

# Supporting growth outweighs inflation unease

But as economic uncertainty reduces, producers may start hiking prices, pushing up non-food inflation

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In its August 2021 policy review, the Monetary Policy Committee (MPC) maintained status quo on the policy rate in a unanimous decision, which was a foregone conclusion given the tentativeness of the economic growth momentum.

It also voted to continue with the accommodative stance for as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target, going forward. However, this vote was not unanimous (5:1), revealing the underlying unease on the inflation outlook.

For the Indian economy, Q1 FY2022 was challenging to say the least. Vaccine optimism in advanced economies caused global commodity prices to soar. At the same time, the second wave of Covid necessitated State-wise restrictions, generating domestic supply constraints. A combination of these factors led the CPI inflation to breach the upper threshold of the MPC's medium term target range of 2-6 per cent in both May and June.

Following this spike, the MPC has considerably raised its forecast for the FY22 CPI inflation to 5.7 per cent from 5.1 per cent, with risks broadly

balanced. Worryingly, the Committee has forecast inflation at 5.9 per cent in Q2 FY22 and 5.8 per cent in Q4, alarmingly close to the 6 per cent upper threshold, which is likely to keep the markets on the edge.

The revival in the monsoon has boosted kharif sowing and supply-side measures taken by the Government have softened the prices of edible oils and pulses. Accordingly, the outlook for food inflation appears relatively benign. However, once rising vaccine coverage reduces economic uncertainty, producers may shake off their current trepidation towards hiking prices, pushing up non-food inflation towards the end of the year.

Simultaneously, the MPC has retained its June forecast for the FY22 real GDP expansion of 9.5 per cent. Interestingly, the quarterly projections have undergone a considerable revision. Despite the second wave and the gradual rise in vaccine coverage, the growth estimate for Q1 has been revised upwards, suggesting that the extent of the shock was not as much as previously feared.

Nevertheless, this has been rebalanced by a lowering of the growth projections for the subsequent three quarters, implying that pent-up demand is unlikely to emerge as a big driver of growth going forward.



Inflation is inching up is stock

As domestic demand strengthens and starts seeping into inflationary pressures, the MPC will have to shift its focus to the anchoring of inflationary expectations from the over-arching preservation of growth. Based on this, ICRA anticipates a change in the stance to neutral from accommodative in the February 2022 policy review, followed by a hike in the repo rate of 25 basis points (bps) each in the April and June 2022 reviews.

## Liquidity support

As expected, the liquidity support measures announced by the RBI were largely incremental in nature, following the broad-based support to the acutely affected sectors seen in the past few policies. For instance, the RBI has decided to extend the operating period for the ₹1 trillion On-Tap Targeted Long-Term Repo Operations (TLTRO) scheme by a quarter

to December 31, 2021. Given the high systemic liquidity and muted credit growth, the demand from banks under this scheme has been rather subdued at ₹53.2 billion. Incrementally, as the funding rates in the money market are much lower than the repo rate, this extension in the deadline is unlikely to result in a meaningful demand from banks.

Moreover, the deadline for the achievement of financial parameters under Resolution Framework 1.0 has been deferred to October 1, 2022, from March 31, 2022, given the adverse impact of the second wave of Covid on the corporate borrowers' recovery. To address this stress, the RBI has announced a relaxation in the sector specific thresholds in respect of four out of the five ratios that are linked to the operational performance of the restructured entities.

ICRA estimates the overall corporate restructuring at around ₹700 billion or 0.7 per cent of the loan book of banks. The relaxation provided by the RBI will provide some relief to these borrowers by giving them more time to meet the requisite thresholds.

The RBI had commenced normal liquidity operations, with a resumption of the 14-day variable rate reverse repo (VRRR) operations since January 15, 2021, for an amount of ₹2 trillion, that has been rolled over in

the subsequent fortnightly auctions. It has now been decided to step up the amount of the fortnightly VRRR auctions from ₹2.5 trillion on August 13 to ₹4 trillion on September 24.

The central bank has emphasised that the enhanced VRRR auctions should not be misinterpreted as a reversal of the accommodative policy stance. With the substantial surplus in systemic liquidity, the gradual incremental absorption through VRRR should not materially impact the near-term rates.

However, the new benchmark 10-year G-sec (6.10 GS 2031) yield may continue to creep up, with the average CPI inflation for FY22 projected close to the upper threshold of the 2-6 per cent medium term target, and a budgeted fiscal deficit of 6.8 per cent of GDP.

Following the policy announcement, the 10-year yield had risen by almost 5 bps intra-day. Subsequently, the entire notified amount of ₹140 billion for the 10-year paper was cancelled in the G-sec auction held on August 6, after which its yield retreated somewhat. In the absence of its inclusion in liquidity operations, the benchmark yield may remain volatile, rising to as much as 6.35 per cent by the end of this quarter.

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