September 30, 2022

The RBI hikes the repo rate by 50 bps; unchanged policy stance indicates further policy tightening ahead

- In today's meeting, the RBI's Monetary Policy Committee (MPC) continued the front-loading of rate hikes to contain inflationary pressures.
- It raised the policy repo rate by 50 bps to 5.90%, leading to a cumulative rate increase of 190 bps in FY23 so far.
- With inflation remaining above the RBI's upper tolerance threshold, the MPC assessed that the persistence of high inflation necessitates further calibrated withdrawal of monetary accommodation.
- On the inflation outlook, the MPC retained its headline CPI projection at 6.7% YoY for FY23, sounding cautious given the high uncertainty.
- The central bank cut its FY23 real GDP projection from 7.2% YoY to 7.0% due to a lower-than-expected Q1 FY23 growth print. The central bank expects economic resilience to continue and economic activity to gain further traction.
- Despite significant moderation in the inter-bank systemic liquidity, the RBI kept the policy stance unchanged as "focused on withdrawal of accommodation to ensure that inflation remains within the target going forward". In our view, this would imply the need for additional policy tightening.
- The RBI expects the liquidity to be augmented by a pick-up in government spending and the drawdown of banks' excess cash reserve ratio and excess statutory liquidity ratio holdings.
- With a sharp decline in forex reserves in one year, the RBI's intervention to support currency movement is likely to be calibrated going forward and will need to be accompanied by measures to boost FX inflows.
- The RBI did not provide explicit forward guidance, citing a highly uncertain environment.
- Given elevated inflation, unchanged policy stance, and aggressive policy tightening by major central banks, we now see the terminal repo rate at 6.5% compared to 6.0% previously in the current tightening cycle.

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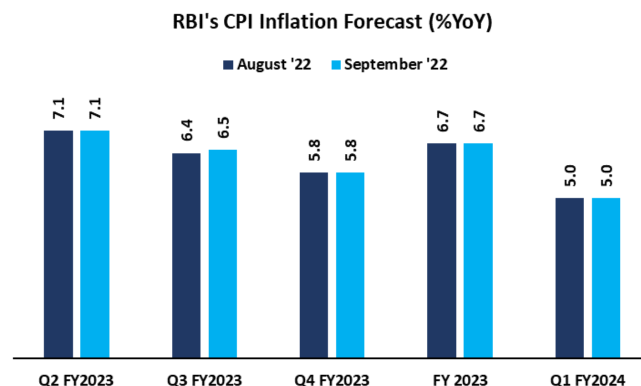
The RBI continues with front-loading of rate hikes; retains its stance of "focus on withdrawal of accommodation"

The RBI's MPC met in the backdrop of aggressive rate hikes by major central banks, tightening global financial conditions, protracted geo-political tensions, lurking global recessionary fears, and elevated domestic inflationary pressures. In today's meeting, the MPC continued the front-loading of rate hikes to contain inflationary pressures and raised the policy repo rate by 50 bps to 5.90%. This is the third consecutive 50 bps rate hike, leading to a cumulative rate increase of 190 bps in FY23. With today's rate action, the Standing Deposit Facility Rate stands adjusted to 5.65% and the Marginal Standing Facility Rate and Bank Rate to 6.15%. However, the decision was not unanimous, with one member dissenting (Dr. Ashima Goyal) who voted for a 35 bps repo rate hike. With an announcement of a lower-than-budgeted government borrowing program for the second half of the fiscal year and the RBI policy meeting being mostly on the expected lines, the 10-year yields remained largely range-bound today.

Given that the inflation print continues to stay above the RBI's upper tolerance threshold, the MPC reiterated that the persistence of high inflation necessitates further calibrated withdrawal of monetary accommodation to restrain the broadening of price pressures, anchor inflation expectations, and contain the second-round effects. Moreover, the growth momentum domestically has remained resilient despite the turmoil in the global economy, providing the RBI space to continue hiking rates to tame inflationary pressures. In our view, aggressive monetary policy actions and forward guidance by major central banks, especially the US Fed, have also led the RBI to go for a higher than 35bps rate hike, given implications for yield differential and pressures on the currency. Concerning the forward guidance, the MPC decided to continue with the focus on withdrawal of accommodation – again with one member dissenting (Prof. Jayanth R. Verma). This was despite the inter-bank systemic liquidity falling sharply in the past few weeks. The surplus level of core liquidity has possibly prevented the RBI from announcing any measures to correct the temporary liquidity mismatches. Additionally, the Governor highlighted that even as the nominal policy repo rate has been raised by 190 bps so far, the policy rate adjusted for inflation trails the 2019 levels, leading to the continuation of the focus on the withdrawal of accommodation stance. Given the highly uncertain environment, the RBI did not provide explicit forward guidance. We assess that the policy statement was slightly hawkish, given the unchanged inflation projection and an unchanged policy stance. Given this and external accounts pressures, we now see the terminal rate at 6.5% compared to 6% previously.

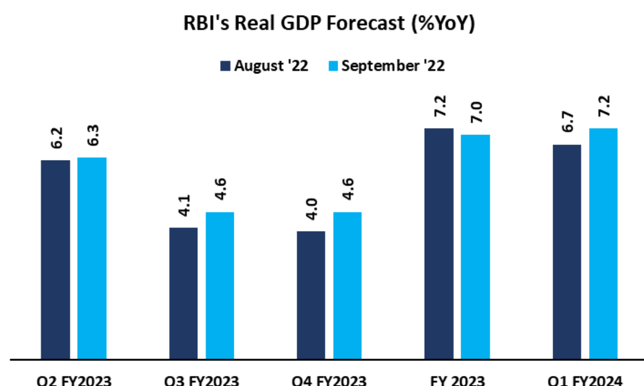
RBI retained its headline CPI inflation projection for FY23 at 6.7%, with a marginal change in the Q3 FY23 projection



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

On the inflation outlook, the MPC retained its headline CPI projections at 6.7% YoY for FY23, sounding cautious given the high uncertainty. While the quarterly forecast for Q3 FY23 was revised marginally upwards from 6.4% YoY earlier to 6.5% YoY, the Q2 FY23 and Q4 FY23 projections were retained at 7.1% YoY and 5.8% YoY, respectively. For Q1 of FY24, the RBI retained its inflation projection at 5.0% YoY. The RBI acknowledged that moderating global commodity prices, especially Brent Crude oil prices if sustained, will provide relief to domestic inflation. Indeed, the Brent oil prices fell to ~US$91/bbl (average as of September 28), compared with the average of US$98/bbl in August and US$105/bbl in July. However, we expect the uncertainty regarding the crude oil prices to persist as OPEC is expected to cut oil supply in its next meeting scheduled for October 5, amidst the slowing demand and continued fall in oil prices. This is possibly why the RBI has lowered its crude oil price assumption marginally by $5/bbl to US$100/bbl in the RBI's inflation projections. The RBI governor also highlighted the upside risks to the inflation emanating from food price pressures stemming from cereals (both wheat and rice), imported inflation (due to currency depreciation) and a catch-up in the services inflation. This is counterbalanced by easing input cost and output price pressures across firms (as per the RBI survey) and bright prospects for rabi crops. The wholesale price index also eased further in August, falling to an 11-month low of 12.4% YoY, down from 13.9% in July, reflecting the continued easing of the input pressures. Moreover, the favourable base effect in the second half of FY23 will also help moderate inflation.

RBI revised its growth projection downwards from 7.2% to 7.0% for FY23



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

On the economic outlook, the RBI assessment indicates that the central bank expects the resilience to continue and economic activity to gain further traction. The economic growth in Q1 FY23 stood at 13.5% YoY, supported by private consumption and investment demand, but came in much lower than the RBI's expectation of 16.2% YoY. High-frequency indicators, however, suggest that the Indian economy has held its ground in the face of continued external headwinds despite some indicators showing seasonal-related impact in Q2 FY23. Domestic economic activity has started gaining further traction, with both facets of consumption and investment demand noting a revival reflecting the impact of the festival-led demand, continued catch-up in the services sector, and increased CAPEX spending by the government. The robust bank credit growth in the industrial sector and increase in the capacity utilization of the manufacturing sector from 73.0% in Q4 FY22 to 74.3% in Q1 FY23 also bode well for investment activity. On the supply side, both the manufacturing and services sector PMIs for July and August indicate robust momentum. The agricultural sector also remained resilient with the catching up of the monsoon. Furthermore, the comfortable level of reservoirs will likely bode well for the Rabi sowing ahead. The RBI assesses the outlook for aggregate demand as positive, with rural demand catching up and urban demand expected to strengthen further with the typical upturn in the second half of the year. However, the positive impulses from the domestic demand are being offset by the weaker external demand as the global slowdown weighs on the exports of the country. But as per the Governor, the surplus exports from the services side should help contain the trade deficit. Keeping the missed outcome of economic growth in Q1 and all the above factors in consideration, the RBI revised its real GDP growth projection for FY23 downward from 7.2% YoY to 7.0% YoY. However, the quarterly forecasts for Q2 FY23, Q3 FY23, and Q4 FY23 were revised slightly upwards to 6.3% YoY, 4.6% YoY, and 4.6% YoY, respectively, from 6.2% YoY, 4.1% YoY, and 4.0% YoY earlier. Additionally, the growth for Q1 FY24 was also revised upwards from 6.7% YoY to 7.2% YoY, and growth for FY24 is pegged at 6.5% as per the latest Monetary Policy Report.

RBI to conduct fine-tuning operations depending on evolving liquidity conditions

On the liquidity management front, the RBI governor noted that the recent moderation in inter-bank systemic liquidity is largely temporary, potentially led by the tax payments and the forex outflow as RBI continues to intervene in the foreign exchange market to prevent excess volatility in the domestic currency. As such, the systemic liquidity surplus stood at ~Rs 8.7K crores as of September 29, down from ~Rs 2 lakh crore at the start of the month. This has led to the firming up of the short-term rates, with the weighted average call rate reaching 5.55% (September 29) compared to 5.02% at the beginning of September. Despite the moderation in systemic liquidity, the RBI did not announce any measures to correct the temporary liquidity mismatches. This could be because of the core liquidity remaining in surplus. As per the Governor, the pick-up in government spending in the second half of the year and the drawdown of the excess cash reserve ratio (CRR) and excess statutory liquidity ratio (SLR) holdings of banks are likely to augment the liquidity ahead. Keeping the current moderation in liquidity in view, the RBI decided to merge the 28-day VRRR which was announced in the October 2021 policy, with the fortnightly 14-day main auction. Subsequently, from now on, only 14-day VRRR auctions will be conducted. The RBI will also continue to manage liquidity through its two-way fine-tuning operation as and when warranted.

The central bank also highlighted the resilient external sector amidst the global headwinds. 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. The latest data shows that the current account deficit (CAD) for Q1 FY23 is at 2.8% of GDP, with the trade deficit at 8.1% of GDP. With the continued dollar strength, hawkish policy guidance by the US Fed, and the expected widening of India's current account deficit, we continue to see depreciation pressures in the near term. RBI's forex reserves have fallen sharply to $537.5 bn (as of September 23) compared to over $640 bn (October 2021), although a large chunk of the drop is due to a change in valuation (as per the RBI). Accordingly, the RBI's FX intervention will likely be calibrated going forward and will need to be accompanied by measures to boost FX inflows.

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

Discussion Paper on Expected Loss Based Approach for Loan Loss Provisioning by Banks

- As a step towards converging with globally accepted prudential norms, it is proposed to adopt the expected loss approach for loss allowances required to be maintained by banks in respect of their exposures. As a first step, a discussion paper on the various aspects of the transition will be issued.

Discussion Paper on Securitisation of Stressed Assets Framework (SSAF)

- The RBI has decided to introduce a framework for securitization of stressed assets in addition to the ARC route, similar to the framework for securitization of standard assets introduced in September 2021. Accordingly, a discussion paper detailing relevant contours of the proposed framework will be issued shortly, inviting comments on certain specific aspects.

Internet Banking Facility for Customers of Regional Rural Banks (RRBs)

- The RRBs are currently allowed to provide Internet Banking facilities to their customers with prior approval of the Reserve Bank, subject to fulfilment of certain financial and non-financial criteria. Keeping in view the need to promote the spread of digital banking in rural areas, the criteria for RRBs to be eligible to provide internet banking are being rationalized, and guidelines will be issued later.

Measures pertaining to payment and settlement systems

- **Regulating Offline Payment Aggregators (PAs):** Keeping in view the similar nature of activities undertaken by online and offline Payment Aggregators, the RBI decided to apply the current regulations (presently applicable to PAs processing online or e-commerce transactions) to offline PAs as well. This measure is expected to bring in synergy in regulation covering activities and operations of PAs apart from convergence on standards of data collection and storage. The detailed instructions will be issued separately.

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