

RBI Policy Review: A calibrated response to excess liquidity

- In today's policy statement, the RBI continued with its line of supporting growth despite the recent spikes in inflation. That said, recognizing the concerns around inflation (RBI revised up its inflation forecast to 5.7% from 5.1% for FY22) and the excess build-up in systemic liquidity over the last month (at INR 8.5 lakh crore as of 4 August), we saw the central bank take its second step towards some form of liquidity normalization. The first being the tolerance towards some upward adjustment in the 10-year yield in July.*
- The RBI announced an increase in the quantum of variable reverse repos (VRRR) by INR 2 lakh crore to a total INR 4 lakh crore by September-end. The VRRR does not in a conventional sense remove liquidity from the system like a CRR increase, absorption through OMOs (selling bonds) or FX interventions. However, this switch to a longer tenure of reverse repo operations (by raising the amount under the window) does increase the cost of liquidity and is likely to be viewed by the market as some form of liquidity normalization. Therefore, in response to the VRRR announcement, we expect short term rates to increase and return on instruments like CPs to rise.*
- India bond yields rose post the RBI's policy announcement. Short-end of the curve rose the most, with 1-year rising by 20 bps since yesterday while 10-year rising by ~ 4 bps to 6.24% (vs. 6.207% in the previous session). We expect the 10-year yield to trade in the range of 6.20-6.25% in the near-term and rise to 6.25-6.30% by the end of Q3 FY22. G-SAP auctions (worth INR 25,000 crore each in two tranches) announced for the month of August are likely to keep a sharp rise in yields in check. With regards to the bond yield curve, while the 10-year yield has inched up in response to the policy announcement today, the uneven structure of the curve could persist unless there are more evenly distributed interventions, across the curve, through G-SAP, OMOs, Operation Twists by the central bank.*
- We expect the RBI to keep rates unchanged in the current fiscal year (both repo and reverse repo) and wait for more sustainable signals on growth recovery before moving the interest rate needle. We expect any increase in the reverse repo to be announced in Q4 FY22 or Q1 FY23 at the earliest. A repo rate increase is unlikely to come through before Q2 FY23, contingent on a revival in growth and the impact of future pandemic waves remaining contained.*

The Specifics:

Inflation Outlook: For FY22, the RBI has revised up its inflation forecast by 60 bps to 5.7% (from 5.1% earlier), with risks broadly balanced. The RBI highlighted that there is a large amount of slack in the economy, with output remaining below its pre-pandemic level. In line with other major central banks, the RBI labelled the recent spike in inflation readings as transitory (driven by adverse supply shocks, demand supply mismatches and spill-overs from rising global commodity prices). The RBI expects

inflation to hover closer to the RBI's upper band of 6.0% in Q2 FY22 and expects it to ease in Q3 FY22 supported by Kharif arrivals and as supply side disruptions wane.

The revision was seen for all quarters as the RBI noted risks related to input cost pressures building up in the economy although, weak demand conditions are tempering the pass-through to output prices and core inflation.

- **Our View:** We expect inflation to average at 5.8% for FY22. While inflation is expected to remain below the RBI's upper threshold of 6.0% in the near-term, we expect CPI inflation to climb back above 6% from Dec-21 onwards as the base effect drops off and pricing up power improves in the system along with elevated input costs.

RBI Inflation forecast

%YoY	Q2 FY22	Q3 FY22	Q4 FY22	FY22
RBI (June forecast)	5.4	4.7	5.3	5.1
RBI (revised forecasts)	5.9	5.3	5.8	5.7

Growth Outlook: The RBI kept its growth forecast unchanged at 9.5% for FY22. However, it revised its quarterly forecasts. For Q1, the RBI revised up its forecast as economic activity started normalising with the phased reopening of the economy while for the remaining quarters forecasts were revised downwards. The RBI expects Q1 FY23 GDP to grow by 17.2%.

The RBI expects broad-based recovery in demand (including travel, tourism and recreational activities) with easing of restrictions and increasing coverage of vaccinations.

Growth forecast

%YoY	Q1 FY22	Q2 FY22	Q3 FY22	Q4 FY22	FY22
RBI (June forecast)	18.5%	7.9%	7.2%	6.6%	9.5%
RBI (revised forecast)	21.4%	7.3%	6.3%	6.1%	9.5%
HDFC Bank	16.0%	8.0%	6.0%	6.5%	9.1%

Key Announcements:

Liquidity Measures:

- **Variable Rate Reverse Repo announcement:** The RBI to conduct variable rate reverse repo auctions of INR 2.5 trn on 13th August, INR 3 trn on 27th August, INR 3.5 trn on 9th September and INR 4 trn on 24th September. The quantum announced is higher than 14-day VRRR auctions worth INR 2 trn that the RBI has been conducting since January 2021.
- **On-tap TLTRO - Extension of deadline:** On-tap TLTRO scheme further extended by a period of three months till 30 Dec 2021.

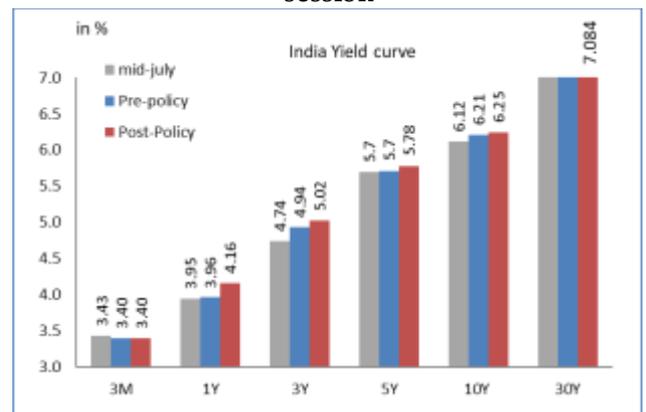
- **Marginal Standing Facility:** The RBI has extended the relaxation given to banks on MSF by three months till 30 December 2021
- **G-SAP 2.0:** The RBI to conduct two GSAP auctions worth INR 25,000 crore each on 12th August and 26th August, under G-SAP 2.0.

Transmission: taking stock of transmission since last policy

(eop, in %)	May-21	Jun-21	Jul-21	MoM-June (in bps)	MoM-Jul (in bps)
WACR	3.18	3.16	3.05	-2	-11
MCLR-Median	7.33	7.30	7.30	-2.5	-
TREP-eop	3.23	3.22	3.33	-1	11
T-Bill 3M	3.41	3.40	3.41	-1	1
T-Bill 6M	3.61	3.70	3.53	9	-17
CP-3M	3.62	3.62	3.70	0	8
CP-6M	3.95	4.00	3.95	5	-5
WALR-Fresh Loans	7.81	7.80	7.64	-1	-16
1Y Term Deposit (avg of low, high)	5.20	5.20	5.20	0	0
10Y G-Sec	6.02	6.05	6.20	2.9	15.3
5Y G-Sec	5.59	5.72	5.73	13.2	0.6
10Y AAA	7.12	7.13	7.19	1.44	5.96
10Y AA	8.45	8.84	8.15	38.99	-69.51

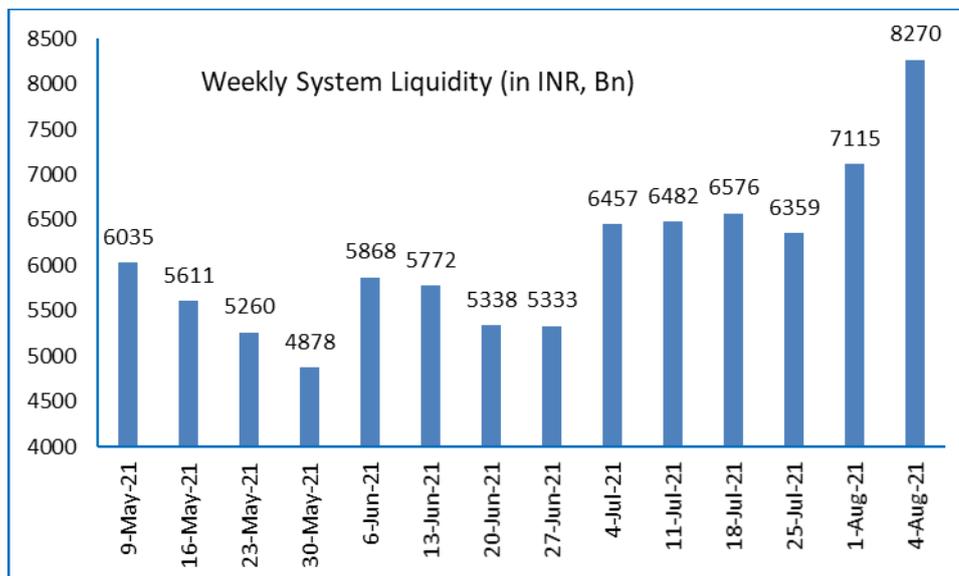
Source: CEIC, Reuters, RBI, HDFC Bank

India yield curve: Short-end of the curve rose. 1-year yield rose by 20 bps to 4.16% today vs. 3.96% in the previous session



Source: Reuters, RBI, HDFC Bank

Systemic Liquidity (average) rose above INR 8 trn in Aug-21



Source: CEIC, HDFC Bank

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