Growth over Inflation: MPC expected to continue with status quo

Brickwork Ratings, Bengaluru, 04 February 2022: *With the economy still in the recovery mode and the pandemic continuing to disrupt the recovery process, the MPC is expected to keep the policy rates stable at the current levels in its upcoming meeting, despite the persistence of higher inflation. However, there is limited scope for the MPC to continue with the current policy stance for long as supply chain disruptions, the elevated level of borrowing shown in the budget and rising crude oil prices amid excess liquidity may exert pressure on inflation.*

Liquidity management by the RBI to support financial stability

Supporting the broad-based economic recovery remained a priority for the RBI's Monetary Policy Committee (MPC) since the outbreak of COVID-19 beginning March 2020. After reducing the policy repo rate by 115 basis points from February to May 2020, the MPC has maintained the *status quo* and kept the policy repo rate at 4%, along with an accommodative policy stance. The Marginal Standing Facility (MSF) rate and reverse repo rate have also remained unchanged at 4.25% and 3.35%, respectively. Huge liquidity infusion by the RBI has kept the system in surplus, helping the central and state governments to finance themselves at lower rates.

The accommodative policy stance and surplus liquidity continued in 2021-22, while the RBI resumed normal liquidity operations in a phased manner in sync with the revised liquidity management framework. Beginning with rebalancing liquidity from passive absorption under fixed-rate reverse repo under its Liquidity Adjustment Facility (LAF) to market-based reverse repo auctions such as Variable Rate Reverse Repo (VRRR), the 14-day VRRR auctions were deployed as the main operation under the LAF. To mop up excess liquidity, the size of the 14-day VRRR was gradually enhanced to Rs 7.5 lakh crore by end-December 2021. The cash reserve ratio was gradually raised to the pre-pandemic level of 4% by May 2021. Yet, the net durable liquidity remained in surplus at Rs 10 lakh crore as on 14 January 2022. The daily liquidity absorption under the LAF averaged Rs 8 lakh crore between 15 December 2021 and 13 January 2022, and stood at Rs 7 lakh crore as on 3 February 2022. Hence, the RBI may continue with draining excess liquidity.

Growth remains a priority despite inflationary worries

The RBI and government took a number of steps to support economic activities, helping the economy recover from the COVID-19 pandemic disruptions. However, repeated waves of the pandemic have disrupted the recovery process. Even as the economy has shown a revival, the first advance estimate of GDP for the current fiscal shows that it is just 1.2% higher than the pre-pandemic level. The first advance estimate of GDP for 2021-22 has pegged growth at 9.2%, lower than the RBI's estimate of 9.5%. In fact, the revision in the estimates of the earlier years' (2020-21) has led to a downward revision of this estimate to 8.8%. In some contact-intensive sectors, revival has been slow and is yet to reach the 2019-20 level. A significant slowdown in manufacturing sector growth, in particular, is a matter of concern as this will also have an impact on employment. Virtually, all the growth engines, except public investment and exports, have been stuttering; both private consumption and investment are yet to revive. Risk to growth tilted to the downside following the emergence of new COVID-19 variants, prolonging economic recovery. Supply chain disruptions and rising international commodity prices added to the woes.

Considering the economic impact of the third wave of the pandemic and downside risks to the recovery process, Economic Survey 2021-22 has projected 8% to 8.5% growth in India's real GDP in the next fiscal. This is lower than the IMF's and World Bank's latest growth forecasts of 9% and 8.7%, respectively. The impact of the pandemic on the economy is considerable, and hence, Union Budget 2022 also has laid greater emphasis on growth acceleration, rather than achieving fiscal consolidation. The budget has increased the capital expenditure to a record level of 2.9% of the GDP to nurture growth and pegged the fiscal deficit at 6.4% of the GDP for 2022-23.

Rising inflationary pressures; MPC may need to start on a tightening path

The CPI inflation rate crossed the 5.5% mark after five months in December 2021, increasing by 68 basis points over the previous month. After softening from their elevated levels, crude oil prices have also started moving up and have crossed USD90 per barrel recently, building the pressure on fuel inflation. Persistent supply constraints may increase cost push pressures already evident in WPI inflation, which have persisted in double-digit levels since the last nine months. Food inflation is also expected to increase further due to supply bottlenecks and adverse weather conditions, in addition to the waning base effect. With a low base and continued supply-side concerns, we expect retail inflation to remain close to 6% in Q4FY22. Although the inflation outlook for Q4 estimated by the RBI at 5.7% is below the upper band of the target, it needs close monitoring as there has been a consistent rise in inflation in the past three months. Advanced economies have already started normalizing their policy rates on the back of mounting inflationary pressures. In fact, the Bank of England has already announced the increase in the policy rate by half a percentage point. There is a heightened risk of capital outflows from India due to the withdrawal of liquidity by advanced economies. Thus, the MPC may need to start on a tightening path if inflation continues to rise.

Expectations from the MPC

Mounting inflationary pressures are real; hence the MPC may continue unwinding its liquidity while maintaining the accommodative stance. In short, considering the COVID-19 variant Omicron impact on economic recovery, the RBI may continue to hold the policy rates at the current levels in the upcoming policy meeting. We expect the MPC to start increasing the policy rates, beginning with normalizing the policy corridor between the repo and reverse repo rate. We expect the RBI to hike the reverse repo rate in its April 2022 policy meeting.

The outlook on inflation and growth may remain unchanged for the current fiscal, while the statement is keenly awaited for its forward guidance on inflation and the GDP for the next fiscal.

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