NSE

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## RBI Monetary Policy: Inflation (finally) takes precedence

**The RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy repo rate unchanged at 4% and maintain an accommodative stance while focusing on withdrawing accommodation citing worsening growth-inflation dynamics. The RBI also introduced an overnight unlimited collateral-free Standing Deposit Facility (SDF) at 3.75% as the new floor of the Liquidity Adjustment Facility (LAF) corridor, whereby banks would deposit excess liquidity with the RBI at their discretion. This normalises the much-anticipated LAF corridor to pre-pandemic level of 50bps and strengthens the monetary policy operating framework by having standing absorption and injection facilities at the lower and upper end of the corridor respectively. The overnight fixed rate reverse repo (FRRR), however, has been retained at 3.35% as a liquidity management tool but deployed only at RBI's discretion, even as it has lost its relevance owing to SDF introduction as the floor.**

**The MPC acknowledged a build-up of upside risks to the inflation trajectory and downside risks to growth outlook in the wake of intensifying geopolitical tensions, hardening commodity prices, persistent supply chain bottlenecks, divergent policy stance and resultant financial market volatility. As such, the RBI reduced its FY23 GDP growth forecast from 7.8% to 7.2%, with growth in FY24 pegged at 6.3%. Headline CPI inflation estimate for FY23 has also seen a sharp jump from 4.5% to 5.7%, assuming a normal monsoon and average crude oil price of US$100/bbl. This is more aligned with market expectations now and reflects the impact of ongoing geopolitical uncertainty and persistent supply shortages on global commodity prices and key food items and their pass-through to retail prices.**

**A shift in RBI's focus from 'reviving and supporting growth on a durable basis' in the February policy to 'withdrawing accommodation to curtail inflationary pressures' in today's policy provides a clear indication of the future policy direction. In fact, a hike of 40bps in overnight rate via SDF introduction is more hawkish than market expectations of a guidance at best considering a massive dovish tilt in the February policy. This is reflected in a steep 10-30 bps spike in sovereign bond yields across the curve during the day, with as high as 40bps intraday movement in the one-year paper.**

**With inflation taking precedence, today's policy paves way for a change in stance to 'neutral' in the June monetary policy, followed by hike in policy repo rates beginning the August policy. Overall, we maintain expectations of 75bps hike in repo rate in the current fiscal year, with more hikes not ruled out if inflationary pressures fail to abate. On the liquidity front, despite a huge surplus overhang, the RBI would resort to only a gradual and calibrated withdrawal spanning over multiple years to ensure minimal disruption and effective completion of the Government's borrowing programme. This, in turn, should provide some support to bond yields in the wake of huge incoming supply this year.**

- **RBI keeps policy rates and stance unchanged but shifts focus towards gradual normalisation:** In the first bi-monthly monetary policy review of FY23, 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 surprisingly unanimously this time as opposed to a divergence seen over the previous four policies where Prof. Varma voted in favour of changing the stance to neutral. Notwithstanding retention of the accommodative stance, inflation took precedence over growth as the MPC clearly indicated a shift in their focus towards withdrawing accommodation to curtail intensifying inflationary pressures while gradually normalising liquidity conditions to support growth and successfully complete the Government's borrowing programme.

*Policy rates and stance unanimously kept unchanged but focus shifting towards gradual normalisation.*

- **Standing Deposit Facility (SDF) introduced as the new floor of LAF corridor:** The RBI introduced an overnight unlimited collateral-free SDF at 3.75% as the new floor of the LAF corridor (difference between the SDF and MSF rates), whereby

banks would deposit excess liquidity with the RBI at their discretion. This normalises the much-anticipated LAF corridor to pre-pandemic level of 50bps, increases RBI's flexibility to absorb liquidity and strengthens the monetary policy operating framework by having standing absorption and injection facilities at the lower and upper end of the corridor respectively. The overnight fixed rate reverse repo, however, has been retained at 3.35% as a liquidity management tool but would be deployed only at RBI's discretion, even as it has lost its relevance owing to SDF introduction as the floor.

- **Growth forecasts downgraded:** Economic recovery that was underway, facilitated by abating risks on the COVID front, rapid vaccinations and supportive fiscal and monetary policies now faces significant downside risks emanating from intensifying geopolitical tensions, hardening commodity prices, persistent supply chain bottlenecks, divergent policy stance and resultant financial market volatility. While consumer confidence index has remained in the contraction zone despite improvement, business expectations have witnessed a sequential moderation. Considering these headwinds, the RBI has downgraded its FY23 GDP growth forecast from 7.8% to 7.2% assuming average crude oil price at US$100/bbl, with growth figures for Q1, Q2, Q3 and Q4FY23 pegged at 16.2% (vs. 17.2% in Feb policy), 6.2 (vs. 7%), 4.1% (vs. 4.3%) and 4.0% (vs. 4.5%) respectively. Growth in FY24 is estimated at 6.3% with quarterly growth ranging from 5.9% to 6.8%. A 100bps change in global growth estimate from the baseline may result in a 40bps change in RBI's growth estimate. Similarly, a US$10/bbl increase in baseline crude oil price assumption could lead to a 20bps dip in baseline growth estimate.

*FY23 GDP growth forecast has been reduced by 60bps to 7.2%, with growth estimate for FY24 pegged at 6.3%.*

- **Inflation expected at much higher levels in FY23:** Headline CPI inflation has been breaching the RBI's upper tolerance level since the last policy review and is expected to overshoot RBI's 5.7% estimate for Q4FY22 by a wide margin. Ongoing geopolitical tensions, coupled with accentuated global supply-chain disruptions, have led to a sharp spike in global commodity prices and logistics cost. Additionally, increase in global cereal prices have fed into domestic prices, while supply shortages have continued to build price pressures on other food items. This may feed into final retail prices, notwithstanding support from continued slack in the economy. Considering this, the RBI has revised its FY23 inflation forecast by a steep 120bps from 4.5% to 5.7%, aligning it more with market expectations, assuming a normal monsoon and average crude oil price of US$100/bbl. A US$10/bbl increase in baseline crude oil price assumption of US$100/bbl may lead to a 30bps spike in baseline inflation estimate.

*The RBI has revised its FY23 inflation forecast by a steep 120bps from 4.5% to 5.7%.*

- **Gradual liquidity normalisation to provide support to Government's borrowing programme:** Even as the RBI has hinted towards withdrawing accommodation as soon as the next policy review, it would withdraw excess surplus liquidity currently prevalent in the system to the tune of Rs8.5trn in a phased and calibrated manner over multiple years to ensure minimal disruption, support growth and successfully complete the Government's borrowing programme. The enhancement of limit available to banks under the Held to Maturity (HTM) category from 22% to 23% until March 31st, 2023 is also likely to provide demand support for G-secs, thereby providing some respite to bond yields in the wake of huge incoming supply this year.

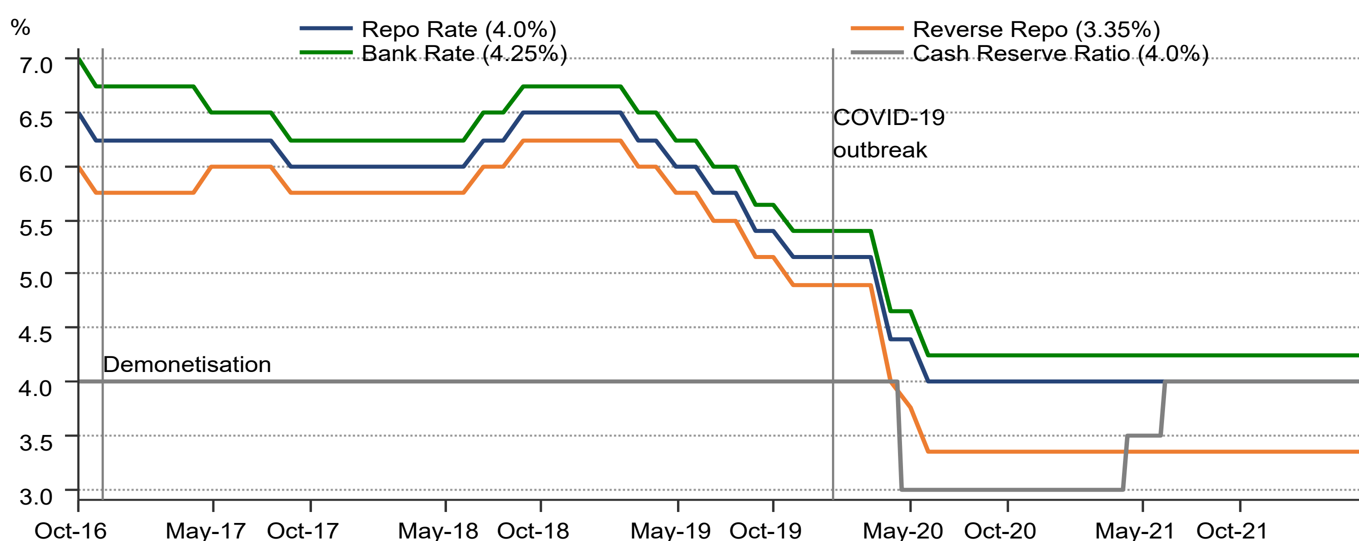
- **Inflation takes precedence over growth; normalization in the making:** Following an unexpectedly strong dovish tone in the February policy, today's policy has taken a U-turn with inflation taking precedence over growth. A shift in RBI's focus from 'reviving and supporting growth on a durable basis' in the February policy to 'withdrawing accommodation to curtail inflationary pressures' in today's policy provides a clear indication of the future policy direction. In fact, a hike of 40bps in overnight rate via SDF introduction is more hawkish that market expectations of a guidance at best considering a massive dovish tilt in the February policy. This is reflected in a sharp spike in sovereign bond yields across the curve post the policy announcement—as high as ~40bps for one-year paper. With inflation taking precedence, today's policy paves way for a change in stance to 'neutral' in the June monetary policy, followed by hike in policy repo rates beginning the August policy. Overall, we maintain expectations of 75bps hike in repo rate in the current fiscal year, with more hikes not ruled out if inflationary pressures fail to abate.

**Table 1: Current policy rates**

| Key rates | Previous value | Current value |
|---|---|---|
| Repo Rate | 4.0% | 4.0% |
| Reverse Repo Rate | 3.35% | 3.35% |
| Standing Deposit Facility (SDF) | NA | 3.75% |
| Marginal Standing Facility (MSF) Rate | 4.25% | 4.25% |
| Bank Rate | 4.25% | 4.25% |
| Cash Reserve Ratio (CRR) | 4.0% | 4.0% |
| Statutory Liquidity Ratio (SLR) | 18.0% | 18.0% |

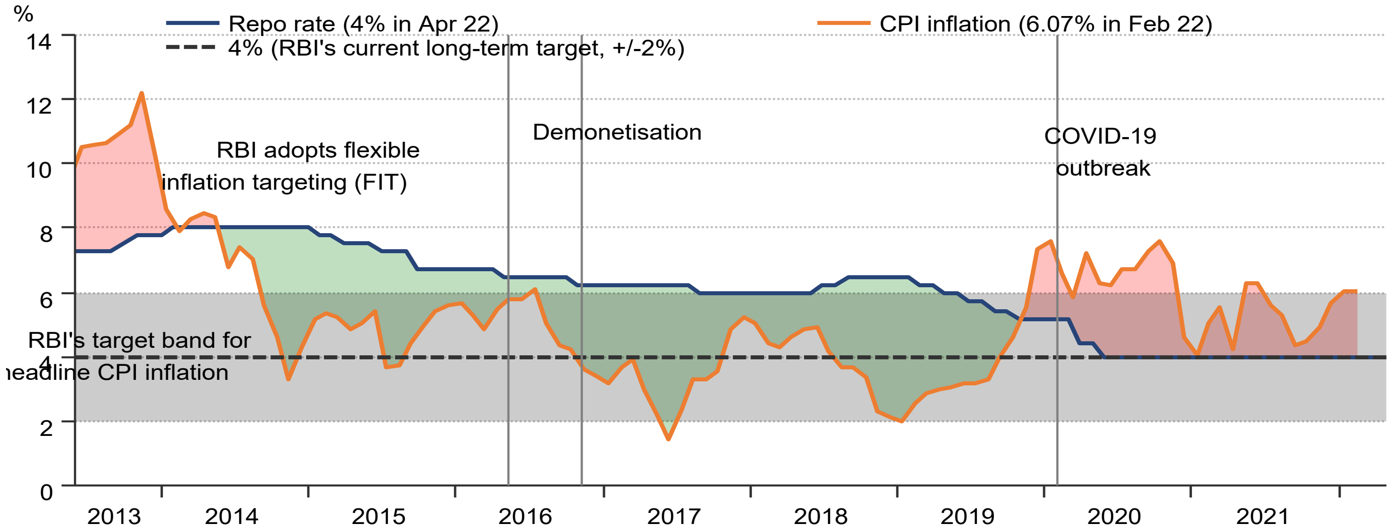
Source: RBI, NSE EPR.

**Figure 1: Policy rates kept unchanged**




Source: Refinitiv Datastream, NSE EPR.

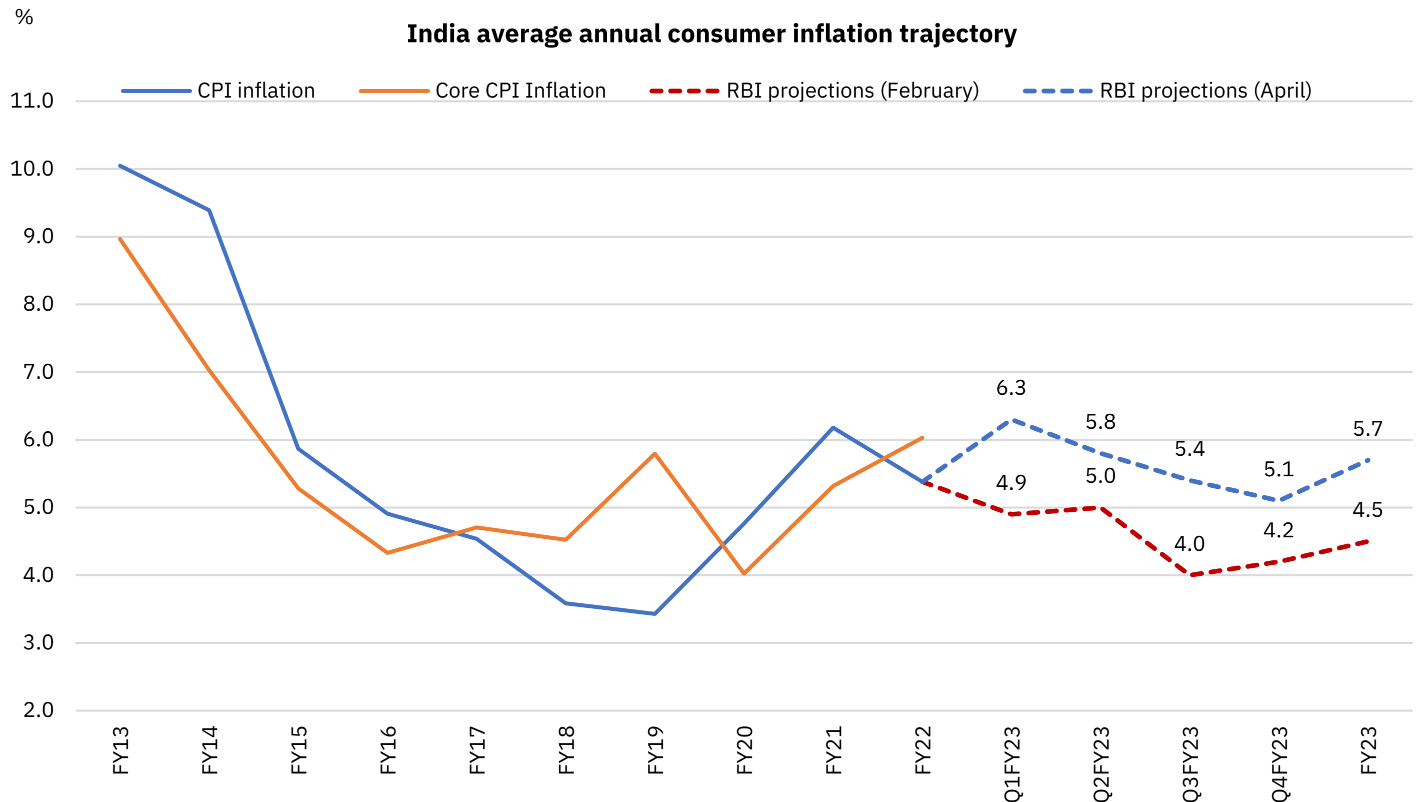
**Figure 2: Real interest rates have remained negative for more than two years now**




Source: Refinitiv Datastream, NSE EPR.

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

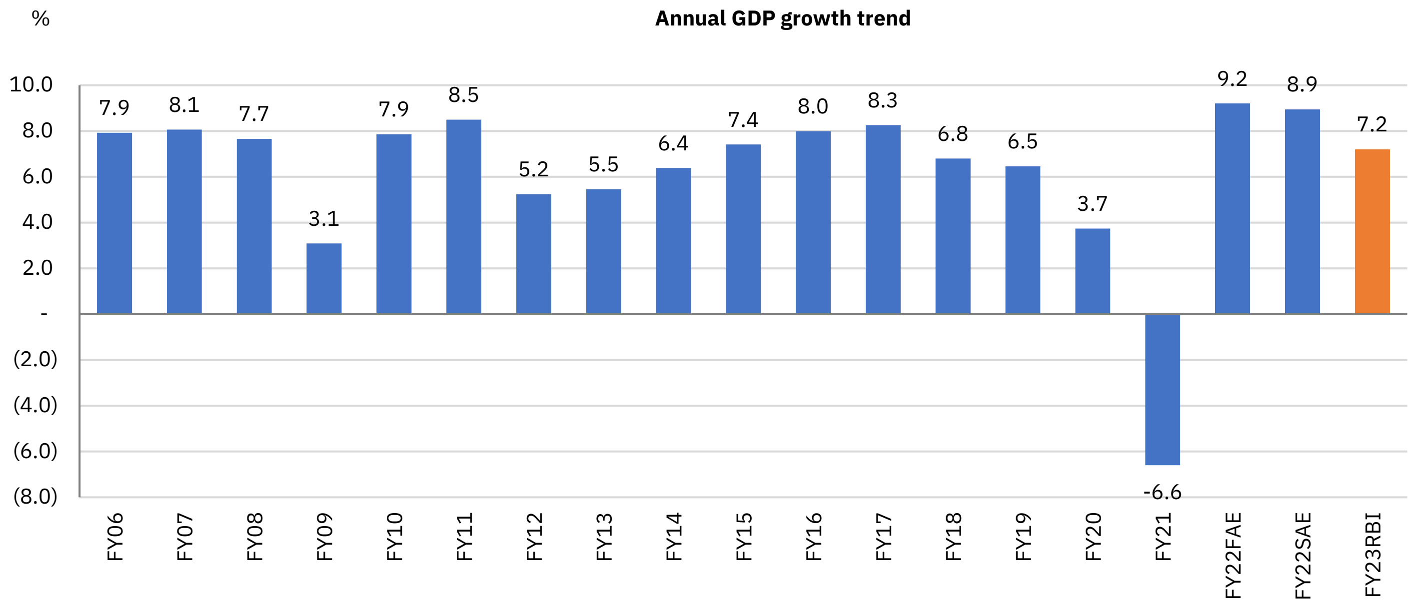
The RBI I has revised its FY23 inflation forecast by a steep 120bps from 4.5% to 5.7%, aligning it more with market expectations, assuming a normal monsoon and average crude oil price of US$100/bbl.




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

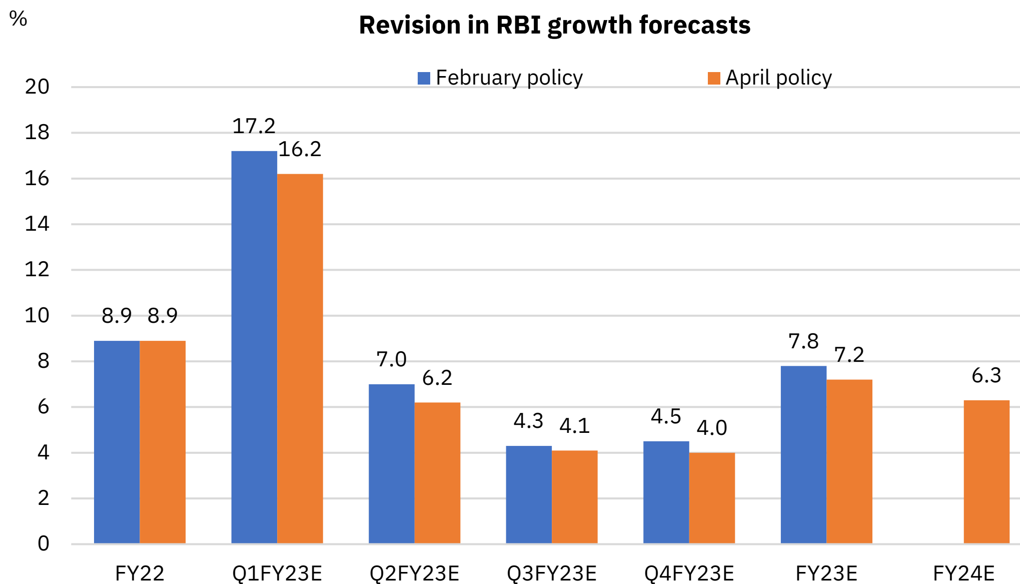
**Figure 4: GDP growth trend and estimate for FY23**

The RBI has downgraded its FY23 GDP growth forecast from 7.8% to 7.2% assuming average crude oil price at US$100/bbl, with growth figures for Q1, Q2, Q3 and Q4FY23 pegged at 16.2% (vs. 17.2% in Feb policy), 6.2 (vs. 7%), 4.1% (vs. 4.3%) and 4.0% (vs. 4.5%) respectively. Growth in FY24 is estimated at 6.3% with quarterly growth ranging from 5.9% to 6.8%.




Source: CMIE Economic Outlook, RBI, NSE EPR. RBIe = RBI estimate, FAE = First Advance Estimate, SAE = Second Advance Estimate.

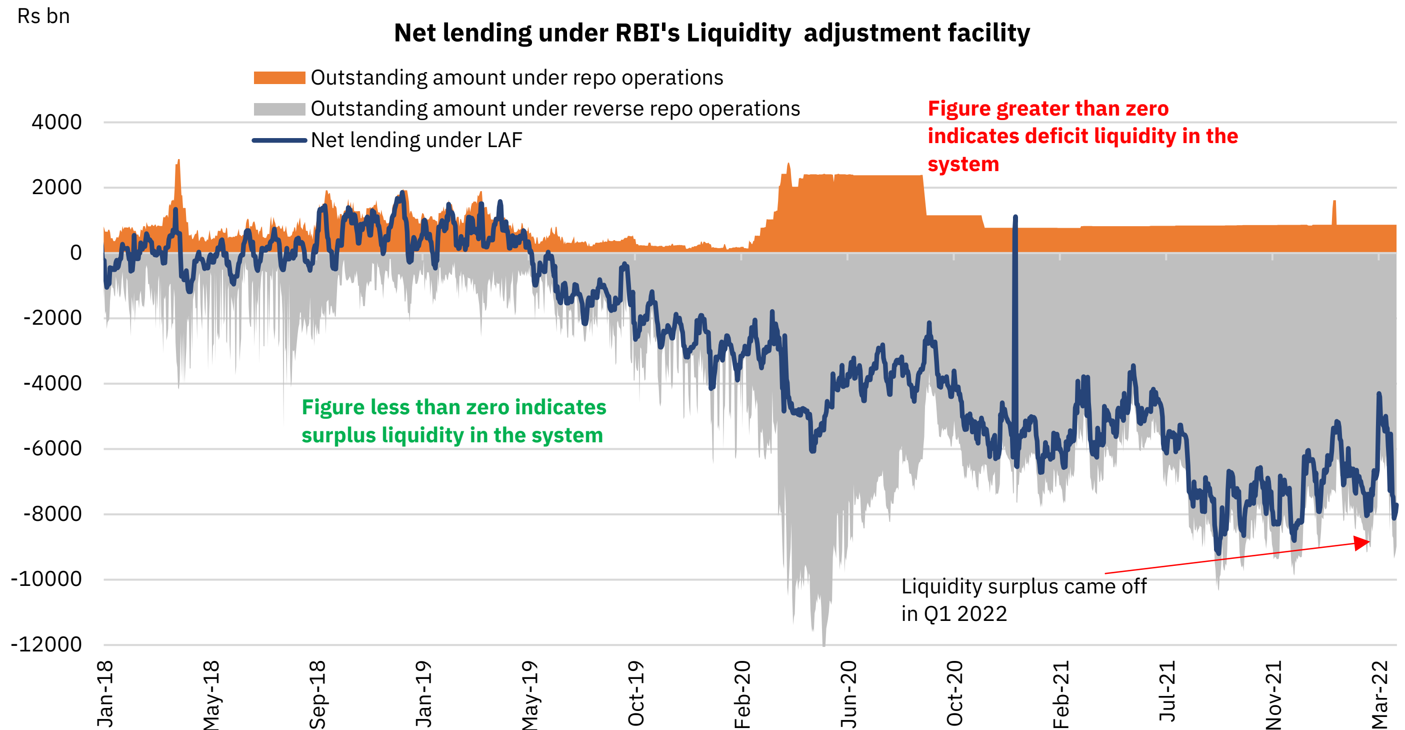
**Figure 5: Revision in RBI growth forecasts**




Source: CMIE Economic Outlook, RBI, NSE EPR. E = RBI estimates.

**Figure 6: Net lending under RBI's Liquidity Adjustment Facility**

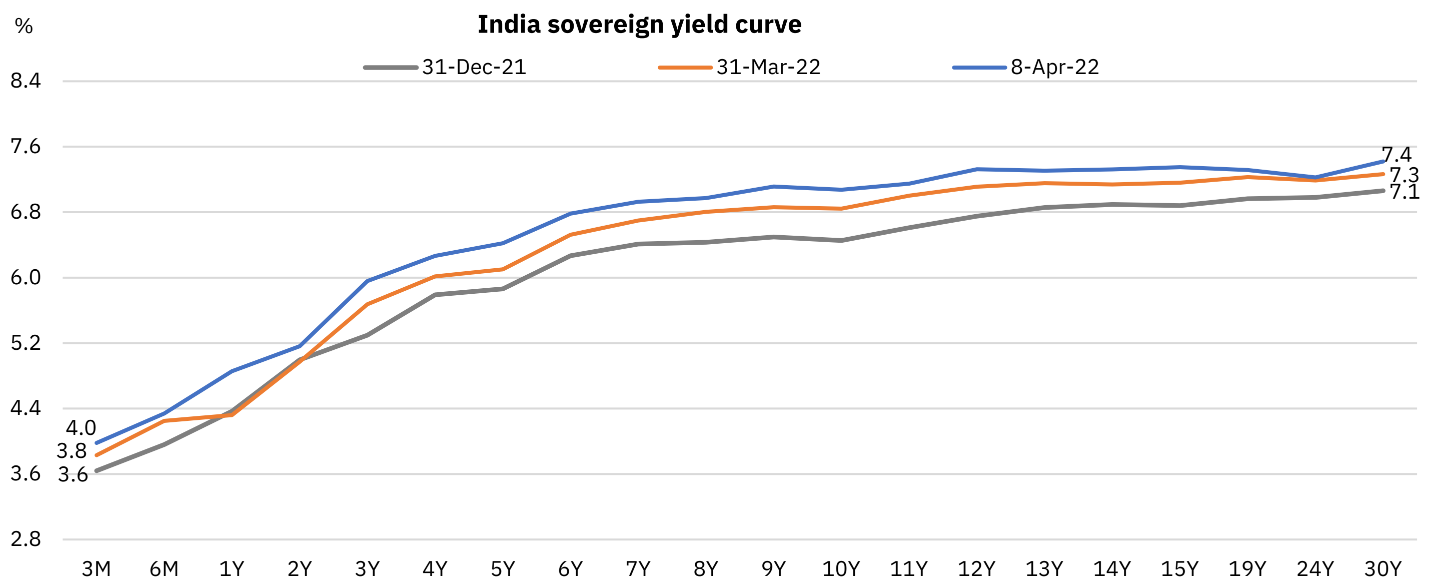
Huge liquidity injection during the pandemic, coupled with unconventional liquidity measures undertaken, has led to a liquidity surplus overhang of nearly Rs8.5trn which the RBI aims to withdraw in a gradual and calibrated manner. The objective is to ensure minimal economic disruptions and successfully complete the Government's borrowing programme.




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

**Figure 7: India sovereign yield curve**

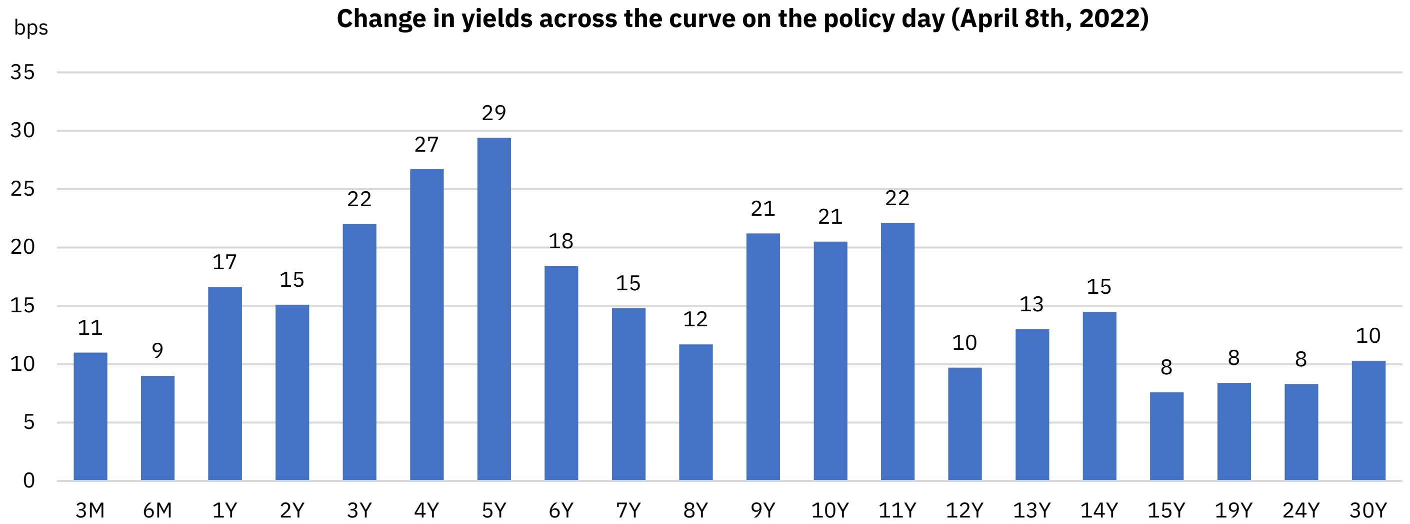
Indian fixed income markets followed global suit, with yields rising across the curve in 2022 thus far. Besides global factors, rising inflationary pressures back home, expectations of rate hike, rising crude oil and commodity prices and heavy supply of Government paper led to an upward shift in the yield curve.




Source: Refinitiv Datastream, NSE EPR.

**Figure 8: Movement in yield curve on the policy date (April 8th, 2022)**

Stronger-than-expected hawkish tilt today led to a sharp spike in sovereign bond yields across the curve post the policy announcement and nearly as high as ~40bps intra-day movement in the one-year paper.




Source: Refinitiv Datastream, NSE EPR.

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