MPC Review: A dovish pivot

- **MPC voted unanimously to keep repo rate unchanged at 4%. Accommodative stance maintained with 5:1 majority. Reverse repo rate was kept unchanged at 3.35% instead of our view of 20bps increase**
- **RBI retained its FY23 growth forecast at 7.8% on the back of traction seen in exports, higher public capex and revival of contact intensive services as virus wanes. We expect GDP growth at 8.2% in FY23**
- **Despite rising international energy and commodity prices, RBI reduced Q1 inflation to 4.9% (-10bps). FY23 inflation estimated at 4.5% on the back of supply side response from government**
- **Yields fell across the board, short-end more than long-end**
- **Earlier we believed RBI will narrow the corridor before changing stance. Now we expect RBI to change stance and narrow the corridor simultaneously in June and communicate its strategy in April**

RBI pegged FY23 growth forecast at 7.8%: RBI has retained its growth forecast at 7.8% in FY23. Growth is likely to sustain because of rising exports (+46.8% in FYTD22), government capex (+25% in FY23) and success of government schemes such production linked incentives (PLI). India is now the second largest manufacturer of mobile phones with a production of 300mn handsets. Real estate sector is recovering and India's start-up ecosystem is the third largest in the world. In addition, IT sector is on the cusp of growth cycle driven by global push for digitization and higher IT spend. With a normal monsoon and more than adequate reservoir levels, we estimate GDP to grow by 8.2% in FY23. Key risks to our forecast: mutation of virus, higher global commodity and energy prices and supply-side bottlenecks.

Inflation to edge lower: Since the last policy, international oil prices have moved up by USD 15/barrel. In this calendar year alone, international base metal prices are up by 6%. This backdrop is likely to push upward pressure on inflation outcomes next financial year. Not only did RBI reduce its inflation forecast for Q1FY23 marginally by 10bps to 4.9%, it also believes inflation is likely to be at target level in Q3FY23 at 4% before settling in at 4.2% in Q4FY23. While there are inflationary pressures emanating from pass-through of higher input costs to consumers, RBI's estimates suggest it is building-in supply side response from government to manage any upside risk. For instance, the government did reduce petroleum and custom duties on petroleum and food products earlier. Outlook on food inflation is benign on the back of surplus food stocks with government and uptick seen in rabi sowing. Our base case scenario is for CPI to be at 5% in FY23, with a supply side response. Lower oil prices and supply side response can pull it closer to RBI's projections.

India has decoupled: In the statement and press conference, RBI emphasized on the fact that India's domestic conditions are far different from what other large central banks are facing. Thus, policy response is also very different. US, UK and Europe looking at inflation levels which are at multi-decade highs compared with India which is looking at inflation levels close to target in H2FY23. Thus drawing any one-to-one correlation between AE central banks and India is unlikely to hold in coming months.

Managing liquidity needs of the economy: RBI's focus remains absorbing excess liquidity through variable rate reverse repo (VRRR) auctions. Share of VRRRs in overall liquidity operations has increased to 82% from 70% in October. Going forward, 14-day VRRR and VRR auctions will be main tools for liquidity management, while shorter-tenors will be used to manage unanticipated changes. In order to manage aggregate credit needs of the economy, RBI has enhanced limits under voluntary retention route (VRR) by INR 1tn. In order to develop corporate bond market, RBI has notified guidelines for credit default swaps (CDS). This will go a long way in managing and pricing credit risk. In order to enable more efficient price discovery, in interest rate derivative markets, RBI has allowed banks to undertake transactions in foreign currency interest rate derivatives market. These steps show RBI's focus on building efficient markets in India and broaden the corporate bond market. However, this still leaves room for managing the government's elevated gross borrowing program in FY23. For this, we expect RBI to announce more measures in April policy.

Policy normalization path: We anticipated RBI to increase reverse repo rate today. We believed normalization of corridor in two-step hike of 20bps each will be followed by change in stance and then repo rate hike. We now believe RBI does not need to narrow the corridor between repo and reverse repo and then change its stance. In fact, RBI will look at simultaneously changing stance and reducing policy corridor by raising reverse repo rate. However, as stated in the post policy interaction, RBI will communicate its policy glide path. Thus, we expect RBI to telegraph its strategy in the next policy. This will give it room to raise repo rate by 75bps in FY23.

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Annexure: Statement on developmental and regulatory measures:

- **Extension of On-tap Liquidity Facilities for Emergency Health Services and Contact-intensive Sectors:** On-tap liquidity facilities of INR 500bn and INR 150bn for emergency health services and contact-intensive sectors, respectively, were announced in May and June 2021 during the second wave of the pandemic. Banks were given certain incentives for lending under the two schemes. On account of the continued uncertainties brought on by the third wave, the two schemes are being extended from 31 March 2022 to 30 June 2022.
- **Voluntary Retention Route (VRR) - Enhancement of Limits for FPIs:** It is proposed to enhance the limit for investments under the scheme by INR 1tn from INR 1.5tn at present to INR 2.5tn with effect from 1 April 2022.
- **Permission for Banks to deal in Foreign Currency Settled - Rupee Derivatives Market:** It has been decided to allow banks in India to undertake transactions in the offshore Foreign Currency Settled-Overnight Indexed Swap (FCS-OIS) market with non-residents and other market makers.
- **Enhancement of the Cap under e-RUPI (Prepaid Digital Vouchers using UPI:** It is now proposed to increase the cap of e-RUPI vouchers issued by the Central government and State governments from INR 10,000 to INR 1,00,000 per voucher and permit such e-RUPI vouchers to be used more than once.
- **Enabling Better Infrastructure for MSME Receivables Financing – Increasing NACH Mandate Limit for TReDS Settlements:** To further enhance the ease of financing the growing liquidity requirements of MSMEs, it is proposed to increase the NACH mandate limit from INR 10mn at present to INR 30mn for TReDS related settlements.

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