

RBI Monetary Policy: Divergent policy focus remains on growth

The RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy rates unchanged (repo rate: 4%) and on a 5 to 1 majority to continue with the accommodative stance. Prof. Varma maintained a divergent view on retaining the policy stance for the fourth time in a row. The MPC acknowledged the need for continued policy support in the absence of a broad-based economic recovery, particularly in private consumption and contact-intensive services, despite limited economic ramifications of the ongoing third wave, and the Union Budget FY23 raising capex targets driven by enhanced market borrowing. The RBI expects FY23 GDP growth at 7.8%, a tad higher than our estimate of 7.5%, but lower than the 8.5% posted by the Economic Survey. Notwithstanding a potential improvement in growth recovery, headline consumer inflation is expected to moderate in FY23, with RBI's estimate for the fiscal pegged at 4.5%—lower than our estimate of 5%.

Targeted liquidity support to vulnerable segments of the economy continued with the RBI announcing extension of on-tap liquidity windows for emergency health services and contact-intensive sectors by another three months until June 2022. Investment limit for foreign portfolio investors (FPIs) under the Voluntary Retention Route (VRR) was enhanced by Rs 1trn to Rs 2.5trn, thereby facilitating long-term investments in government/corporate bonds. The MPC also announced restoration of normal liquidity management framework comprising of 14-day variable rate repo (VRRs) and variable rate reverse repo (VRRRs) as the main liquidity management tools, supported by fine tuning operations to take care of any unanticipated liquidity mismatches in the interim period.

The commentary was far more dovish than our and market's expectations, particularly when seen in the light of incrementally hawkish rhetoric by key global central banks. The MPC not only chose to stay put on policy rates vs. our expectations of a 15-20bps hike in reverse repo but reiterated its commitment towards a sustainable growth revival, thereby yet again refraining from providing any guidance on policy rate normalisation. With major central banks already on the tightening path, this risks the RBI getting pushed further behind the curve, thereby exposing the economy to potentially steeper and/or faster rate hikes going forward, especially if inflationary situation worsen. Given the unexpected dovish tilt today, a reverse repo hike even in the April policy doesn't look certain. That said, we maintain our expectations of a 50-75bps hike in repo rate in FY23. On the liquidity front, we expect the RBI to continue using VRRRs/VRRs and occasionally longer maturity auctions to rebalance liquidity conditions.

- **RBI keeps policy rates unchanged; maintains an accommodative stance:** In the sixth bi-monthly monetary policy review of FY22, the RBI's MPC unanimously voted to keep the policy rates unchanged. As such, the repo, reverse repo, and bank/Marginal Standing Facility (MSF) rates remain unchanged at 4.0%, 3.35% and 4.25% respectively. The accommodative stance was also retained but with a 5:1 vote, with Prof. Varma voting against it for the fourth time in a row. The MPC acknowledged that the recovery in economic activity has been uneven and incomplete, with private consumption and contact-intensive services remaining below the pre-pandemic levels, thereby calling out for continued policy support. At the same time, the MPC drew comfort from an expected moderation in CPI inflation trajectory to closer to the target rate of 4% by the third quarter of FY23.
- **FY23 GDP growth forecast pegged at 7.8%:** High-frequency indicators point to some moderation in growth momentum, reflecting supply constraints and surge in Omicron cases, with the former disrupting recovery in contact-intensive services. The MPC acknowledged the absence of a broad-based recovery even as the impact of the ongoing third wave has been limited. That said, growth prospects are likely to improve, supported by a strong Rabi season, pick-up in urban and rural demand, robust Government spending on public infrastructure, buoyant external demand, and easier financial conditions. As such, the RBI expects GDP growth in FY23 at 7.8%, with growth figures for Q1, Q2, Q3 and Q4FY23 pegged at 17.2%, 7%, 4.3%

Policy rates unanimously kept unchanged. Accommodative stance retained but with a 5:1 vote for the fourth time in a row.

FY23 GDP growth forecast has been pegged at 7.8%, higher than our estimate of 7.5% but much lower than 8.5% projected by the Economic Survey.

and 4.5% respectively. This is a tad higher than our estimate of 7.5% for the fiscal, but much lower than 8.5% estimated by the Economic Survey. Global financial market volatility, rising crude oil and commodity prices and persistence of supply-side bottlenecks remain key downside risks to domestic growth outlook.

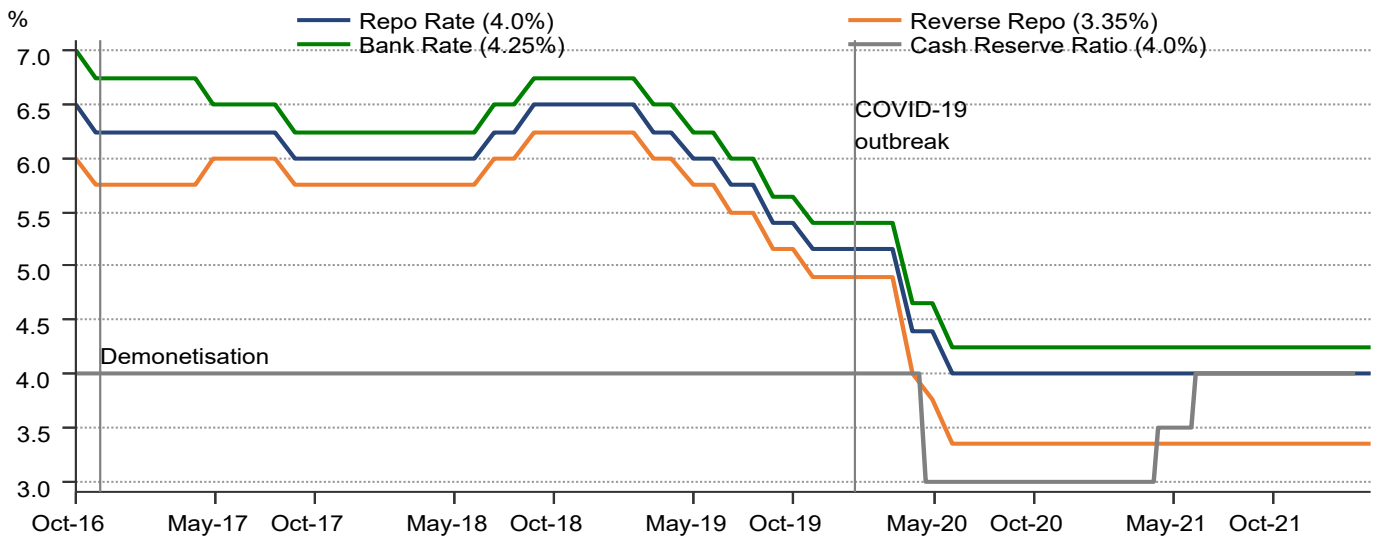
- **Inflation expected to ease in FY23:** Headline CPI inflation has fared on the expected lines since the last policy review, even as an unfavourable base may keep food prices elevated in January. Going forward, inflation is expected to gradually come off, aided by strong supply-side intervention by the Government in pulses and edible oils, fresh arrivals of winter crops, easing of pandemic-induced supply-side woes and subdued pass-through of higher input costs to final prices. As such, the RBI expects the headline CPI inflation to average at 4.5% in FY23, down from an estimated 5.3% in FY22, slowly marching lower to the RBI's mid-point target of 4% by Q3FY23. This is nearly 50bps lower than our estimate of 5%. On the negative side, continued surge in crude oil and other commodity prices, persisting supply shortages of key industrial components and higher logistic costs are likely to put upside pressures on the inflation trajectory going ahead.
- **Normal liquidity management framework restored:** With gradual return of normalcy and easing liquidity requirements, the RBI decided to restore the revised liquidity management framework. This comprises of 14-day VRRs and VRRRs becoming the main liquidity management tools and would be conducted to coincide with the Cash Reserve Ratio (CRR) maintenance cycle. These would be supported by VRRs of varying tenors and other fine-tuning operations to take care of any unprecedented liquidity mismatches in the interim period.
- **Additional measures:** Targeted liquidity support to vulnerable segments of the economy continued with the RBI announcing a) extension of term liquidity facility of Rs500bn to emergency health services by another three months until June 2022 and b) extension of on-tap liquidity window to banks of Rs150bn at the repo rate exclusively for on-lending to contact-intensive services by another three months until June 2022. Investment limit for FPIs under the VRR—first introduced in March 2019 to enable FPIs to make long-term investments with greater operational flexibility—was enhanced by Rs 1trn to Rs 2.5trn, thereby facilitating stable long-term investments in government and corporate bonds.
- **Growth continues to take precedence over inflation:** The commentary was far more dovish than our and market's expectations, particularly when seen in the light of incrementally hawkish rhetoric by key global central banks. The MPC not only chose to key policy rates unchanged vs. our expectations of a 15-20bps hike in the reverse repo rate but reiterated its commitment to revive growth on a durable basis, thereby yet again refraining from providing any guidance on policy rate normalisation. With major central banks already on the tightening path, this risks the RBI getting pushed further behind the curve, thereby exposing the economy to potentially steeper and/or faster rate hikes going forward, especially if inflationary conditions deteriorate. Given the unexpected dovish tilt today, a reverse repo hike even in the April policy doesn't look certain. That said, we maintain our expectations of a 50-75bps hike in repo rate in FY23. On the liquidity front, we expect the RBI to continue using VRRRs/VRRs and occasionally longer maturity auctions to rebalance liquidity conditions.

Average CPI inflation for FY23 is estimated at 4.5%, down from 5.3% in FY22, but 50bps higher than our estimate of 5%.

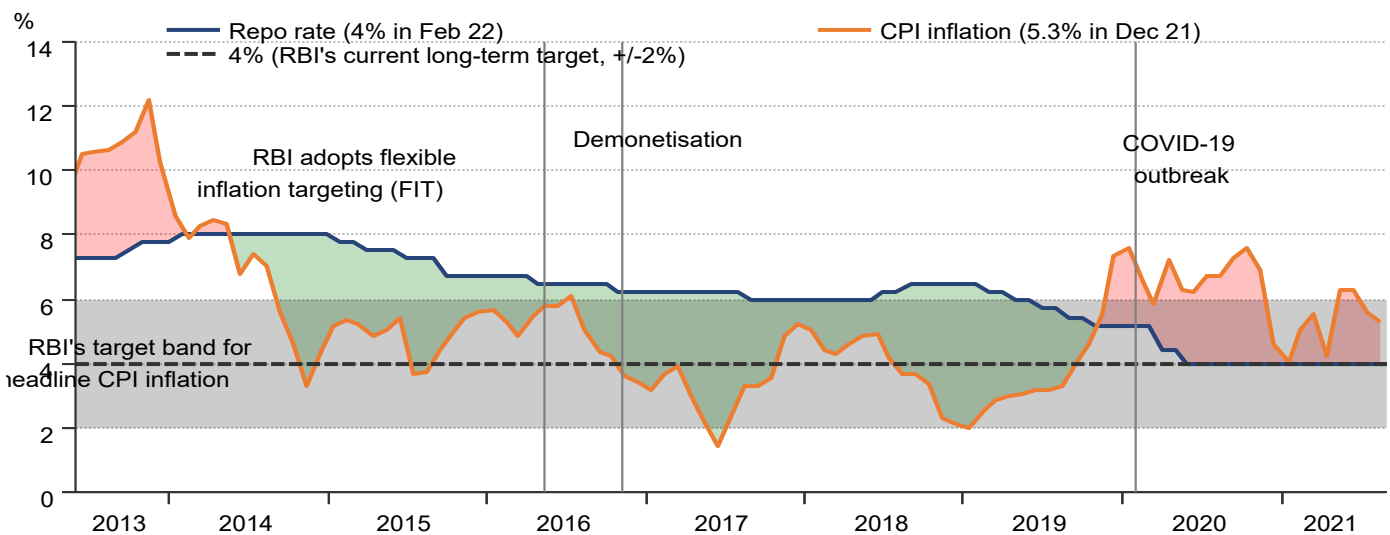
Table 1: Current policy rates

Key rates	Current value
Repo Rate	4.0%
Reverse Repo Rate	3.35%
Marginal Standing Facility (MSF) Rate	4.25%
Bank Rate	4.25%
Cash Reserve Ratio (CRR)	4.0%
Statutory Liquidity Ratio (SLR)	18.0%

Source: RBI.

Figure 1: Policy rates kept unchanged


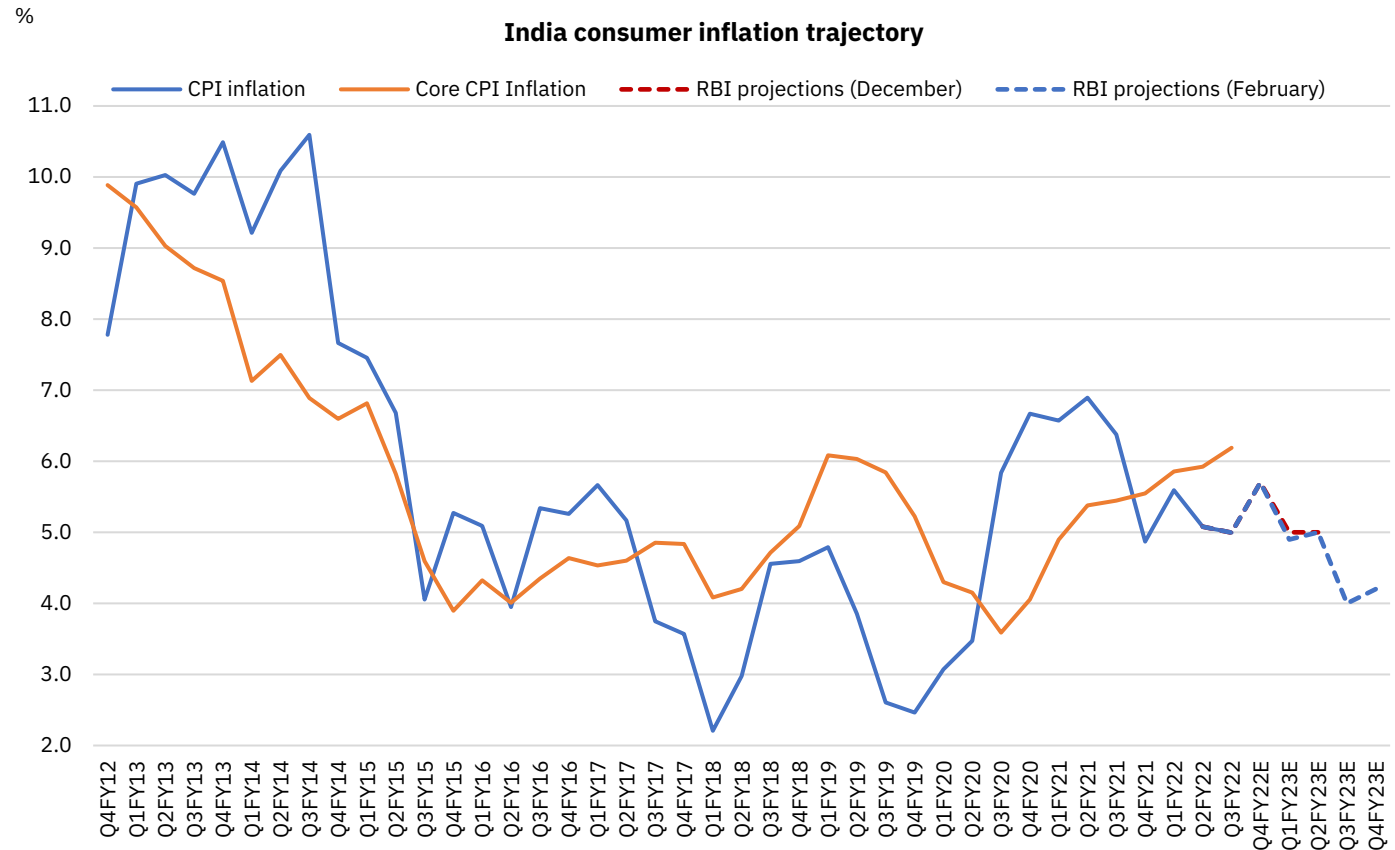
Source: Refinitiv Datastream.

Figure 2: Real interest rates have remained negative for nearly two years now


Source: Refinitiv Datastream.

Figure 3: India's consumer inflation trajectory and RBI's forecasts

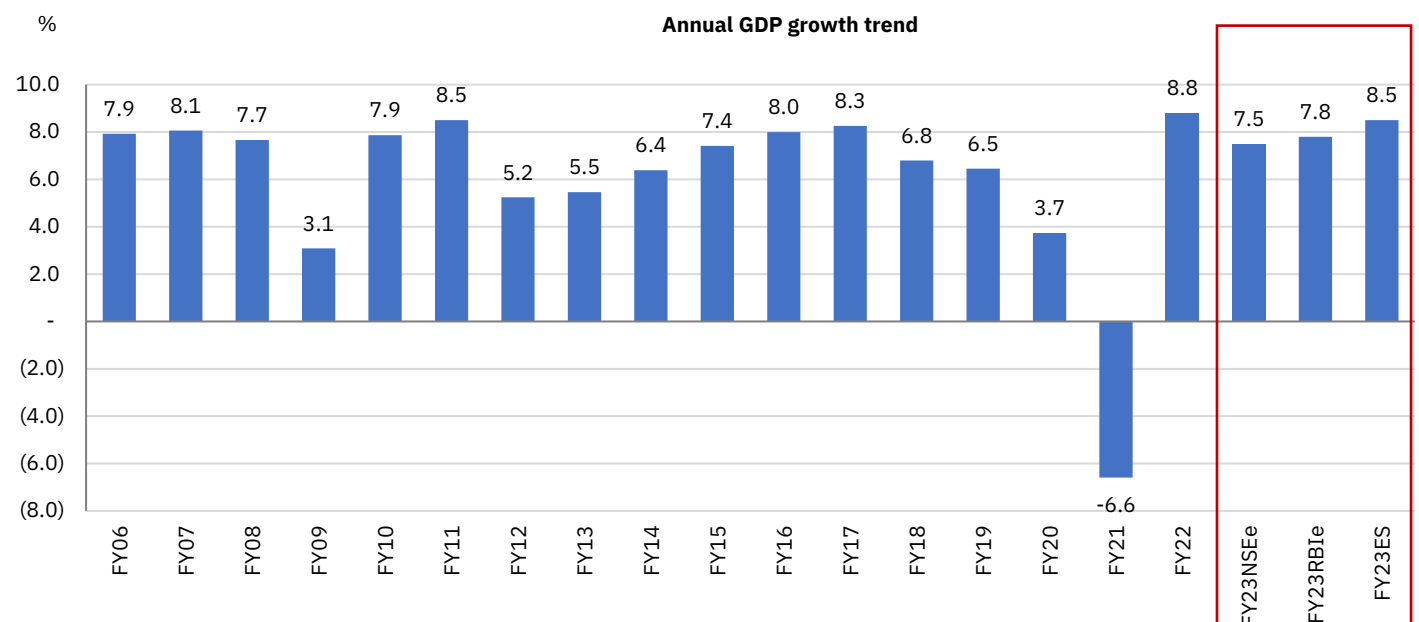
The RBI expects the headline CPI inflation to average at 4.5% in FY23, down from an estimated 5.3% in FY22, slowly marching lower to the RBI's mid-point target of 4% by Q3FY23.



Source: CMIE Economic Outlook, RBI EPR. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

Figure 4: GDP growth trend and estimate for FY23

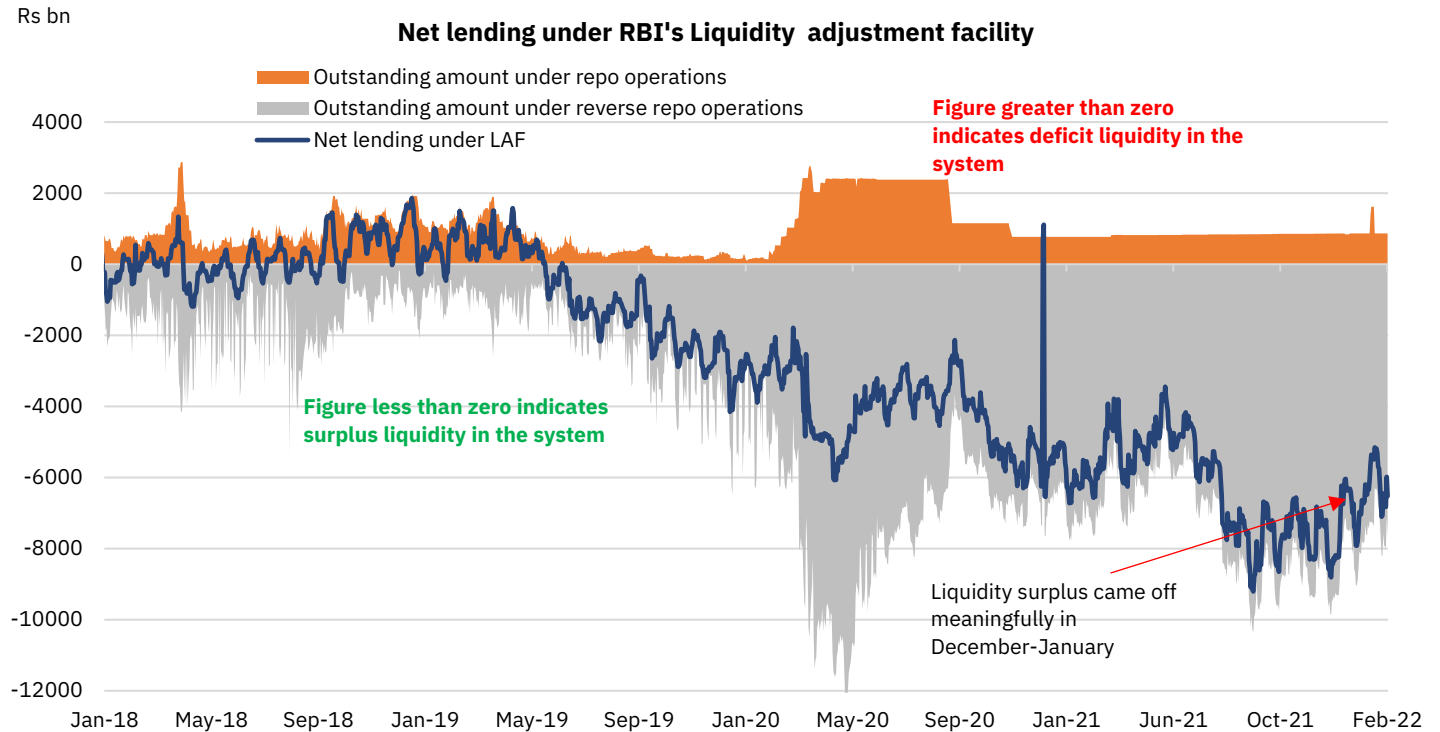
The RBI has pegged FY23 GDP growth forecast at 7.8%—a tad higher than our estimate of 7.5% but much lower than 8.5% estimated by the Economic Survey



Source: CMIE Economic Outlook, RBI, NSE EPR. NSEe = NSE estimate, RBIe = RBI estimate, ES = Economic Survey

Figure 5: Net lending under RBI's Liquidity Adjustment Facility

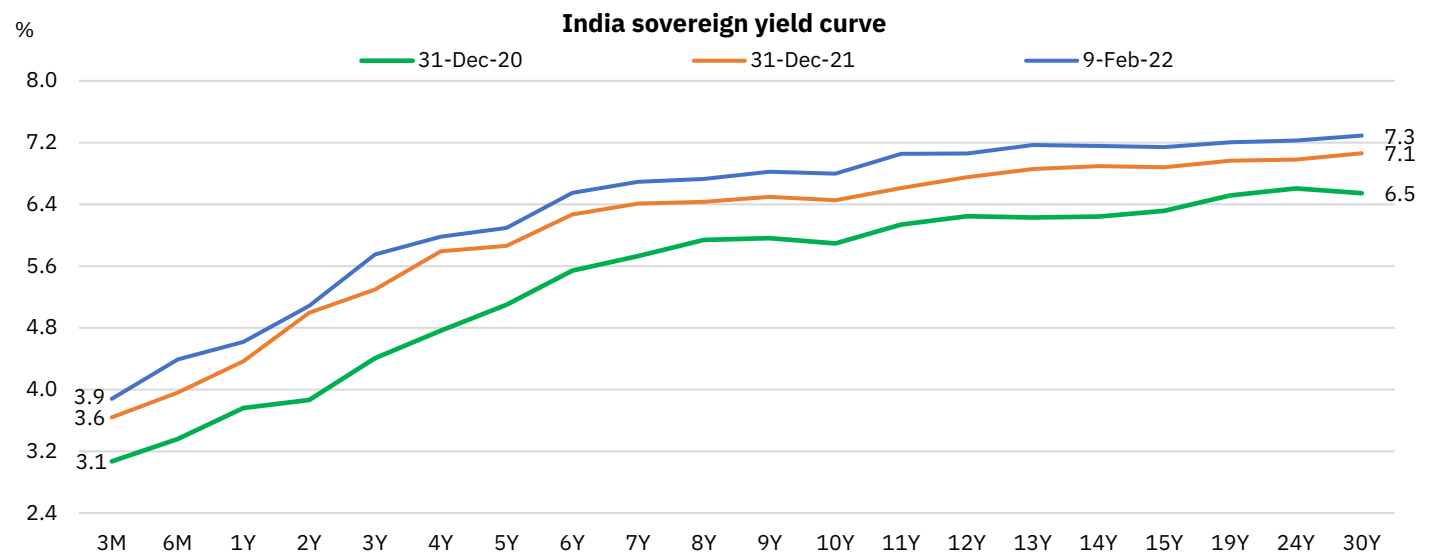
Average net daily liquidity in the system has come off meaningfully from Rs 7.6trn/Rs7.4trn in November/December 2021 to Rs 6.4trn in January.



Source: CMIE Economic Outlook, Refinitiv Datastream, NSE EPR.

Figure 6: India sovereign yield curve

Indian fixed income markets followed global suit, with yields rising across the curve in 2021 and further in 2022 thus far, reflecting the impact of continued normalization of surplus liquidity, introduction of shorter-tenor VRR auctions and higher cut-offs, rising global bond yields and heavy supply of Government paper, both the Centre as well as states.



Source: Refinitiv Datastream, NSE EPR.

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