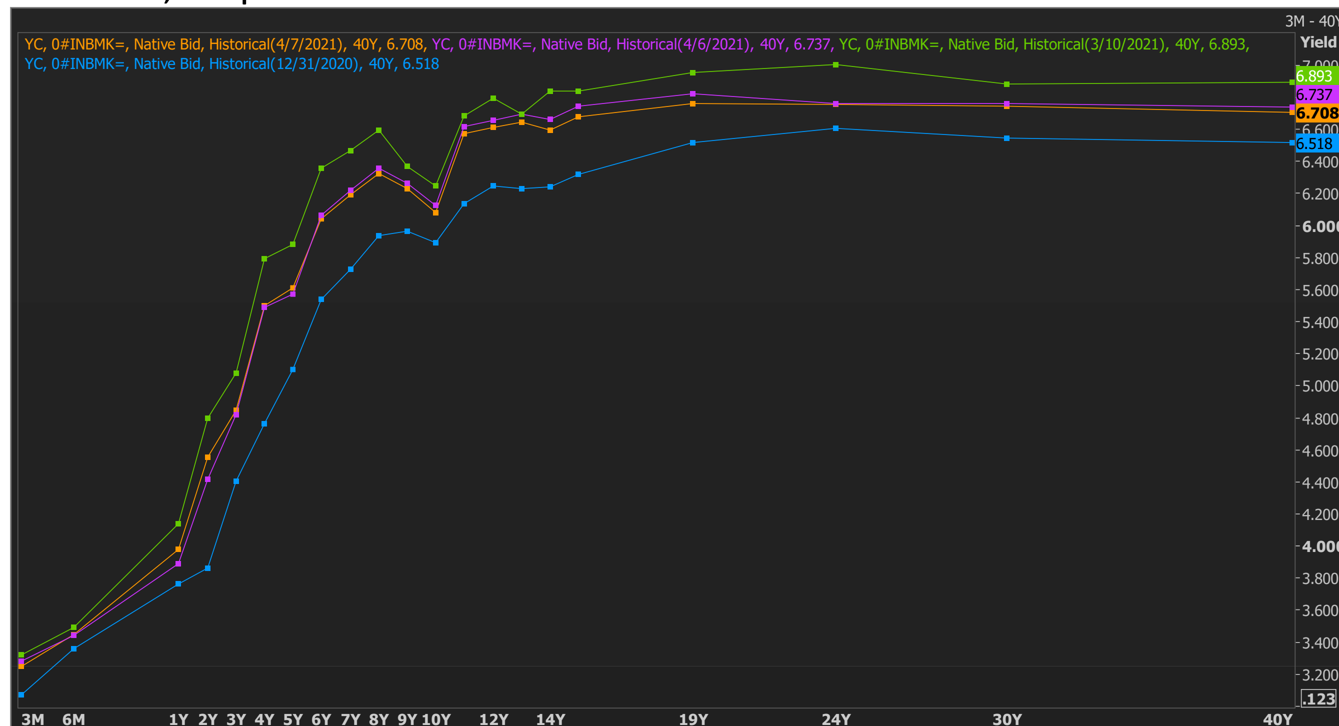
Source: CMIE, RBI, ASKWA Research

Exhibit 6: The term spread has seen volatility in recent times



Source: CMIE, RBI, ASKWA Research

Exhibit 7: Yield curve softened from March 10, 2021 level but shifted up as well as steepened from the December 31, 2020 position



Source: Refinitiv, ASKWA Research.

Implication and outlook:

On rates and stance

In the last RBI policy on Feb-21 we had alerted the reader to take note of the alteration of stance as an indication towards "normalizing" extraordinary monetary policy that was provided as part of Covid-19 response. We maintain that the current policy has taken that "normalization" process forward, albeit in a more graduated way. The key pointer to this is the change in the accommodative stance from a "time based guidance" to a "state based guidance" as exemplified by the following articulations.

- **Feb-21 Stance**: The MPC also decided to continue with the accommodative stance as long as necessary – **at least during the current financial year and into the next financial year** – to revive growth on a durable basis and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward. (Formatting in Bold added)
- Apr-21 Stance: The MPC also decided to continue with the accommodative stance 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 that inflation remains within the target going forward. (Formatting in Bold added)

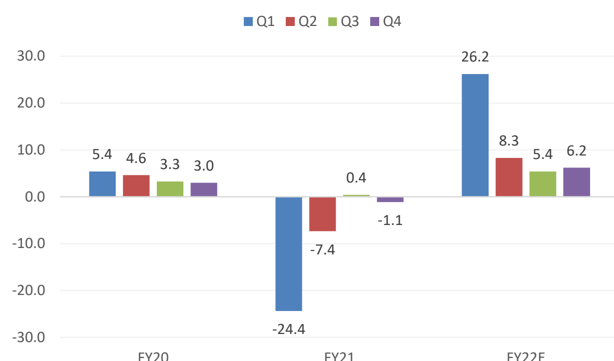
Once again this is a very substantial change within the broadly accommodative stance. At the outset, the time commitment is explicit and helps build policy rate anchor with more certainty while the latter is a conditional, open-ended and subject to interpretation forward guidance that leaves substantial scope for surprises for the market. In a way it expands the menu of options that RBI can exercise within next six months to one year and indeed its time to build a revised expectation for future policy rate action well within FY22, even if growth and inflation balance pans out exactly as predicted by RBI.

On growth and inflation projection

RBI's GDP growth projection points to the moderate pace of recovery it expects at 10.5% for FY22 (from -8% during FY21). The fact that RBI expects the terminal GDP growth rate (Q4 FY22) at 6.2% despite modest base advantage, points toward rather moderate recovery expectation it has anchored itself to. On the inflation too its evaluation is fairly balanced with easing food inflation on the domestic front being counterbalanced by pressures from imported inflation on account of commodity reflation trade globally. The combined impact of the two is expected to keep inflation around 5% in FY22 implying a 120 bps easing from FY21 level.

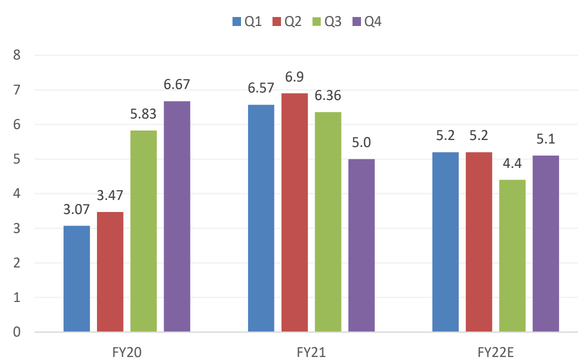
RBI expects gradual recovery with inflation anchored within tolerable limits

Exhibit 8: RBI builds in moderate GDP projection



Source: RBI, ASKWA Research

Exhibit 9: Inflation projection is moderate too



Source: RBI, ASKWA Research

On liquidity: Open mouth notwithstanding …

RBI sought to clarify its VRRR measure as "*part of RBI's liquidity management operations and should not be read as liquidity tightening. In fact, by paying a higher rate of interest on liquidity absorptions through the VRRR auctions, the RBI is indirectly expanding liquidity*" (Italics added). Notwithstanding, RBI's explanation, the measure is likely to be viewed as a liquidity tightening measure as it withdraws the supply of liquidity from the overnight market in a more durable basis leaving the demand unchanged thereby enhancing the demand supply gap at the shortest maturity bracket. If the response to VRRR auctions is poor in view of the opportunities of rising near-term rates even within high quality space, the measure is likely to be ineffective too. The net impact is likely to provide an upside thrust to the short-term rate, thus flattening the yield curve somewhat as an unintended consequence.

The second liquidity measure (of more permanent nature) concerned G-SAP 1.0 - a de facto OMO (without a specified calendar), the first tranche of which of INR1 tn has been announced (with auction of INR 250 bn by mid Apr-21). However, we must note that the measure is neither unexpected nor sufficient. During FY21 itself, OMO exceeding INR3 tn and Operation Twist exceeding INR2 tn was required to sail through the heavy borrowing programme. This was in a year when the economy faced severe downturn resulting in low credit demand. During FY22, if credit demand picks up even by a modest amount; a higher liquidity support would be required particularly in view of the fact that the net Government borrowing would stay high for the second consecutive year. Second, if the net foreign accretion is less due to current account reverting to deficit or the need for forex intervention stemming from episodic volatility in INR, much higher OMO would be required. Management of the yield curve both with respect to its position as well as shape would therefore continue to remain a challenge. Therefore, G-SAP 1.0 in our view needs to go upto at least 5.0.

Strategy for Fixed Income investment

As RBI focusses on smother transition to an eventual rate and liquidity normalization cycle, it sets itself for a more arduous course of yield management. We retain our 10 year forward guidance to 5.75 to 6.75% (changed from 5 to 6.5% post Union Budget). We also maintain that possibilities of faster than expected hardening of market yields and earlier than expected exit of ultra-loose policy exist.

As in the last policy we maintain that – Carry is King! Term structure remains steep, and value remains at the medium range of the curve. While the extreme long-end (10 year+) could have some enhanced volatility, the risk-reward is best for the 5-6 year average maturity profile. Extreme low duration remains devoid of carry and hence wouldn't be optimum for long term allocations. While emphasis on higher grade (AAA + sovereign) stays, selective credit opportunities need to be explored for yield enhancement. Opportunities that provide protection against rising yields such as Inflation Indexed Bond (IIBs) or Floating Rate Bonds (FRBs) should be explored too. Hence the fixed income product strategy should be anchored toward the following opportunities.

1. **5-6 year remain the sweetest part of the yield curve. Offers the best carry, is likely to suffer the least dislocation in yields (and hence MTM impact).**
2. **Floating Rate Funds, especially those with a large active component in OIS participation, to take advantage of rising short term yields.**
3. **Tactical sub-AAA credits, as always, with tactical being the key-word.**

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