Central Bank Watch: Dovish despite stubborn inflation

Unchanged policy rate: *The RBI kept its policy rate unchanged at 4%, as expected, and continued to keep its policy stance accommodative. The MPC reiterated that the stance is likely to remain accommodative as long as necessary – atleast through this year and next year.*

Liquidity surplus continues: *Some section of the market had anticipated the central bank to act on the rising surplus liquidity in the system in light of the increasing inflationary pressures. However, the absence of any major liquidity absorption measures in the midst of a prolonged inflationary episode and indeed the upward revision of both the RBI's growth and inflation forecasts might be somewhat puzzling. However, it could mean that the RBI is a) still cautious about the durability of growth given the myriad uncertainties related to growth, b) it sees inflation as principally a supply side-problem amenable to supply rather than monetary intervention, c) it is willing to tolerate higher inflation as long as growth impulses become firmly entrenched and 4) it perhaps expects some natural moderation in liquidity surplus as the government usually goes into collection mode in the last quarter of the fiscal.*

<u>*In fact, given its emphasis on growth revival and the suggestion that there is still some more space left for monetary support, another 25-50 basis point cut in 1H CY2021 cannot be ruled out.*</u>

Inflation and Growth estimates: *The RBI revised up its inflation forecast for Q3 to 6.8% and 5.8% for Q4 from its earlier estimate of 4.5-5.4% for H2 FY21. While the RBI sounded caution in terms of the inflation trajectory, it was much more sanguine on the growth outlook, revising the GDP growth estimate from -9.5% to -7.5% for FY21. While our inflation and GDP forecasts for FY21 are broadly in line with the RBI's estimates for FY21, we do see some risks that need to highlighted – 1) Upside risk to inflation forecasts for Q4 FY21 and especially for Q1 FY22 as inflationary pressures are becoming more broad based (not restricted to the food category) and 2) the durability of the recent pick-up remains uncertain at this stage (lead indicators for October and November are beginning to show some softness).*

Bond View: *10-Y bond yield fell by 3 bps to 5.907% (at the time of writing) as compared to yesterday's closing level of 5.932% as the RBI continued to remain dovish.* <u>*We expect the 10-year yield to trade in the range of 5.85-5.95% in the near-term as the RBI intervenes to keep borrowing costs low.*</u>

FX View: *A deviation from the last policy, the governor explicitly mentioned that "the RBI has taken measures for dampening volatility" (in INR due to surge is capital flows) "and is enabling orderly evolution of the exchange rate in* <u>*consonance with underlying domestic fundamentals*</u>*". Furthermore, the RBI said that it is "mindful of the consequences of its FX intervention action on domestic liquidity and inflation" and is sterilising the same through the reverse repo.* <u>*Given this rhetoric, we continue to expect the central bank to intervene in the FX market, moderating the appreciation pressures on the INR and keeping it more fairly valued in the months ahead.*</u> <u>*We expect the USD/INR pair to trade at 73.0-74.0 through this fiscal year.*</u> *The USD/INR was trading at 73.78 at the time of writing compared to yesterdays' close of 73.86.*

Regulatory Changes: *In terms of the other policy announcements, the most notable were a) the extension of the On tap TLTRO to other sectors in synergy with the ECLGS 2.0 scheme, and b) To help banks conserve capital and boost lending, Commercial and cooperative banks will not make any dividend pay-out from profits pertaining to FY20.*

The Specifics:

Inflation Outlook: In today's policy the RBI highlighted that widening gap between wholesale and retail inflation points to the supply-side disruptions and presence of pricing power in the system. The Monetary Policy Committee (MPC) reckons that inflation is likely to remain elevated, barring transient relief in the winter months from prices of perishables. In addition, COVID cost-push pressures could continue to weigh on core inflation as demand picks up with normalization in economic activity.

The RBI expects CPI inflation to average 6.8% in Q3 and ease to 5.8% in Q4 FY21 compared to its earlier forecast of 4.5-5.4% for H2 FY21. For H1 FY22, inflation is expected at 4.6% - 5.2%, revised up from 4.3% estimated earlier, with risks broadly balanced.

- We expect headline inflation to remain elevated in the near term (remaining higher than ~6% in Dec-20). Persistence in protein inflation likely to keep a floor on food inflation even as other components of food inflation ease. Core inflation (CPI excluding food and fuel) is also expected to remain sticky.

Inflation forecast

%YoY	Q3	Q4	FY21
RBI	6.8	5.8	6.5
HDFC Bank	6.9	5.8	6.5

Growth Outlook: On the growth front, the RBI expects the recovery in rural demand to strengthen further, while recovery in urban demand is likely to gain momentum as unlocking spurs economic activity. The RBI expects the recovery to return to positive growth in H2 FY21. Looking at the internals, the central bank noted that demand for contact-intensive services is likely to remain subdued in the near-term due to social distancing norms and risk aversion. **The RBI expects growth to contract by 7.5% in FY21 (revised upwards from -9.5% earlier) and expand 6.5% - 21.9% in H1 FY22, with risks broadly balanced**.

We expect GDP growth to turn marginally positive to 0.5% in Q3. For FY21, we expect growth to contract by 7.5%. In the months ahead, it would be crucial to look at the durability of the current pickup in activity as the second wave of the infection impacts certain parts of the country. Moreover, global growth continues to remain on a fragile footing and commodity prices have firmed up (compared to Q2). Bottom-line is that in terms of the recovery we are still not out of the woods yet.

Growth forecast

%YoY	Q3	Q4	FY21
RBI	0.1	0.7	-7.5

Key Regulatory Announcements:

Liquidity Measures:

- **On Tap TLTRO:** To bring the 26 stressed sectors identified by the Kamath committee within the ambit of sectors eligible under on tap TLTRO.
    - *Banks can avail funds from RBI under TLTRO and seek guarantee under ECLGS 2.0 to provide credit support to stressed sectors.*

- *Liquidity availed by banks under the scheme has to be deployed in corporate bonds, commercial papers, and non-convertible debentures.*
- *Investments made by banks under this facility will be classified as held to maturity (HTM) even in excess of 25 percent of total investment permitted to be included in the HTM portfolio.*
- *All exposures under this facility will be exempted from reckoning under the large exposure framework (LEF).*

- **Extending the Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF) to Regional Rural Banks (RRBs) and permitting the RRBs to participate in the call/Notice money market both as borrowers and lenders.**

Other measures:

- **Commercial and cooperative banks to not make any dividend pay-out from profits pertaining to FY20 to help banks conserve capital and create fresh room for lending.**

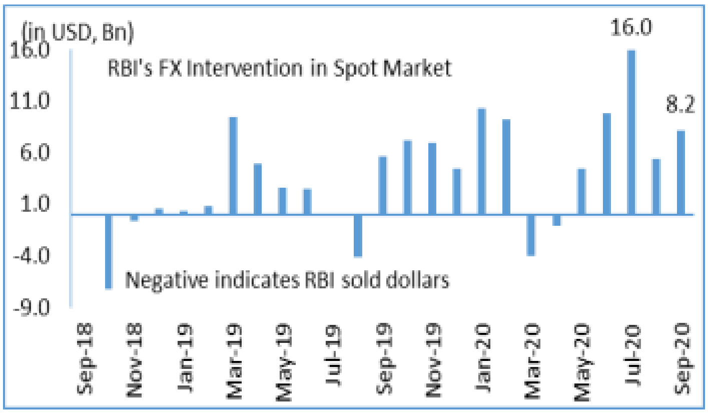
Charts and Tables

Transmission of policy rate cuts

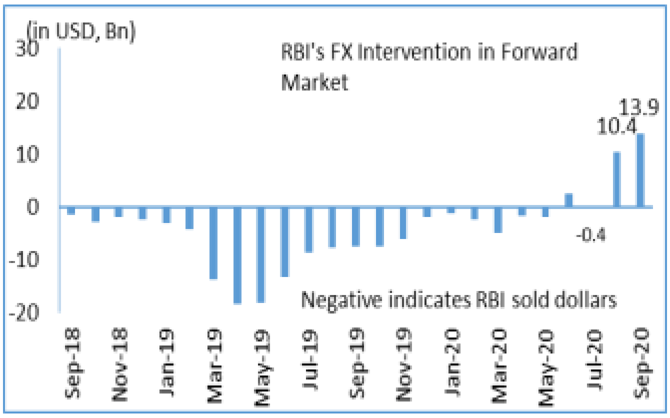
	Pre COVID-19	Post COVID-19
(in bps)	Transmission b/w Feb 19 & Jan-20	Transmission b/w Feb-20 & latest
Repo Rate	-135	-115
Reverse Repo	-135	-155
CRR	0	-100
WACR	-149	-197
TREP	-181	-212
T-Bill 3M	-128	-203
T-Bill 6M	-123	-182
CPs (average of low, high)	4	-208
WALR	-45	-88
Term Deposit (1Y)	-63	-100
10Y G-Sec	-99	-45
5Y G-Sec	-69	-75
10Y AAA	-70	-77
10Y AA	-29	-75

Source: HDFC Bank, CEIC

RBI has intervened in the spot market to keep rupee close to its fair value

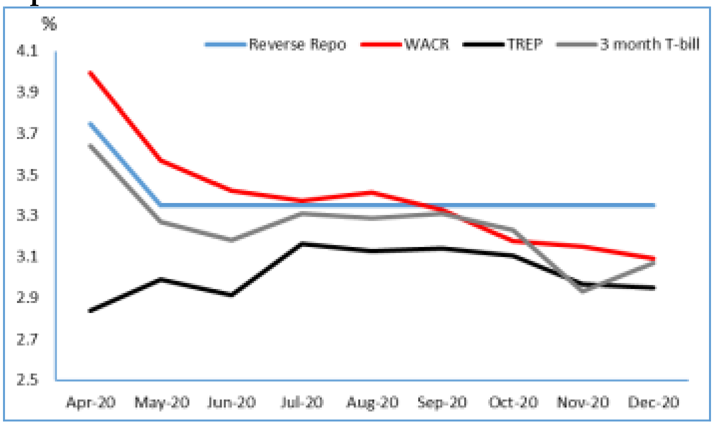


To address liquidity concerns, the RBI has ramped up intervention in the forward market as well

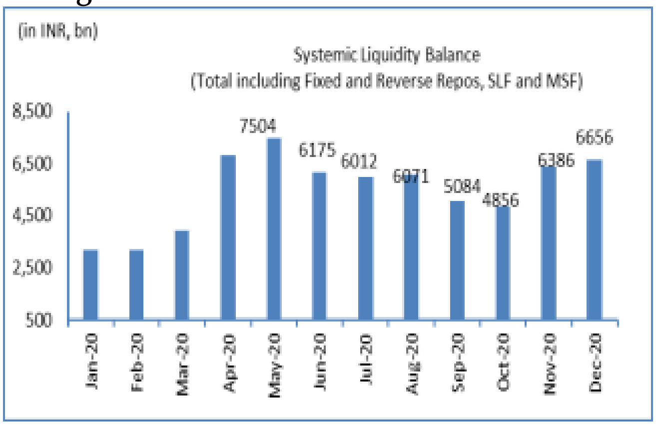


Source: CEIC, Reuters, RBI, HDFC Bank

Short-term rates continue to remain below reverse repo in Dec-20



Liquidity surplus rose further in Dec-20 to an average INR 6656 bn



Source: CEIC, Reuters, RBI, HDFC Bank

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