Economics

DBS Flash

India: RBI signals 'one size does not fit all'

Economics/Growth/India

DBS Group Research October 8, 2021

Radhika Rao
Senior Economist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *The RBI left key policy rates on hold*
- *The accommodative stance was delinked from an increase in the scale of liquidity absorption*
- *Bond purchase program i.e., G-SAP will be suspended*
- *Barring risks of a third Covid wave, we expect the focus to shift to inflation as expectations remain elevated*
- *High commodity prices – crude oil and coal – are a risk for pipeline pressures*
- ***Implications for forecasts**: Phased increase in the reverse repo rate is the next step, before a change in stance*
- ***Implications for markets**: Oil, policy normalisation, lack of GSAP and global factors should push up Gsec yields, overshadowing fiscal positives. The INR is weakening along our expectations*

Three Es of the policy decision

Notwithstanding the shift amongst the G10 countries towards normalising policy, the Indian central bank emphasised that 'one size does not fit all' when it comes to the rate path, suggesting domestic considerations will outweigh global catalysts, when it comes to changing the policy direction. In a unanimous decision, the RBI Monetary Policy Committee (MPC) maintained the policy repo rate unchanged at 4.0%, the reverse repo rate at 3.35% and upper end of the liquidity adjustment facility (LAF) i.e., the marginal standing facility (MSF) rate at 4.25%. The stance was also held as accommodative.

- **Economic assessment:** On growth, the MPC acknowledged the ongoing normalisation in high frequency indicators, including adversely affected contact-intensive services. This was, however, accompanied by a caution on the trajectory owing to the uncertain Covid path, supply disruptions and high logistics costs, elevated commodity prices, and potential global financial market volatility. **Overall, notwithstanding positive signs, the central bank/MPC remains circumspect on the growth outlook**, highlighting the existing slack by way of output still being below pre-COVID level, below normal service sector activity, sub-par capacity utilisation rates, subdued credit growth (we add) and a challenging external environment. **The GDP forecast was held unchanged at 9.5% yoy for FY22**, along our expectations.

On inflation, the catch-up in kharif sowing and record production were expected to have a salutary effect on food inflation, alongside administrative measures by the government (import tax cuts). However, the upturn in commodity prices, including oil, metals, elevated inputs prices - shortage of raw materials, high logistics costs – were seen as risks and keeping core pressures sticky. **FY22 CPI inflation projection was lowered to 5.3% vs 5.7% before.**

Table: Snapshot of RBI's projections (% y/y)

	CPI inflation	GDP
Apr21 MPC		
FY22	**5.0**	**10.5**
FY23	**4.7**	**6.8**
4QFY21	5.0	
1QFY22	5.2	22.6
2QFY22	5.2	8.3
3QFY22	4.4	5.4
4QFY22	5.1	6.2
Jun21 MPC		
FY22	**5.1**	**9.5**
1QFY22	5.2	18.5
2QFY22	5.4	7.9
3QFY22	4.7	7.2
4QFY22	5.3	6.6
Aug21 MPC		
FY22	**5.7**	**9.5**
1QFY22	5.6	21.4
2QFY22	5.9	7.3
3QFY22	5.3	6.3
4QFY22	5.8	6.1
1QFY23	5.1	17.2
Oct21 MPC		
FY22	**5.3**	**9.5**
1QFY22	5.6	20.1
2QFY22	5.1	7.9
3QFY22	4.5	6.8
4QFY22	5.8	6.1
1QFY23	5.2	17.2

Source: RBI, DBS; changes are marked in red

- **Excess liquidity**: The RBI highlighted the need for ample surplus liquidity to support a speedy and durable economic recovery, citing the potential liquidity overhang at more than INR13.0trn into early-October. While there was a need for liquidity to be in sync with economic developments, the process needs to be "gradual, calibrated, and non-disruptive".

In this respect, **the scale of VRRR (variable reverse repo rate) will be gradually raised from INR4trn to INR6trn** by early December, through fortnightly auctions – INR 4.5trn on October 22, INR 5trn on November 3, INR 5.5trn on November 18, and INR 6trn on December 3. Hinging on the quantum of capital flows, pace of government expenditure and credit offtake, the 14-day VRRR auctions might be complemented with 28-day VRRR auctions later in the year. For now, the RBI expects the current liquidity operations to absorb INR 2-3trn by early-December.

In what is being perceived as a tapering signal, **the RBI suspended the bond purchase program i.e., G-Sec Acquisition Program** (G-SAP), after INR2.37trn purchases in first half of FY22 and INR3.1trn in FY21. "The existing liquidity overhang, the absence of a need for additional borrowing for GST compensation and the expected expansion of liquidity in the system as Government spending increases in line with budget estimates", were cited as reasons of cease G-SAP operations. There was a kneejerk spurt in GSec yields, especially long-end, before stabilising.

- **Expectations/ guidance: The broad thrust of the policy decision was along our expectations,** a) cut in inflation forecasts, b) expansion in the VRRR size, c) status quo on all main parameters. Whilst we had expected the scale of G-SAP to be cut and made liquidity neutral through op-twists/OMOs, **the decision to cease purchases comes as a surprise.**

  The guidance delinked the accommodative stance on policy from liquidity absorption, implying that policymakers remain circumspect about growth prospects while inflation risks are under watch. Add to this, the central bank emphasised that 'one size does not fit all' when it comes to the rate path, suggesting domestic considerations will outweigh global catalysts on deciding if and when to change policy direction.

  Barring risks of a third Covid wave, we expect the focus to shift to inflation beyond the near-term moderation that we are likely to witness between September and November. Here global developments will also matter, particularly in light of the rally in commodity prices, including oil, coal, and metals, as well as elevated input prices via shortage of raw materials, high logistics costs. Inflationary expectations are elevated, rising from pre-pandemic levels of 9% and likely to stay sticky above 11% this year. Barring a third Covid wave, we see scope for reverse repo rate to be gradually raised, which is likely to be followed by a change in stance. Repo rate hikes, in our view, are only likely to considered in second half of 2022, at the earliest.

  Meanwhile, the accompanying Monetary Policy Report outlined the baseline assumptions for the RBI, where the most notable change is the increase in fuel prices and slight depreciation in the currency.

Other measures

The full list can be found here:

- **On Tap Special Long-Term Repo Operations (SLTRO) for Small Finance Banks (SFBs)** - the special three-year long-term repo operation for Small Finance Banks (SFBs), introduced in May 2021, will be extended to December 2021 and make it available On Tap.

RBI Monetary Policy Report: Baseline assumptions

Factors	October 2020	April 2021	October 2021
Oil	$40.9pb in H2FY21	$64.6pb in FY22	$75pb in 2H FY22
Monsoon	9% above LPA in 2020	Normal for 2021	1% below long-period avg
Global growth	-4.9% in 2020; 5.4% in 2021	5.5% in 2021 and 4.2% in 2022	6% in 2021, 4.9% in 2022
Exchange rate	USDINR: $73.6	USDINR: $72.6	USDINR: $74.3 in 2H FY22

Source: RBI, DBS

- **Introduction of Retail Digital Payment Solutions in Offline Mode –** Encouraged by the pilot runs to test technologies that enable digital payments even in remote places (where internet connectivity is either absent or barely available), a framework will be introduced for retail digital payments in offline mode across the country.

- **Review of Ways and Means Advances (WMA) Limits**: To help States/UTs to manage their cash flows in midst of the pandemic, the interim enhancement in limits will be extended for until Mar22, alongside other enhancements to this special dispensation.

Commodities' surge an additional watch point

Global crude prices have surged to three-year highs. Following the rally in Brent prices, India's crude benchmark is up ~60% year to date, rising towards $81/bbl. After a two-month hiatus, domestic fuel retailers have resumed price increases, with the rigidity in domestic fuel taxes magnifying the net impact at the pump. As the table below shows, the retail selling price as on 1-Oct is more than 2x of the base price of the fuel type. Additionally, taxes (centre and states) are at 1.4x the petrol base price and 1.1x of diesel, based on prevailing prices in the capital.

Price Buildup of fuel (Delhi effective 01-Oct-21)

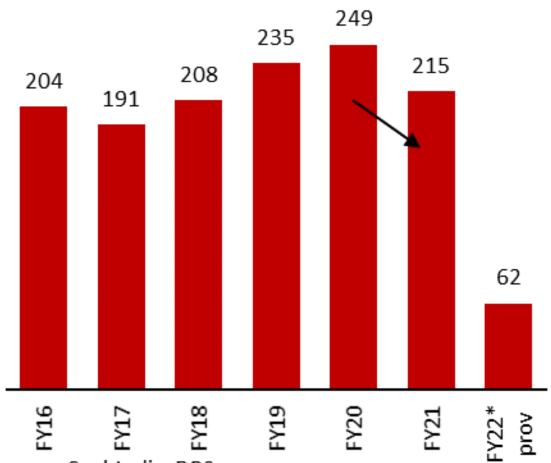
Components	01-Oct-21 Petrol	Diesel
Base price plus freight	41.6	42.6
Excise duty	32.9	31.8
Dealer commission (avg)	3.9	2.6
VAT	23.5	13.2
RSP - Retail selling price	101.9	90.2
RSP vs base price (% of base px)	245	212
Taxes vs base price (% of base px)	136	106

Source: IOCL, DBS

Under the CPI basket, fuel and light has 6.8% weight, with transport and communication (T&C) at 8.6%. The fuel index is up an average 11.6% y/y between Apr-Aug21 and T&C up 11% in the same period. The direct and indirect impact via the weightage of fuel and related products in the inflation basket, implies that for every $10pb move in the oil prices, it results in 30-40bp change in the headline CPI according to the RBI, with a bigger impact on WPI inflation.

Separately, a shortage in coal supply is looming, with the nodal authority cautioning that more than half of the coal-fired plants had less than a week's stock, by late-September (link). This shortfall is driven by a combination of a reopening driven surge in demand for power/ electricity, weather-led disruptions hurting mining activity, and slower imports due to high costs (coal and logistics). This also comes at a time when a supply crunch and outages in China has fuelled global prices further. A widening gulf between global and local prices also drew more consumers to shift to more domestic sources, with prices of the latter capped by the leading state-owned local producer. Over 70% of the domestic energy is produced by coal-fired plants and three-fourths of the needs are imported.

Coal imports (volume, mn tonnes)



Source: Coal India, DBS

For inflation, the commodity's direct weight on the retail CPI basket is negligible (0.04%) and modestly higher (2.1%) in the wholesale price basket, but the indirect impact might be amplified, channelled via higher input prices through producers as well as manufacturers (aluminium smelters, cement, steel mills etc.) and utility tariff increases if distribution utilities receive approvals. Apart from hurting the pace of production, through the value chain, risks of an eventual impact on discretionary purchasing power and consumption are additional concerns.

In all, the impact of commodity price pressures is likely to show with a lag as base effects dominate in the near-term. **Sep-Nov21 CPI inflation is likely to provide transient relief**, owing to base effects and administrative steps (lower import duties on edible oils etc.). Beyond the near-term relief, pass-through of high energy/coal prices, rising input prices (high raw materials and logistics), service sector reopening pressures, delayed rains pushing up staples (vegetables) and receding base effects, are likely to buoy headline CPI back towards 6% yoy in the next quarter. We expect inflation to average 5.2% y/y in FY22, before settling between 4-4.5% (DBSf: 4.3%) next year.

Implications for markets

Asian local currency sovereign bonds have lots to contend with in the second half of 2021 which will also spillover into 2022, caught between rising developed market yields, inflation concerns and risks emanating from China (spanning from slowdown to energy crisis, which might stoke price concerns). While US Federal Reserve has signalled plans to start tapering, few other major central banks have been more hawkish, including the BOE, RBNZ etc. Compared to few of the regional high yielders, India's recovery from the Delta hit has been stronger, providing the room for the RBI to tolerate higher rates/yields in the coming months as rising oil costs bite. Generic 10Y yield has risen 25bps since mid-2021, while the 2Y yield has stopped falling and rising since September. We look for the yields to shift up further by end-year (see table for forecasts). Even as the G-SAP program has been discontinued, it is accompanied by the caveat that volatile movements will attract the central bank's hand as yield movements are still viewed as 'a public good'.

The INR's path is evolving along our expectations. Given the likelihood of the Fed to taper asset purchases by end 2021 or early 2022, we expect the USD to remain strong into 1Q22. High oil prices and the subsequent pressure on the trade/current account math are weighing on the currency. In light of the record high trade deficit in September and likely elevated deficits in rest of FY22, we revise up our current account deficit forecast to -1.1% of

GDP, but still benign compared to 2013. Thirdly, the central bank's preference also remains to absorb capital flows to prevent further gains in the rupee's relative strength, keep volatility low and strengthen the foreign reserves cushion, marking a floor for the USDINR.

India – Economic& Market Forecasts

Indicator	Unit	2019	2020	2021	2022
Real GDP growth*	% yoy	4.0	-7.8	**9.5**	**5.8**
CPI inflation*	% yoy	3.7	6.6	**5.1**	**4.5**
Current account*	% of GDP	-0.9	0.9	**-1.1**	**-1.3**
Fiscal balance*	% of GDP	-3.8	-4.6	**-9.2**	**-6.8**

* Fiscal year basis (April to March)

End of period	Yr/Qtr	1Q	2Q	3Q	4Q
Policy rate, %	2021	4.00	4.00	**4.00**	**4.00**
Last: 4.00	2022	**4.00**	**4.00**	**4.25**	**4.50**
10Y bond yield, %	2021	6.17	6.05	**6.25**	**6.40**
Last: 6.18	2022	**6.45**	**6.50**	**6.60**	**6.70**
USD/INR	2021	73.1	74.3	**74.0**	**75.5**
Last: 73.693	2022	**76.5**	**76.0**	**75.5**	**75.0**

DBS forecasts in red; Actual data in black
Sources: DBS Research, Bloomberg data

Group Research

Economics & Macro Strategy

Taimur Baig, Ph.D.
Chief Economist
Global
taimurbaig@dbs.com

Chang Wei Liang
FX & Credit Strategist
Global
weiliangchang@dbs.com

Ma Tieying, CFA
Economist
Japan, South Korea, Taiwan
matieying@dbs.com

Nathan Chow
Senior Economist
China, Hong Kong SAR
nathanchow@dbs.com

Radhika Rao
Senior Economist
Eurozone, India, Indonesia
radhikarao@dbs.com

Chua Han Teng, CFA
Economist
Malaysia, Philippines, Thailand, Vietnam
hantengchua@dbs.com

Irvin Seah
Senior Economist
Singapore
irvinseah@dbs.com

Violet Lee
Associate
Publications
violetleeyh@dbs.com

Daisy Sharma
Analyst
Data Analytics
daisy@dbs.com

Eugene Leow
Senior Rates Strategist
G3 & Asia
eugeneleow@dbs.com

Duncan Tan
Rates Strategist
Asia
duncantan@dbs.com

Chris Leung
Chief Economist
China, Hong Kong SAR
chrisleung@dbs.com

Samuel Tse
Economist
China, Hong Kong SAR
samueltse@dbs.com

Philip Wee
Senior FX Strategist
Global
philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations)