Reserve Bank of India begins policy normalisation

India's central bank left main policy interest rates unchanged but raised the cash reserve ratio for banks by 50 basis points. Even though this signals towards the end of the easing cycle, we don't think a rate hike will be on the table anytime soon

Reserve Bank of India Governor Shaktikanta Das

Source: Shutterstock

3.50%

Cash reserve ratio for banks

After 50bp hike today

Higher than expected

RBI policy normalisation begins

The Reserve Bank of India unanimously voted to leave the key policy rates, the repurchase rate and the reverse repurchase rate, unchanged at 4.00% and 3.35% respectively. There was no change to the accommodative policy stance that has been in place since the outbreak of

Covid-19 and will be maintained as long as necessary.

However, policymakers caught the markets off guard as they decided to raise the cash reserve ratio for banks by 50 basis points to 3.50% effective 27 March - the first of the two-phase normalisation of the 100 bp cut implemented at the onset of Covid-19 outbreak in March 2020.

But it doesn't come as a complete surprise, though in that the cut was earmarked for one year. The second phase of 50bp CRR hike to 4.00% is set for 22 May. While CRR hike typically drains out banking system liquidity, RBI's Governor Shaktikanta Das sees it as opening space for injecting additional liquidity.

> *The cash reserve ratio normalisation opens up space for variety of market operations of the central bank to inject additional liquidity. - RBI Governor Shaktikanta Das*

Among other measures announced today included an exemption for banks from maintaining cash reserves against loans made to new small borrowers; extension of relaxation of the marginal standing facility (MSF) for banks for six more months until the end of September; and, easier availability of funds to non-bank finance companies for lending to stressed sectors.

Direct online access for retail investors to government bond market via gilt accounts with the central bank was also proposed in a drive to deepen financial markets, as well as an integrated ombudsman scheme for customer grievances redressal to be rolled out by June 2021.

Where is the economy headed?

The governor's statement struck an optimistic cord on the recovery of the economy from a record Covid-induced slump, particularly noting significant fiscal thrust, improved capacity utilisation in the manufacturing sector, surging direct and portfolio investment, and improving flows of financial resources to the commercial sector.

The central bank sees the country's GDP bouncing by 10.5% in the fiscal year 2021-22, which starts in April. This is to be led by a front-loading of recovery with as much as a 26% surge in the first half of the year followed by an estimated -7.7% contraction in the current fiscal year.

> *It is our strong conviction, backed by forecasts, that in 2021-22, we would undo the damage that COVID-19 has inflicted on the economy – RBI Governor Das.*

On inflation, the central bank sees it hovering near the top end of its 2-6% target zone throughout the first half of FY21-22 and subsequently easing to 4.3% in 3Q. The inflation optimism rests on food inflation trajectory, which the RBI expects to be shaped favourably by bumper harvest and softer poultry demand amid worries of avian flu.

What do we make of all this?

We think the central bank's decision to leave main policy rates unchanged but raise the cash reserve ratio by 50bp comes as a clear signal that the central bank's monetary easing cycle has run its course. While this reflects the central bank's confidence in a V-shaped economic recovery in FY21-22, which also aligns with the government's view of 11% growth in the next fiscal year. That said, we think the recovery will continue to face strong headwinds from both local and external factors, and this is likely to leave growth short of the official projections.

Our GDP growth forecasts are -9.8% contraction in FY20-21, followed by an +8.1% growth next year.

> *Even as the phased normalisation of CRR goes ahead, we don't think the hike in the policy rates will be on the table anytime soon.*

We also view the move to normalise policy as an acknowledgement of the persistent inflation risk ahead. Inflation might have drifted back within the RBI's 2-6% policy target zone in December, after a year of remaining above-target, though but we don't think the risk has completely disappeared just yet. The ample banking system liquidity together with expansionary fiscal policy and potential pass-through of rising global oil prices to domestic fuel prices should keep inflation elevated this year.

The higher cash reserve ratio may draw out some excess liquidity but not a whole lot given policy remains supportive of the banking system liquidity in a bid to push growth higher. Even as the phased normalisation of CRR goes ahead, we don't think the hike in the policy rates will be on the table anytime soon, at least not in 2021.

Indeed, the government bond market remains at the receiving end of such a macro policy mix. The yields have been under upward pressure since January and the pressure is intensified sharply following the announcement of FY21-22 budget earlier this week.

The central bank's decision didn't give any respite to the bond market, anyway. If sustained, the higher yields will add to the servicing cost of already high public sector debt. The announcement, however, buoyed sentiment towards the Indian rupee initially, though the currency pared gains in subsequent trading hours.