2 June 2021

ECOLOGUE

RBI Policy Preview: No headline changes

With the backdrop of growth related headwinds in both urban and rural sectors, increase in economic uncertainty, and rise in inflationary pressures, the RBI is expected to signal continuation of easy financial conditions and keep the repo and reverse repo rate unchanged. We do see a realistic chance for the RBI to reduce its earlier growth forecast of 10.5% and highlight increasing risks to the downside. Further, RBI will continue to pursue its broad intent of plugging weak spots in the economy and ensure adequate liquidity flows to various segments.

Acknowledge a growth hit: Though the lockdown in the second wave is less stringent than the first and mobility indices have contracted at a lesser pace than last year, the decline in consumer sentiment remains evident. High frequency indicators like decline in E-way bills, moderation in PMI manufacturing, sequential contraction in vehicle registrations, and high unemployment rates already highlight the stress in consumption demand. In our view, despite unlocking of the economy in mid/end June, consumption demand is unlikely to recover steadfastly due to increased economic costs and health related uncertainty going forward.

On the investment side, manufacturing capacity utilization remains at a low of 66.6% in June 2021 as per RBI's OBICUS Survey vis-à-vis a recent high of 76.1% in March 2018. With spare production capacity in hand and shrivelling consumption demand, fresh investments are unlikely to pick-up anytime soon despite negative real interest rates, regulatory reforms and prevalence of abundant liquidity. Overall, we see a realistic chance for the RBI to reduce its earlier projection of 10.5% to a shade below the 10% level and also highlight increased downside risks to growth.

Policy tilted to revive growth: On inflation, we expect the MPC to retain its projection of Headline CPI at around 5.0% level, similar to ours. Despite upside risks core inflation, on account of supply chain disruption, higher commodity prices, and pass-through of higher prices to end-consumers, the MPC is likely to draw comfort from the headline inflation remaining within RBI's target band of 2-6% for FY22, and lower than FY21 print of 6.2%. We think that the RBI will tilt towards its efforts to kick-start growth and see through the inflation risks for the moment. Despite this, the MPC will not be able to bring down policy interest rates further as real policy rates are anyways in the negative zone. Further, savings interest rates at the 1-year point are mostly negative too and any further cuts in the interest rate can hurt the savers. Thus, the stance of monetary policy will be maintained while ensuring adequate liquidity in the system. Overnight call money rates are currently below the reverse repo rate and the RBI would continue to remain comfortable with the same.

Yield management to continue: Meanwhile, the RBI is likely to announce the third tranche of G-sec purchase of INR 400 bn under G-SAP 1.0 which has a target of INR 1 tn. Until now, the RBI has announced INR 600 bn of g-sec purchases under this scheme. This has probably become more essential now as the Central Government announced its intention to borrow an additional INR 1.58 tn in FY22 to meet the needs of Compensation Cess due to the State governments. While we see the possibility of more rounds of G-SAPs to be announced, we do not think that the RBI will do that immediately. Communication to the market will indicate clear inclination of the RBI to enable the system to absorb any additional supplies of government papers.

More enablers from RBI may be announced: The room available for traditional monetary policy is increasingly becoming constricted. In the absence of any further opportunity to cut rates, we expect the RBI to continue to use its balance sheet to keep financial market conditions easy. Further measures from the RBI could include:

- More flexibility to banks to implementing restructuring plans in light of the hit to the economy due to the second COVID wave.
- Similar to the COVID loan book for healthcare related sectors, the RBI can expand the scope for incremental lending to MSME and small businesses and an equal amount can be placed with the RBI at 25 bps lower than the repo rate.
- Reduction in risk weights on bank lending to NBFCs/MFI that exclusively lend to MSMEs and small businesses.

Highlights

- No change expected in repo, reverse repo, stance on liquidity and the overall accommodative stance
- RBI may revise down its FY22 GDP growth projection of 10.5% and highlight risks to growth as being higher than for inflation
- The RBI is likely to announce the 3rd tranche of g-sec purchase of INR 400 bn under G-SAP 1.0 and facilitate credit flows to businesses

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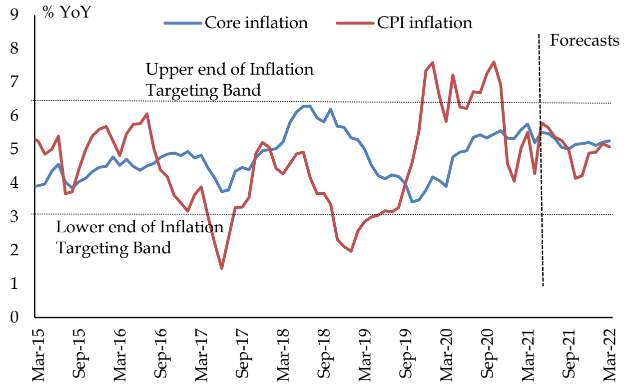
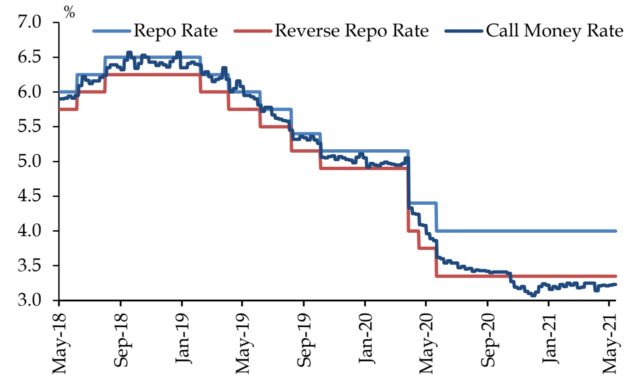
Exhibit 1: Trends in core and headline CPI inflation



Source: CEIC, Yes Bank Economics Research

Exhibit 2: Trends in key policy & call money market rates



Source: CEIC, Yes Bank Economics Research

About YES BANK

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