MPC Review – A much needed Pivot

- **RBI surprised the markets by narrowing LAF corridor to 50bps from 90bps with introduction of SDF in lieu of reverse repo at 3.75%, effectively raising reverse repo rate by 40bps**
- **RBI has explicitly stated it is beginning withdrawal from accommodation. Notably, inflation has again found precedence over growth in its guidance, a first since February 2019**
- **This is because of sharp increase in inflation forecast for FY23 to 5.7% from 4.5% earlier (Our estimate: 6%). GDP growth also revised lower to 7.2% (our estimate: 7.4%)**
- **We now expect RBI to change stance to neutral in June with a repo rate hike. We now expect 100bps repo rate hike in FY23 (75bps earlier) and terminal repo rate at 6% (5.5% earlier)**

LAF corridor normalised, forward guidance changed: RBI normalised the LAF corridor to 50bps while introducing Standard Deposit Facility (SDF) which will be floor of the corridor at 3.75%. Notably, reverse repo rate remained at 3.35% but will be at the discretion of RBI. For operational purposes, SDF is what matters. The forward guidance also changed. First, while stance is accommodative, "withdrawal of accommodation" is part of the guidance. Second, inflation has found precedence over growth in the April policy. While up to February 2022, growth recovery on sustainable basis and mitigating impact of Covid-19 took precedence over inflation.

Inflation revised up: RBI revised its inflation projection for FY23 to 5.7% from 4.5% earlier. The new projection is based on USD 100/bbl oil price. The quarterly trajectory is ranging from 6.3% in Q1 to 5.1% in Q4. More importantly, RBI is currently projecting an inflation of 5.5% in Q4FY24. Our baseline assessment is for inflation at 6% in FY23. While inflation should come down in FY24, we continue to see it above 5% for now on the back of 1) energy prices sustaining at elevated levels, 2) industrial metal prices remaining on the higher side, and 3) disruption to global food supply chains. In the current calendar year alone, oil is up by 29%, coal by 66% and industrial metals by 23%. Global food prices are up by 37% YoY. On the domestic front, services inflation should also nudge higher in the medium-term with contact intensive services resuming.

Growth reduced to 7.2% in FY23: With a sharp revision to global growth to 2.6% from 3.6% earlier (UNCTAD), drag on consumption on account of inflation and decline in corporate margins on account of sharp increase in commodity prices, RBI revised its growth estimate for FY23 to 7.2% (USD 100/bbl). At the same time, higher agri exports and food inflation should propel rural demand. Even urban demand is likely to recover as restrictions have been removed. PLI scheme should aid manufacturing investments and government infra spending will crowd-in private capex. India's start-up ecosystem and IT exports should continue to do well. Thus on balance, we expect growth at 7.4% in FY23.

Corridor narrowed, SDF introduced: RBI was empowered to introduce Standing Deposit Facility (SDF) in 2018. It is uncollateralised liquidity absorption tool as against fixed reverse repo facility which is collateralised liquidity absorption tool. The LAF corridor (difference between and MSF and reverse repo) had been increased to 90bps during pandemic. It now stands at 50bps with SDF being the floor of the corridor. As of yesterday, RBI absorbed INR 7.7tn, largely through variable rate reverse repo window. During pandemic, RBI offered liquidity facilities of INR 17.2tn out of which INR 11.9tn was utilised. The liquidity overhand in the system is to the tune of INR 8.5tn. With withdrawal of accommodation, RBI will engage in calibrated withdrawal of liquidity over a multi-year time frame in a non-disruptive manner with the objective of restoring liquidity to a level consistent with prevailing stance of monetary policy. At the same time, RBI stated that it is focused on completion of borrowing program of the government for which we see calibrated OMOs in the offing. Higher HTM limit for banks is also a step in that direction.

What has changed in our trajectory?: First, we see RBI moving to neutral stance in June and raising repo rate straight away by 25bps. Second, we have raised our terminal repo rate to 6% from 5.5% earlier. Third, we have increased extent of repo rate hike in FY23 and FY24 to 100bps each from 75bps each earlier. Given the unexpected hawkish pivot by RBI, Indian 10-Year yield moved up by 16bps today. We see yields continuing to move up during the year on the back of rising US yields, elevated government borrowing and CPI inflation remaining above RBI's upper tolerance band of 6%. Short-term more than long-term. Our near-term range for 10-year is 7-7.25%.

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Annexure: Statement on developmental and regulatory measures

- **Introduction of the Standing Deposit Facility (SDF)**: SDF is instituted at 3.75% with immediate effect. The SDF to replace the fixed rate reverse repo (FRRR) as the floor of the LAF corridor. The FRRR along with the SDF will provide flexibility to the RBI's liquidity management framework.
- **Restoration of the Symmetric LAF Corridor:** The LAF corridor is restored to its pre-pandemic level of 50bps from the current 90bps. Thus, LAF corridor will be symmetric around the policy repo rate.
- **Individual Housing Loans – Rationalisation of Risk Weights:** The risk weights for all new individual housing loans up to 31 March 2023 will be continued as per circular dated 12 October 2020.
- **SLR Holdings in HTM category:** HTM limits has been enhanced to 23% from 22% earlier for securities acquired between 01 April 2022 to 31 March 2023. The limits would be restored to 19.5% in a phased manner starting from Q1FY24-end.
- **Interoperable Card-less Cash Withdrawal (ICCW) at ATMs:** It is proposed to enable customer authorisation through the use of Unified Payments Interface (UPI) while settlement of such transactions would happen through the ATM networks.
- **Bharat Bill Payment System – Rationalisation of Net-worth Requirement for Operating Units:** It is proposed to align the net worth requirement of non-bank Bharat Bill Payment Operating Units (BBPOUs) with that of other non–bank participants who handle customer funds (like Payment Aggregators) and have a similar risk profile.
- **Cyber Resilience and Payment Security Controls of Payment System Operators (PSOs):** It is proposed to issue the directions for Payment System Operators (PSOs) to cover robust governance mechanism for identification, assessment, monitoring and management of cybersecurity risks including information security risks and vulnerabilities.

Source: RBI

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