RBI Monetary Policy Review

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

- The MPC members unanimously voted to increase the policy repo rate under the Liquidity Adjustment Facility (LAF) by 50 bps to 4.90% with immediate effect
- Consequently, the standing deposit facility (SDF) rate was adjusted to 4.65% and the Marginal Standing Facility (MSF) rate and Bank Rate adjusted to 5.15%
- The MPC also unanimously decided to remain focused on the withdrawal of accommodation to ensure that inflation remained within the target going forward, while supporting growth

In light of the continuing geopolitical tensions between Russia and Ukraine, soaring energy and commodity prices and global supply chain disruptions, the MPC came out with revised growth and inflation outlook. Considering a base case assumption of a normal monsoon and an average crude price (Indian basket) of USD 105/bbl the projections have been mentioned below:

- Real GDP growth for FY2023 has been retained at 7.2% with the following quarterly projections: Q1 FY2023 at 16.2%, Q2 at 6.2%, Q3 at 4.1% and Q4 at 4.0%, with risks broadly balanced
- CPI projection for FY2023 has been revised upwards to 6.7% (from an earlier estimate of 5.7%) with the following quarterly projections: Q1 FY2023 at 7.5%, Q2 at 7.4%, Q3 at 6.2% and Q4 at 5.8%, with risks evenly balanced

Since the February policy, the CPI inflation outlook has been revised upwards by 220 bps and inflation is now expected to remain above the upper tolerance band of 6% through the first three quarters of FY2023. However, the Governor did mention that the projection of 6.7% does not account for the impact of today's policy action. Additionally, the MPC has dropped the phrase "remain accommodative" from the stance and has only retained the term "withdrawal of accommodation". The Governor also mentioned that the RBI remains focused on the orderly completion of the government's borrowing programme and has all tools at its disposal to act when required.

Market Movement

In the absence of any CRR hike announcement and a rate hike of 50 bps broadly in line with market expectations, yields reacted positively to the MPC statement. The increase in CPI projection of 100 bps from the April policy does not include the impact of the hike conducted today. This hints that RBI does not want the markets to get a negative surprise on future inflation prints, given the status quo in market conditions.

Money market papers rallied by 10-15 bps post policy. Corporate bonds up to 3 years moved lower by around 10 bps. G-Sec in the 4-year segment also fell by 10 bps. Longer end G-Sec rallied by almost 10 bps post policy, however, levels corrected towards the end of the day with yields lower only by 2-3 bps d-o-d.

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Outlook

In the run-up to the MPC meeting, bond markets had already been discounting a fair bit of RBI hawkishness with yields having backed up meaningfully across segments. Hence, RBI's 50 bps hike without a concomitant CRR hike, ended up having a calming effect on the markets – leading to some fall in yields post policy, especially at the short to medium end part of the curve.

In his statement as well as later in the press conference, the RBI Governor has been very careful to not give any forward guidance on the future path of interest rate trajectory – either in terms of the likely size of hikes over the coming few meetings or also in terms of the terminal rate. Rather, based on their FY2023 CPI forecast of 6.7% and the Q4 CPI forecast of 5.8%, markets have had to continue guesstimating the likely trajectory. With very high levels of uncertainty on the future trajectory of global parameters such as inflationary pressures in developed markets, likely direction of commodity prices especially oil and also domestic CPI movements over the coming few quarters, Governor Das has made RBI actions entirely data dependent, without any clear framework or guidelines to tie up their actions.

In our view, with Q4 CPI likely to have some upside risks to the RBI projection of 5.8%, we expect the terminal rates to be in the range of 6-6.5% over the course of the next year. That would imply a greater than zero real rate, which is essential from a macro-economic stability perspective and to ensure that savers are not disincentivised any further. Currently, the 2-4 year part of the curve is pricing at a higher terminal rate than this, and accordingly, we see good value in this segment for investors who are looking at a medium-term investment horizon. However, we remain cautious in our outlook on the longer end of the yield curve as that segment needs to become much more attractive (yields to move higher) to justify adequate relative value versus the 2-4 year space.

Source: RBI Press Release, internal