# RBI MPC leaves policy rates unchanged at 4%, stance accommodative for 3rd consecutive time

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By Sameer Narang

Reserve Bank of India (RBI) held its policy rate at 4%. That has been the case now in three consecutive policies. High inflation constrains the central bank from reducing policy rate any further, unlike other Emerging Markets. However, RBI had effectively used forward guidance to manage expectations in the October 2020 policy. In this policy as well, RBI reiterated that accommodative stance will continue in the current and into the next financial year.

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The surplus liquidity is a result of large foreign (FDI and FPI) inflows (US$ 49bn in FYTD21), excess deposit inflows with banks (credit-deposit ratio of 72.6 as of November 2020 compared with 76.4 as of March 2020) and RBI's liquidity operations (OMOs, operation twist and TLTROs). This has resulted in a sharp drop in bond yields for the government and corporate sector.

Government's successful credit guarantee (ECLGS) scheme for MSMEs has been expanded to 26 stressed sectors along with on-tap TLTROs so that banks can lend to these sectors. This bodes well for the revival of the stressed sectors.

RBI's forward guidance on liquidity has also given comfort to markets that RBI will continue to support growth. Since the last policy, the spread of 3Y AAA corporate bonds over comparable G-Sec has fallen from 60bps to 17bps. A similar reduction is seen across tenor and ratings. Corporate bond issuances this year have been higher than last year. The ample availability of liquidity and upturn in the economy has improved debt service capacity of corporate India.

The ample liquidity along with unlocking of the economy and pent-up demand has helped corporate India report better-than-expected results in Q2. High-frequency indicators for November 2020 show that growth momentum continues although there has been some moderation. This has given confidence to RBI to revise its growth estimate for FY21 upward to (-) 7.5% from (-) 9.5% earlier.

However, retail inflation in India continues to inch up despite normalisation of supply side. India is an exception to decline seen in inflation in EMs and advanced economies. In fact, CPI inflation has consistently been above RBI's projections and target. RBI has now revised its inflation projection for Q3 and Q4 of FY21 by 1.4% and 1.3%, respectively. This is broadly in-line with market assessment.

While demand side core inflation is lower at 3.5%, supply side factors have driven India's retail inflation to 7.6%. Food inflation is in double digits led by perishables and certain protein based items such as pulses and egg, meat and fish. While vegetable prices may ease, others are not likely to fall soon. Edible oil prices are also elevated. Global liquidity conditions are also a factor. Despite the contraction in economic growth, a resilient manufacturing demand has led to increase in metal, food and precious metal prices. These feed into domestic inflation. Higher excise duties on petroleum products also have an impact on domestic inflation. Global backdrop suggests liquidity and fiscal policies will be growth oriented thus implying possibility of further increase in global commodity prices in 2021.

This will restrict RBI to reduce policy rate any further. However, what the central bank can't do by reducing policy rates, it has achieved by way of ensuring ample liquidity and forward guidance. Interest rates in India remain low by historical standards despite a large increase in Centre and State borrowings. While the Centre is likely to borrow Rs 13.1tn this financial year (Rs 7.2tn in FY20), states are also likely to borrow Rs 8tn (Rs 5.7tn in FY20). The credit for ensuring orderly conditions and anchoring market expectations goes to RBI.

As the world comes out of the pandemic in the next year, RBI will have to anchor market expectations on liquidity surplus. This may coincide with lower borrowing by government, thus giving room to RBI. It will still have to grapple with high FX inflows into India and stress left by the pandemic on the banking system. RBI has done an excellent job of handling the impact of the pandemic on the financial system. However, its role in guiding markets and liquidity will be even more important next year.

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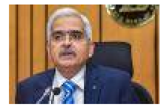

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