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The RBI does a course correction; policy guidance indicates inflation concerns take precedence over economic growth

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- After delivering an ultra-dovish policy in the February meeting, the RBI started a course correction today in the first meeting of FY23.
- As expected, the Monetary Policy Committee (MPC) voted unanimously to maintain the repo rate at 4% and the reverse repo rate at 3.35%. It also kept the accommodative stance unchanged.
- However, it revised the forward guidance indicating a focus on withdrawal from ultra-accommodation and a shift from prioritizing economic growth to focusing on containing inflationary pressures. This is a welcome course correction.
- Since the last meeting, several developments, including geopolitical tensions, higher global commodity prices, supply chain disruptions, accelerated policy normalization by major central banks, etc. have imparted upside risks to the inflation trajectory and downside risks to growth.
- Accordingly, the RBI revised its FY23 projections for inflation to 5.7% from 4.5% previously and economic growth to 7.2% from the earlier 7.8%.
- With a view to reinstating the pre-COVID liquidity management framework, the RBI today decided to restore the width of the LAF corridor to its pre-pandemic configuration of 50 bps.
- To operationalize this, the RBI introduced the Standing Deposit Facility – to absorb liquidity without any collateral- with an interest rate of 3.75%. It will act as the floor of the LAF corridor and offers greater operational flexibility.
- The central bank did not provide any explicit guidance on how it plans to manage the Government's record market borrowing of Rs 14.3 lakh crore in FY23, just stating that it will deploy various instruments as warranted.
- The RBI enhanced the present limit under Held to Maturity category from 22% to 23% of NDTL till March 31, 2023, which will allow banks to buy more government bonds in FY23.
- The RBI assured that it will engage in a gradual and calibrated withdrawal of the liquidity over a multi-year time frame beginning this year while reiterating its commitment to ensuring the availability of adequate liquidity to meet the productive requirements of the economy.
- Given the revised forward guidance, we believe that the RBI could change the policy stance in the next meeting, followed by a repo rate hike in the August/September meeting.

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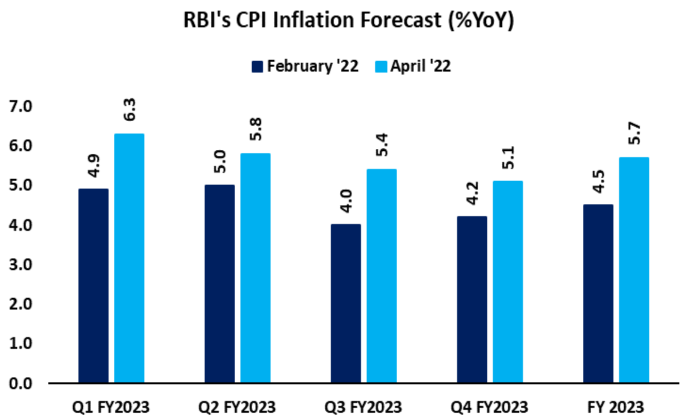
The RBI embarks on formal policy normalization as inflation takes the front seat

After delivering an ultra-dovish policy in the February meeting, the RBI started a course correction today in the first meeting of FY23. As expected, the MPC voted unanimously to keep key policy rates and the accommodative stance unchanged. However, it revised the forward guidance indicating a focus on withdrawal from ultra-accommodation and a shift from prioritizing economic growth revival to focusing on containing inflationary pressures. This is a welcome move given the building up of inflationary pressures. Since the last meeting, several developments, including geopolitical tensions, higher global commodity prices, persistent supply chain disruptions, accelerated policy normalization by major central banks, and volatility in global financial markets have imparted upside risks to the inflation trajectory and downside risks to economic growth. Accordingly, the RBI revised up its inflation projection and cut the economic growth for FY23. With a view to reinstating the pre-COVID liquidity management framework, the RBI today decided to restore the width of the LAF corridor to its pre-pandemic configuration of 50 bps. To operationalize this, the RBI introduced the Standing Deposit Facility (SDF) – an additional tool for absorbing liquidity without any collateral-with an interest rate of 3.75%. It will act as the floor of the LAF corridor, thereby making the reverse repo rate redundant in the context of LAF. The RBI assured that it will engage in a gradual and calibrated withdrawal of the liquidity over a multi-year time frame beginning this year while reiterating its commitment to ensuring the availability of adequate liquidity to meet the productive requirements of the economy. The central bank did not provide explicit guidance on how it plans to manage the Government's record market borrowing in FY23, stating that it will deploy various instruments as warranted. The bond market was clearly disappointed with the 10-year G-Sec yield crossing the 7% level (to ~7.1%) for the first time since 2019. Given the revised forward guidance, we believe that the RBI could change the policy stance to "neutral" in the next meeting, followed by a repo rate hike in the August/September meeting.

RBI maintains a status-quo on key policy rates and the accommodative stance; revises the forward guidance to focus on withdrawal from ultra-accommodation

In a unanimous decision, the MPC kept policy rates unchanged at their respective levels - Repo Rate at 4%, Reverse Repo Rate at 3.35%, and Marginal Standing Facility (MSF) Rate and Bank Rate at 4.25%. The MPC also decided to maintain its accommodative stance; however, it revised the forward guidance, indicating a focus on withdrawal from ultra-accommodation. It stated that ***"the MPC decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth".*** This contrasts with the statement in the February meeting when it had said, ***"to continue with the accommodative stance 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"***. The change in wording shows a shift from prioritizing economic growth revival to now focusing on containing inflationary pressures. Given the revised forward guidance, we believe that the RBI could change the policy stance to "neutral" in the next meeting, followed by a repo rate hike in the August/September meeting.

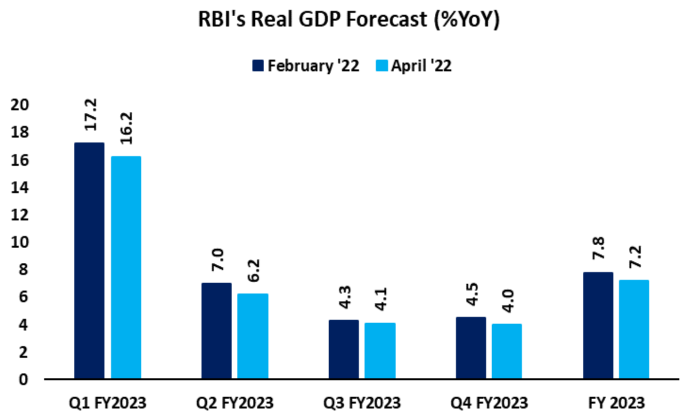
RBI revises the FY23 inflation forecast sharply upward



Source: RBI

Considering developments since the last meeting, the MPC revised its economic growth and inflationary projections for FY23, assuming the oil price at $100/bbl. Since the last meeting, several developments, including escalating geopolitical tensions, hardening of global commodity prices, the likelihood of prolonged supply chain disruptions, divergent monetary policy responses and volatility in global financial markets have imparted sizeable upside risks to the inflation trajectory and downside risks to economic growth as per the MPC assessment. Accordingly, the RBI revised the FY23 projections for inflation to 5.7% YoY compared to the earlier estimate of 4.5% YoY. The RBI expects inflation to peak in Q1 FY23 at 6.3% YoY before gliding towards 5.1% YoY by Q4 FY23. There is considerable uncertainty about the inflation outlook, with its trajectory critically dependent on the evolving geopolitical situation and associated implications for global commodity prices. The RBI expects a normal monsoon and record food-grains production and buffer stock levels to help prevent a major flare-up in domestic prices. It acknowledges high uncertainty in the food price outlook, emphasizing close monitoring and advocating pro-active supply management to contain inflation. With the broad-based surge in prices of key industrial inputs and global supply chain disruptions, the RBI assesses that input cost-push pressures are likely to persist for longer than expected earlier, though also noted limited pass-through to retail prices till now given the continuing slack in the economy. We believe pass-through of the input costs to final consumers will pick up, putting pressure on inflation. CPI inflation has already crossed 6%, the upper threshold of the RBI's inflation target range, in January and February, before the war in Europe led to a further surge in global commodity prices.

The RBI cuts FY23 economic growth forecast



Source: RBI

With regard to the economic outlook, the RBI revised its FY23 economic growth forecast sharply to 7.2% YoY from 7.8% YoY earlier, with a peak of the quarterly economic growth estimated at 16.2% YoY in Q1 FY23 before it eases to 4% YoY by Q4 FY23 in line with the normalization of the base effect. It views risks to the outlook as broadly balanced. Good prospects of rabi output and normal monsoon augur well for rural demand. Ongoing pick-up in contact-intensive services and urban demand is likely to be sustained, supported by the ebbing of the third wave and expanding vaccination coverage. Tentative signs of revival in private investment amidst improving capacity utilization, corporates' improved balance sheets, and pick-up in bank credit should get support from congenial financial conditions and the Government's focus on capital expenditure. But the deterioration in the external environment imparts high uncertainty to the investment prospects and the overall economic outlook. We see downside risks to our FY23 economic growth projection of 7.7% YoY given the evolving geopolitical situation, elevated commodity prices, tightening of global financial conditions, the persistence of supply-side disruptions and weakening external demand conditions. The RBI Governor noted that an improved external sector position, large FX reserves and strengthening of the financial sector should help withstand risks posed by evolving global geopolitical and financial conditions.

The RBI restores the pre-pandemic liquidity management framework; introduces SDF to replace the fixed-rate reverse repo as the floor of the LAF corridor

On the liquidity management framework, the RBI stepped up its measures to move away from ultra-accommodation. The extraordinary liquidity measures undertaken in the wake of the pandemic, combined with the liquidity injected through various other operations of the RBI, have left a liquidity overhang of the order of Rs 8.5 lakh crore in the system. In the second half of FY22, the RBI had focused on migrating from the fixed-rate overnight reverse repo window to the VRRR auctions of longer maturity (supported by fine-tuning auctions of various tenors). As a result of the rebalancing of liquidity through VRRR auctions, the interest rate for around 80% of the total liquidity absorbed under the LAF during Q4:2021-22 has firmed up close to the policy repo rate, thereby preparing the markets for the eventual normalization of the LAF corridor. Accordingly, the RBI today decided to restore the width of the LAF corridor to its pre-pandemic configuration of 50 bps, intending to restore the pre-pandemic liquidity management framework of February 2020. To operationalize this, the RBI decided to introduce the Standing Deposit Facility (SDF) – an additional tool for absorbing liquidity without any collateral- with an interest rate of 3.75% with immediate effect. The SDF will replace the fixed-rate reverse repo as the floor of the LAF corridor and offers greater operational flexibility, given its non-collateralized window. The MSF rate will continue to be at 4.25%, i.e. 25 bps above the policy repo rate. Thus, the LAF corridor will be symmetric around the policy repo rate with the MSF rate as the ceiling and the SDF rate as the floor with immediate effect. Both the standing facilities, viz., the MSF and the SDF will be available on all days of the week throughout the year. The RBI assured that it will engage in a gradual and calibrated withdrawal of this liquidity over a multi-year time frame in a non-disruptive manner beginning this year while reiterating its commitment to ensuring the availability of adequate liquidity to meet the productive requirements of the economy.

Bond markets disappointed by the lack of details to manage the government's large borrowing programme

Markets were hoping for explicit guidance from the RBI with regard to its likely support to absorb the Government's record market borrowing of Rs 14.95 lakh crore (~Rs 14.3 lakh crore after adjusting for switch operations) in FY23. However, the central bank did not offer details on how it plans to manage the Government's borrowing programme.

It only stated that it would remain focused on the completion of the Government's borrowing programme and would deploy various instruments as warranted. As a result, the yield on 10-year G-Sec crossed the 7% level today to ~7.12%. The RBI, however, decided to enhance the present limit under Held to Maturity (HTM) category from 22% to 23% of NDTL till March 31, 2023, with restoration to 19.5% to be done in a phased manner starting from the quarter ending June 30, 2023. This will allow banks to buy more government bonds in the current fiscal. We expect the RBI to intervene during the year to support the government borrowing programme through operation twists/OMOs to prevent a sharp rise in yields.

The RBI also announced developmental and regulatory policy measures listed below related to financial markets and payment and settlement systems –

Individual Housing Loans – Rationalization of Risk Weights

- The risk weights for individual housing loans were rationalized in October 2020 by linking them only with the loan to value (LTV) ratios for all new housing loans sanctioned up to March 31, 2022. Recognizing the importance of the housing sector and its multiplier effects, the RBI extended the applicability of these guidelines until March 31, 2023.

Discussion Paper on Climate Risk and Sustainable Finance

- To better handle climate risk and its potential impact on sustainable finance by individual Regulated Entities (REs), the RBI will issue a discussion paper on Climate Risk and Sustainable Finance on their website for comments of shareholders.

Committee for Review of Customer Service Standards in RBI Regulated Entities

- The RBI has proposed a panel to review the state of customer service in the REs and the adequacy of customer service regulations and suggest measures to improve the same.

Measures pertaining to payment and settlement systems

- To encourage card-less cash withdrawal facility across all banks and all ATM networks/operators, it is proposed to enable customer authorization using the Unified Payments Interface (UPI) while settlement of such transactions would happen through the ATM networks. Separate instructions would be issued to NPCI, ATM networks, and banks shortly.
- Recognizing the increased volume of Bharat Bill Payment System (BBPS) transactions and to provide it an additional boost, the RBI has proposed to reduce the net worth requirement for the non-bank Bharat Bill Payment Operating Units from Rs 100 crores to Rs 25 crores.
- To ensure the safety and the security of digital payments, the RBI will issue separate guidelines for Payment Systems Operators, covering robust governance mechanism for identification, assessment, monitoring, and management of cybersecurity risks including information security risks and vulnerabilities, and specify baseline security measures for safe and secure digital transaction.

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