RBI Monetary Policy Review

September, 2022

L&T Financial Services
Mutual Fund

The Monetary Policy Committee (MPC) came out with their bi-monthly policy statement today. Some of the key announcements are as follows:

→ The MPC decided by a majority of 5 out of 6 members to increase the policy repo rate under the Liquidity Adjustment Facility (LAF) by 50 bps to 5.90%

→ Consequently, the Standing Deposit Facility (SDF) rate was adjusted to 5.65% and the Marginal Standing Facility (MSF) rate and Bank Rate adjusted to 6.15%

→ The MPC also decided by a majority of 5 out of 6 members to remain focused on withdrawal of accommodation to ensure that inflation remained within the target going forward while supporting growth

Among the MPC members, Dr Ashima Goyal voted to increase the Repo Rate by only 35 bps. Similarly, the decision to remain focused on withdrawal of accommodation was not unanimous, with Prof. Jayanth Varma expressing his reservation on this part of the resolution.

Considering a base case assumption of average crude price (Indian basket) of USD 100/bbl the growth and inflation projections have been mentioned below:

→ Real GDP growth for FY2023 has been revised downwards to 7.0% from 7.2% earlier, with the following quarterly projections: Q2 FY2023 at 6.3%, Q3 at 4.6%, Q4 at 4.6% and Q1 FY2024 at 7.2%, with risks broadly balanced

→ CPI projection for FY2023 has been retained at 6.7% with quarterly projections kept broadly unchanged: Q2 FY2023 at 7.1%, Q3 at 6.5%, Q4 at 5.8% and Q1 FY2024 at 5.0%, with risks evenly balanced

The Governor mentioned that global markets have remained extremely volatile and such an uncertain environment has pushed both AEs and EMEs to take decisive steps to curb inflation. Although India is much better placed than most economies, if inflation is not curtailed, the second order effects can unsettle inflation expectations. Against this backdrop, the MPC needs to stay nimble and carry forward its calibrated action on policy rates and liquidity conditions. On liquidity, the Governor mentioned that the RBI will conduct fine-tuning operations in the form of VRRs and VRRRs operations of various tenors, depending on the evolving liquidity conditions.

Market Movement:

The policy action was broadly in line with market expectations. However, the Governor did mention that the current policy rate adjusted for inflation is lower than the levels witnessed in 2019, when Repo Rate was 5.75% and inflation expectations were around 3.4%-3.7%. Whether the MPC treats this as a target level for real policy rates going forward will remain a key monitorable, as this would push terminal rates much beyond 6.50% (which the markets are currently pricing in).

The shorter end saw a relief rally drawing comfort from the Governor's statement that VRR auctions can be used as and when required to inject liquidity into the system. Yields in the 1-year segment moved lower by 5-10 bps. G-Sec and Corporate bonds in the 2-4 year segment were also lower by 3-5 bps. However, longer end G-Sec yields moved higher by 5 bps, with possibly part of the market expecting some news pertaining to OMOs given the recent tightness in liquidity.

Outlook

With the markets already having re-priced MPC hike expectations from 25/35 bps to 50 bps over the past few weeks, the RBI Governor's job today became that much easier. Governor Das stuck to a script which refrained from any kind of forward guidance.

On the margin, we view the September MPC as more hawkish than what markets are currently expecting - by creating enough room for the MPC to take future actions based on the evolving global situation, as well as incoming inflation-growth data domestically. This means that upward risk to the notion of 6-6.25% being the terminal rate in this cycle has increased, especially if global central bank actions over the coming few quarters, necessitate similar RBI actions. The somewhat vague reference to real policy rates still lagging at the June 2019 levels, when real rates were upwards of 2% and liquidity in marginal deficit, seems to imply that a shift to neutral from "withdrawal of accommodation" is still some time (and hikes) away.

The RBI Governor also seemed sanguine about the current liquidity situation, which according to him was still comfortably in surplus. Accordingly, any hopes of the RBI stepping in with OMOs to support markets and infuse liquidity seem unlikely over the near term.

Overall – we remain cautious in our outlook for yields, especially at the longer end and continue to expect longer term interest rates to harden over the coming few months as increased supply meets reduced demand from banks, in an environment of robust credit demand.

Source: RBI Press Release, internal