7 December, 2022

The RBI steps down to a 35-bps hike; unchanged stance suggests still hawkish leaning

- In today's meeting, the RBI's Monetary Policy Committee (MPC) continued to tighten monetary policy and raised the policy repo rate by 35 bps to 6.25%, implementing a cumulative increase of 225 bps since May 2022.
- Furthermore, with systemic liquidity remaining in surplus the MPC retained its stance to focus on withdrawal of accommodation.
- The central bank cut its FY23 real GDP projection from 7.0% YoY to 6.8% owing to drags exerted by the external sector. The growth outlook remains bright amid continued recovery in the services sector, a pick-up in rural consumption and positive investment impulses.
- The central bank retained its headline CPI projection at 6.7% YoY for FY23. Risks of inflation being higher remain due to persistently high prices of certain food items, and catch-up in services inflation.
- The RBI expects liquidity conditions to improve in the period ahead. Further, the governor reiterated that despite being in absorption mode, the central bank stands ready to inject liquidity as and when needed to meet the requirements of the productive sector of the economy. However, he also cautioned the market participants to wean themselves off the liquidity overhang.
- With reference to the external sector, the governor highlighted positive developments amid an otherwise morose global economic environment. These 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".
- In this context we retain our view of terminal rate being at 6.5% by end of FY23, although given the resilient pace of domestic economic activity with a little to no impact of higher interest rates, and an indication of higher rates in the developed world (particularly the US), we do not eliminate the possibility of a higher terminal rate.

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

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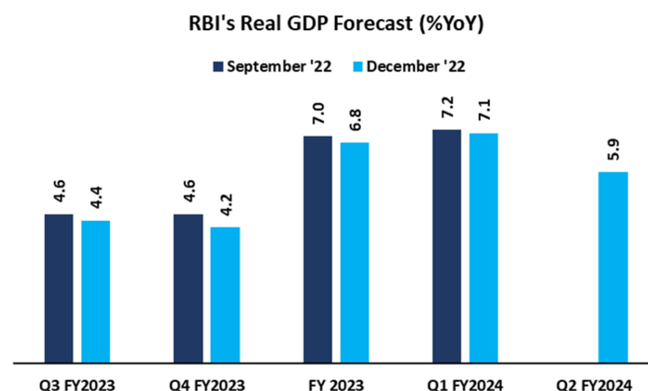
The RBI hikes the policy rate by 35 bps; to continue its focus on the withdrawal of accommodation

In line with the global central banks shifting gears and indicating a moderation in the pace of monetary policy tightening amidst the global growth slowdown, the RBI raised the policy repo rate by 35 bps to 6.25% (from 5.90% earlier) after three consecutive 50-bps hikes. With today's decision, the cumulative tightening in the policy rate for FY23 came up to 225 bps. Consequently, the Standing Deposit Facility Rate stands adjusted to 6.00% and the Marginal Standing Facility Rate and Bank Rate to 6.50%. However, the decision on the quantum of the rate hike was not unanimous with Prof. Jayanth Verma dissenting in the favour of no repo rate hike at all.

Even with a softer rate hike, **we assess the tone of the Governor's statement as still leaning towards hawkish**, reflected in an unchanged policy stance and multiple reiterations of elevated levels of core inflation. While the magnitude of the policy rate was more or less priced in by the market the more hawkish tone led to an increase in 10-year yields by 5 bps to 7.3% post the announcement.

In the context of the current inflation print still being at elevated levels, the MPC reiterated its view that further calibrated monetary policy action is warranted to keep inflation expectations anchored, break core inflation persistence, and contain second round effects. The commentary was slightly changed from last time when the broadening of price pressures was also one of the rationales behind the current decision potentially reflecting the moderation of the global commodity prices recently. Regarding the policy stance, the MPC continued to ***"remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth"*** suggesting that the RBI is prepared to raise rates further should the inflation pressures remain elevated. However, the decision was not unanimous with two members dissenting on this part of the resolution. The governor justified the stance by emphasizing that systemic liquidity remained in surplus mode and is expected to increase in the remainder of FY23. Additionally, adjusted for inflation the policy rate still remains accommodative. Despite the heightened uncertainty on the global front, the governor refrained from providing any forward guidance either in the form of a terminal rate or change in the stance at this juncture. In this context, we retain our view of the terminal rate being at 6.5% by end of FY23, although given the resilient pace of domestic economic activity with little to no impact of higher interest rates, and an indication of higher rates in the developed world (particularly the US), we do not eliminate the possibility of a higher terminal rate.

The RBI revised its growth projection downwards from 7.0% to 6.8% for FY23



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

Regarding the economic outlook, the governor highlighted that the domestic economy has remained resilient in the face of the highly volatile global environment. This was reflected in the Q2 FY23 GDP print of 6.3% YoY which was in line with the RBI's expectations. Although growth slowed from the double-digit expansion in Q1, the comparison would be unfair because of a large base effect at play in the previous quarter. When compared to the pre-pandemic levels, the growth jumped to 107.6% from 103.8% in Q1. The economic recovery has gained further momentum with high-frequency data, including manufacturing and services PMIs for November, showing a pick-up in activity. In agriculture, a strong start to the rabi sowing provides an optimistic outlook for the sector and bodes well for rural demand. From a demand perspective, private consumption was buoyed by the festive-led demand at the beginning of Q3. While urban demand inched up further with a continued catch-up in the services sector especially contact-intensive sectors like travel, hospitality etc., rural consumption is also showing nascent signs of recovery as reflected in a jump in two-wheeler sales (October). Investment activity is also expected to pick up as reflected in improved capacity utilization, increased bank credit etc. and the government's continued push on capital spending. However, the external sector continues to exert a drag on the economic recovery of the country. As such the net trade deficit of the country remained at elevated levels (October) as the weakening external demand weighed down on exports. Recognizing the potential impact of the unfavourable global growth conditions on exports the RBI revised its growth projection for FY23 downwards from 7.0% YoY earlier to 6.8% YoY with Q3 at 4.4% YoY and Q4 at 4.2% YoY from 4.6% in both the quarters earlier. Additionally, the RBI also revised its growth projection downwards for Q1 FY24 from 7.2% to 7.1% and pegged the growth for Q2 FY24 at 5.9%.

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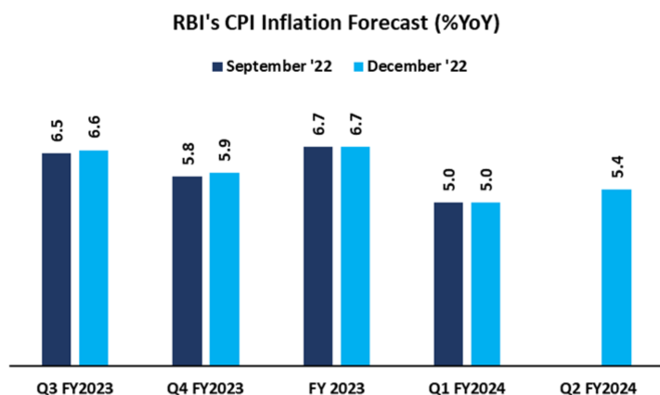
Headline Inflation projection revised up for Q3 and Q4; FY23 unchanged at 6.7%



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

On the inflation outlook, the MPC retained its headline CPI projection at 6.7% YoY for FY23 with risks evenly balanced. Implicit in this was the slightly lower actual CPI print for Q1 FY23 at 7.0% against the RBI forecast of 7.1%. The RBI has otherwise raised its projections for the remaining two quarters, Q3-Q4 from 6.5% and 5.8% earlier to 6.6% and 5.9% respectively in the latest policy. For Q1 FY24 the RBI retained its projection at 5.0% and forecasted the Q2 FY24 at 5.4% respectively. Going ahead, while the base-led softening and the seasonal winter correction in food prices remain supportive of a moderation in the headline rate of inflation, the elevated price levels of certain food items including cereals and milk pose an upside risk. Lower domestic stocks of cereal post the extension of the central food security scheme along with higher global prices because of geo-political factors have kept the cereal inflation elevated at double-digits in October. Further, the risk from adverse weather conditions also persists. The RBI noted that the persistence of high core inflation (which has remained sticky around the 6% mark) remains an area of policy concern. Looking at the internals of core inflation, the goods inflation has moderated, and the easing of input price pressures as reflected in softening of the WPI print (8.4% YoY in October vs a high of 16.6% in May) could support a further easing of the core goods inflation. However, services inflation has inched up with the continued recovery in demand (supported by the waning of pandemic-related uncertainty) and remains an upside risk to domestic inflation. The RBI also erred on the side of caution and kept the oil price assumption unchanged at $100/bbl despite the recent decline, citing the uncertainty on the global front. Indeed, the average Brent price fell to ~US$91/bbl in November and further to ~US$84/bbl in December (data till 6th), compared with the average US$105/bbl in July. Overall, in line with the RBI's view, we expect inflation to ease over the next two quarters.

The RBI cautioned markets to wean themselves off the liquidity overhang

The RBI expects liquidity conditions to improve in the period ahead owing to a moderation in currency in circulation in the post-festival period, an expected pick up in government spending in the remaining part of FY23 and higher forex inflows due to the return of portfolio investors. The governor noted the transient episodes of tight liquidity caused by tax outflows and currency demand. Currently, the systemic liquidity surplus stood at ~Rs1.7 lakh crore as of December 6th, up from ~ Rs75K crore a month ago (and after dipping into deficit for a brief period in the second half of November). Further, the governor reiterated that despite being in absorption mode, the central bank stands ready to inject liquidity as and when needed to meet the requirements of the productive sector of the economy. That said, the RBI cautioned that it would continue to look for durable signs of a turn in the liquidity cycle and as such expects banks to draw down large parts of their Standing Deposit Facility and variable rate reverse repo balances and wean themselves away from the overhang of liquidity surpluses. Further, in a move towards normalization of liquidity conditions, the bank decided to restore market hours - from 9:00 AM to 5:00 PM (from 9:00 AM to 3:30 PM earlier) - in respect of call/notice/term money, commercial paper, certificates of deposit and repo in corporate bond segments of the money market as well as for rupee interest rate derivatives.

The governor also highlighted positive developments in the external sector amid an otherwise morose global economic environment. While the merchandise exports have borne the brunt of the weaker external demand, the surplus of services exports has provided some comfort to India's trade positioning. Furthermore, remittances to India have been strong in Q1 FY23 and are expected to record 12% growth in the full year according to the World Bank. On the financing side, FDI inflows have risen by 6.6% YoY in April-October 2022 while recent return in FPI inflows has helped reduce the net outflows. Additionally, new external commercial borrowing (ECB) agreements have been concluded for $8.6 billion, as a result of the measures announced by the RBI on July 6th 2022 to enhance forex inflows. Overall, this has improved the country's foreign reserves position to ~$560 billion at the start of December from a low of $524 billion in October providing some space for the RBI to manage excessive volatility in the domestic currency. These developments lend comfort to the viability and manageability of a higher current account deficit in FY23.

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

Regulatory and Supervisory measures & Financial Markets

- **SLR Holdings in Held to Maturity (HTM) category**
  To provide further flexibility to banks in managing their investment portfolios, the RBI has decided to extend the dispensation of an enhanced HTM limit of 23 per cent up to March 31, 2024. Banks will now be allowed to include securities acquired between September 1, 2020 and March 31, 2024 in the enhanced HTM limit. The HTM limits would be restored from 23 per cent to 19.5 per cent in a phased manner starting from the quarter ending June 30, 2024.

- **Hedging of Gold in the International Financial Services Centre (IFSC):**
  Currently, resident entities in India are not permitted to hedge their exposure to gold price risk in overseas markets. With a view to providing greater flexibility to these entities to hedge the price risk of their gold exposures, resident entities will now be permitted to hedge their gold price risk on recognised exchanges in the IFSC. This measure will benefit importers/exporters of gold such as jewellers and industries which use gold as an intermediate or raw material. The related instructions will be issued separately.

Payment and Settlement Systems

- **Enhancing the Mandates of Unified Payments Interface (UPI)**
  The capabilities of UPI will be further enhanced by introducing single-block-and-multiple-debits functionality. This facility will enable a customer to block funds in his/her account for specific purposes, which can be debited whenever needed. This will significantly enhance the ease of making payments for investments in securities including through the Retail Direct platform as well as e-commerce transactions. Separate instructions to NPCI will be issued shortly.

- **Expanding the Scope of the Bharat Bill Payment System (BBPS)**
  The BBPS has been steadily expanding since its launch in 2017. At present, it handles recurring bill payments for merchants and utilities and does not cater to non-recurring bills. It also does not cater to bill payments or collections such as payment of fees for professional services, education fees, tax payments, rent collections, etc. for individuals even if those are recurring in nature. Therefore, the scope of BBPS is being enhanced to include all categories of payments and collections, both recurring and non-recurring, and for all categories of billers (businesses and individuals). Separate guidelines will be issued to NBBL (NPCI Bharat Bill Pay Ltd.) in this regard.

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