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The RBI steps down to a 25-bps hike; maintains a cautiously hawkish stance

- The RBI decided to raise the policy rate, the repo rate, by 25 basis points (bps) in its policy meeting on February 8th, 2023, and maintained its cautiously hawkish policy outlook.
- With the latest increase we believe it likely that the RBI has reached the end of its current hiking cycle. That said, further rate hikes cannot be ruled out especially if core inflation continues to remain above 6% over the next few months.
- With liquidity likely to increase over the next couple of months, the central bank maintained its stance of focussing on withdrawal of liquidity and avoiding a relapse of the ongoing trend of disinflation. However, it assured that it will remain responsive towards meeting the productive needs of the economy, as needed.
- The RBI assessed economic activity to have remained strong in Q3 and Q4 FY23. It expects growth to slow to 6.4% in FY24 (from an estimated 7% in FY23).
- The bank expects growth to be supported by good prospects for the agriculture sector, the government's strong thrust on CAPEX and a rebound in contact intensive sectors and discretionary spending.
- Inflation in FY23 is now estimated at 6.5% (6.7% previously). Price pressures are expected to ease further till Q1 FY24 following which the seasonal spike in food prices and unfavourable base effects will lift inflation again. In FY24, inflation is expected to average 5.3%.
- The RBI cautioned that the ongoing pass-through of input costs to output prices, especially in services, could continue to exert pressures on core inflation. Upside risks to inflation in terms of higher commodity prices in FY24 exist.
- External sector drag moderated in H2 FY23 with a narrowing of trade deficit. Other positive developments include robust services exports, strong remittance inflows as well as foreign direct investment. As such the central bank believes that a wider current account deficit in FY23 will be "eminently manageable".

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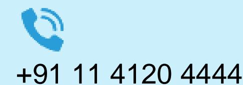
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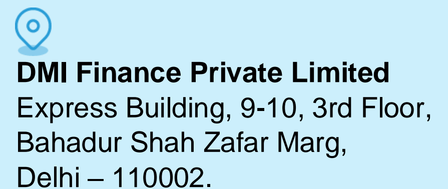
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The RBI hikes the policy rate by 25 bps; to continue to focus on the withdrawal of accommodation

The RBI decided to raise the policy rate, the repo rate, by 25 basis points (bps) in its policy meeting on February 8th, 2023, and maintained its cautiously hawkish policy outlook. With the RBI's decision, the Standing Deposit Facility (SDF) Rate stands adjusted to 6.25% and the Marginal Standing Facility (MSF) Rate and Bank Rate to 6.75%.

The latest rate hike is smaller than the 35-bps hike that was implemented in December and in line with our expectation that while rate hikes will continue, a moderation in the headline rate of inflation plus cumulative tightening previously enacted provided the RBI room to temper the pace of rate hikes. However, the decision to raise the rates yet another time was not a unanimous one within the monetary policy committee with Dr. Ashima Goyal and Prof. Jayanth R. Verma voting against the repo rate hike. The decision to go for a smaller rate hike comes in the backdrop of the tapering of interest rate hikes by major global central banks as inflation around the world continues to decelerate and as central banks judge that tightening efforts to date have shifted monetary policy from accommodative to restrictive territory.

Despite a second consecutive step down in the magnitude of rate hike, the RBI kept its stance unchanged as "focusing on withdrawal of accommodation to ensure that inflation remains within the target while supporting growth". The decision was again not unanimous with Dr Goyal and Prof. Verma voting against this part of the resolution as well. **We assess the central bank's tone as still cautiously hawkish** given the concerns around a persistently high level of core inflation – 6.2% in December –and an unchanged policy stance. With the tone more hawkish than market expectations, the 10-year yield ended the day at 7.34% (~3 bps higher than its previous close).

With the latest increase we believe it likely that the RBI has reached the end of its current hiking cycle. With real rates comfortably in the positive territory, the RBI is likely to pause and assess the impact of rate hikes while allowing the process of monetary policy transmission to complete. Furthermore, with the worst of inflation behind us, inflation adjusted interest rates are likely to increase further in 2023 and contribute to chilling demand. As such, the central bank will be cautious of adding to this. That said, there is a small risk of another rate hike if the core inflation continues to remain above 6% over the next few months. As such, any further rate hikes, if implemented will be data dependent, primarily based on the evolving inflation outlook and the persistence of core inflation.

A continuing high level of excess liquidity is likely the reason for an unchanged stance

The rationale behind sticking with a stance of withdrawal of accommodation is a continuing high level of excess liquidity in the system. According to the governor's statement, average absorption under the liquidity adjustment facility in January 2023 was ~Rs 1.6 lakh crores, which is similar to the levels observed during October-November. In the near future, liquidity is likely to remain in large surplus owing to an expected pickup in government spending as the financial year draws to a close. Given the continued strong demand for credit and transient episodes of tight liquidity, deposit rates are on the rise which will further boost the banking system liquidity (increase in the weighted average domestic term deposit rates between May and December was 213 bps for fresh deposits and 75 bps for outstanding deposits). Furthermore, India remains a bright spot for international investors amid a slowing global economy, which means that portfolio inflows are expected to increase in 2023 bolstering liquidity. Maturity of the pandemic era Long Term Repo Operations and Targeted Long Term Repo Operations are expected to only partly offset the increase in liquidity. As such, the RBI has decided to remain steadfast in its resolve to wipe up excess liquidity from the system and avoid a relapse of the ongoing trend of disinflation. At the same time it assured that it will remain responsive towards meeting the productive requirements of the economy, as needed.

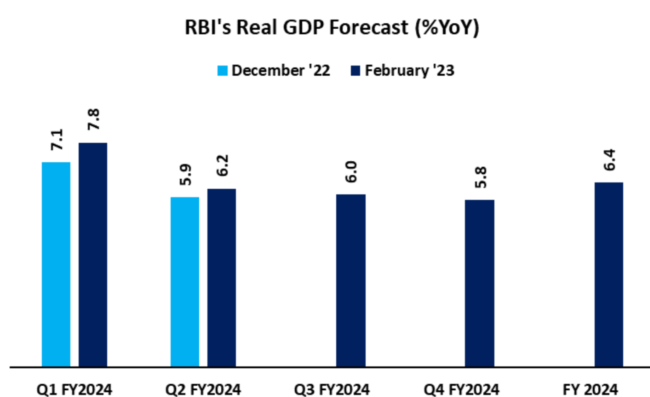
Additionally, in a move towards normalising liquidity operations, it decided to restore market hours – from 9:00 AM to 5:00 PM – for the government securities market. The move will aid smooth completion of the market borrowing programme of the centre and the states. Looking ahead, we believe that the central bank will look for durable signs of a turn in the liquidity cycle when banks draw down a large part of their standing deposit facility (SDF) and variable rate reverse repo (VRRR) balances (as mentioned by the governor in his last statement) before it considers changing its stance to neutral.

The economy continued to recover in Q3-Q4 FY23; growth to remain resilient in FY24

The RBI assessed economic activity to have remained strong in Q3 and Q4 FY23. This is in line with the high frequency data observed over the past few months. Consumer spending in Q3 FY23 was supported by the festival season and a continued release of pent-up demand in the contact intensive sectors like travel, tourism and hospitality. According to RedSeer, e-commerce players in 2022 recorded sales worth around double of that recorded in 2019 during the festival season. Retail credit growth remained strong in December reaching around 20% YoY. Retail auto sales (passenger vehicles, two-wheelers and

three wheelers) grew by a strong 29% YoY in October-December as festive offers attracted buyers. Domestic air passenger traffic crossed the pre-pandemic levels for the first time. Investment indicators were strong as well with higher project announcements, increase in cement and steel consumption and strong growth in non-oil and non-gold-and-silver imports. According to the RBI survey on order books, inventory and capacity utilisation, seasonally adjusted capacity utilisation increased to 74.5% in Q2 FY23 from 74.3% in Q1.

Growth revised up for H1 FY24; full year growth forecast at 6.4%



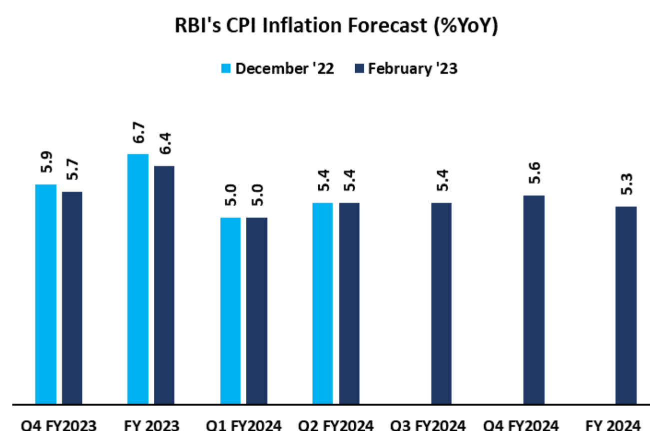
Source: RBI. Note: December '22 and February '23 refer to projections given by the RBI in its December 2022 and February 2023 MPC updates, respectively.

The lead indicators from Q4 have also remained positive while signalling a slight moderation in the pace of economic activity. The PMI for manufacturing came in at 55.4 in January, slowing from an average of 56.3 in October-December 2022 whereas that for services was recorded at 57.2 compared with an average of 56.7 in the previous quarter. The rebound in contact-intensive sectors and discretionary spending is expected to support urban consumption. The government's continued thrust on CAPEX will support investment activity. Strong growth in rabi sowing bodes well for the agriculture sector prospects and rural demand. Overall, the RBI expects growth to slow to 6.4% in FY24 (from an estimated 7% in FY23). It revised up its projection for Q1 FY24 to 7.8% (from 7.1% previously) and for Q2 to 6.2% (from 5.9% previously). For Q3 and Q4 it forecasts growth at 6% and 5.8%.

Inflation to continue to moderate until Q1 FY24; pickup thereafter owing to seasonal factors and base effects

The RBI recalibrated its inflation projection for FY23 as moderation in the headline rate of inflation has materialized at a much quicker pace than the central bank had expected. Indeed, average inflation in October-December came in at 6.1% compared with the RBI's projection of 6.6%. Accordingly, inflation in FY23 is now expected to be 6.5% (6.7% previously). Inflation is projected to moderate further in the remaining part of FY23 and into Q1 FY24 led by the ongoing easing of food prices and a favourable base effect. It is expected to accelerate again from July owing to a seasonal spike in food prices and the base effect turning unfavourable. Furthermore, the ongoing pass-through of input costs to output prices, especially in services, could continue to exert pressures on core inflation. As such, the RBI projects inflation at 5% in Q1 FY24, 5.4% in Q2 FY24, 5.4% in Q3 FY24 and 5.6% in Q4 FY24 with an annual inflation projection of 5.3% for FY24, which, if realized would mark a 1.2 percentage point downshift from FY23. International crude oil prices have remained at bay until now, which has aided moderation of price pressures. However, we believe that this will remain a key upside risk for inflation going forward as oil prices (and potentially other industrial commodities) are likely to rise with the recovery of the Chinese economy. The latest projections are based on the assumption of a normal monsoon and oil prices at US$95/bbl (downward revision of US$5/bbl).

Inflation expectations revised down for FY23; FY24 inflation at 5.3%



Source: RBI. Note: December '22 and February '23 refer to projections given by the RBI in its December 2022 and February 2023 MPC updates, respectively.

External sector drag moderated in H2 FY23

The governor also noted positive developments in the external sector in H2 FY23. Import growth moderated as lower commodity prices (particularly crude oil) helped in narrowing the country's trade deficit. Furthermore, services exports grew handsomely by 25% YoY in Q3 FY23. Remittance growth in H1 was much higher than the World Bank's projections and is expected to remain strong in H2, which along with a services surplus will aid in partly offsetting the deficit on the trade account. The central bank expects the current account deficit (CAD) to narrow in H2 and remain eminently manageable and within the parameters of viability.

Turning to the financing of the CAD, the capital account inflows have been strong as well. Net foreign direct investment in the first nine months of FY23 was US$22.3 billion (compared with US$24.8 billion in the corresponding period last year) and foreign portfolio inflows turned positive on aggregate in Q2-Q3, reflecting the fact that Indian capital markets remain attractive despite a gloomy global economic environment. Foreign exchange reserves have recovered from a low of US$524 billion in October 2022 to US$577 billion as of late January 2023, which is equivalent to 9.4 months' worth of imports.

The RBI also announced the developmental and regulatory policy measures listed below:

Financial markets

- **Introduction of Securities Lending and Borrowing in Government Securities:**
  To further develop the government securities market, the lending and borrowing of G-secs will be permitted which will augment the existing market for 'special repos'. The system is expected to facilitate wider participation in the securities lending market by providing investors an avenue to deploy idle securities and enhance portfolio returns. Furthermore, a well-functioning market for securities lending and borrowing will add depth and liquidity to the G-secs market, aiding efficient price discovery. Draft Directions will be issued separately for stakeholder comments.

Regulation

- **Recovery of Penal Charges on Loans:**
  At present, Regulated Entities (REs) are required to have a policy for levy of penal interest on advances. The REs, however, follow divergent practices on levying of such charges. In certain cases, these charges are founded to be excessive. It has been decided that any penalty for delay/default in servicing of the loan or any other non-compliance of material terms and conditions of the loan contract by the borrower shall be in the form of 'penal charges' in a reasonable and transparent manner and shall not be levied in the form of 'penal interest' that is added to the rate of interest being charged on the advances. Further, there shall be no capitalisation of penal charges (i.e., the same shall be recovered separately and shall not be added to the principal outstanding). However, in case of any deterioration in credit risk profile of the borrower, REs shall be free to alter the credit risk premium under extant guidelines on interest rate. Draft guidelines to the above effect shall be placed on RBI website shortly, for comments from stakeholders.

- **Regulatory Initiatives on Climate Risk and Sustainable Finance:**
  In order to mitigate climate-related financial risks for REs the central bank had issued a Discussion Paper on Climate Risk and Sustainable Finance in July 2022. Based on the feedback received, the RBI has decide to issue the following guidelines in a phased manner–
  - Broad framework for acceptance of Green Deposits
  - Disclosure framework on Climate-related Financial Risks
  - Guidance on Climate Scenario Analysis and Stress Testing.

Payment and Settlement Systems

- **Expanding the scope of Trade Receivables Discounting System (TReDS):**
  For the benefit of MSMEs, the Reserve Bank had introduced a framework in 2014 to facilitate financing of their trade receivables through TReDS. To provide further impetus to TReDS platforms, their scope of activity is proposed to be expanded as stated below. These measures will help in further improving the cash flows of MSMEs.
  - Insurance facility will now be permitted on TReDS. This will encourage financing / discounting of payables of buyers irrespective of their credit ratings. Accordingly, insurance companies will be permitted to participate as a "fourth participant" on TReDS, apart from the MSME sellers, buyers and financiers.
  - All entities / institutions eligible to undertake factoring business under the Factoring Regulation Act will be permitted to participate as financiers in TReDS.
  - Secondary market operations will now be enabled on TReDS platforms. This will allow financiers to offload their existing portfolio to other financiers within the same TReDS platform, if required.

- **Extending UPI for Inbound Travellers to India:**
  UPI has become hugely popular for retail digital payments in India. An enhancement has recently been made to provide UPI access to non-resident Indians who have international mobile numbers linked to their NRE/NRO accounts. It is now proposed that all inbound travellers to India be

permitted to access UPI for their merchant payments (P2M) while in the country. To start with, this facility will be extended to travellers from the G-20 countries, arriving at select international airports. Going forward, this facility will be enabled across all other entry points in the country. Necessary operational instructions will be issued shortly.

Currency management

- **QR Code based Coin Vending Machine - Pilot project:**
  The Reserve Bank of India is preparing a pilot project on QR Code based Coin Vending Machine (QCVM) in collaboration with a few leading banks. The QCVM is a cashless coin dispensation machine which would dispense coins against a debit to the customer's bank account using Unified Payments Interface (UPI). The pilot project is planned to be initially rolled out at 19 locations in 12 cities across the country.

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