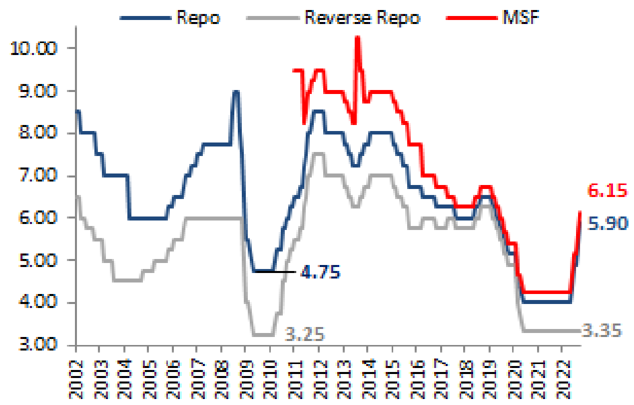
RBI hiked its policy rates by 50 bps (third hike since May-22 aggregating 190 bps) by a vote of 5:1 vote of the Monetary Policy Committee (MPC). Thus Repo, SDF & MSF rates stand at 5.90%, 5.65% and 6.15%, respectively. Dr. Ashima Goyal voted to increase the repo rate by 35 basis points. The MPC maintained its stance "remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". However, the stance was not unanimous as Prof. Jayanth R. Varma expressed his reservations. The fifth iteration of the projection of FY23 real GDP growth lowered it to 7% from 7.2% earlier (a cumulative drop of 80 bps) while inflation estimate has been kept unchanged at 6.7% (with upgrade in quarterly estimates to make do for the actual Q1 drop). RBI also stepped up the Q1 FY24 GDP growth estimate to 7.2% (from 6.7% earlier) while keeping the inflation unchanged at 5%. MPC also noted that "inflation is likely to be above the upper tolerance level of 6 per cent through the first three quarters of 2022-23, with core inflation remaining high. The outlook is fraught with considerable uncertainty, given the volatile geopolitical situation, global financial market volatility and supply disruptions".

Other measures:

- **Liquidity:** In view of the moderation in surplus liquidity, it has now been decided to merge the 28-day VRRR with the fortnightly 14-day main auction. Consequently, from now on, only 14-day VRRR auctions will be conducted.
- **Loan Loss Provisioning by Banks**: Banks currently follow the incurred loss approach for provisioning on their loan assets, whereby provisions on loan assets are made after the stress has materialised. A more prudent and forward-looking approach is the expected loss-based approach, which requires banks to make provisions based on an assessment of probable losses. As a step towards converging with globally accepted prudential norms, we will issue a discussion paper on the proposed transition for stakeholder comments.
- **Internet banking by RRBs:** Regional Rural Banks (RRBs) are currently allowed to provide Internet Banking facility to their customers, subject to fulfilment of certain criteria. Keeping in view the need to promote the spread of digital banking in rural areas, these criteria are being rationalised. The revised guidelines will be issued separately.
- **Offline Payment Aggregators**: Online Payment Aggregators (PAs) have been brought under the purview of RBI regulations since March 2020. It is now proposed to extend these regulations to offline PAs, who handle proximity/ face-to-face transactions. This measure is expected to bring in regulatory synergy and convergence on data standards.
- **Securitisation of Stressed Assets Framework (SSAF)**: It has now been decided to introduce a framework for securitisation of stressed assets. This will provide an alternative mechanism for securitisation of NPAs, in addition to the existing ARC route. A Discussion Paper (DP) on the proposed framework is being issued for feedback from stakeholders.

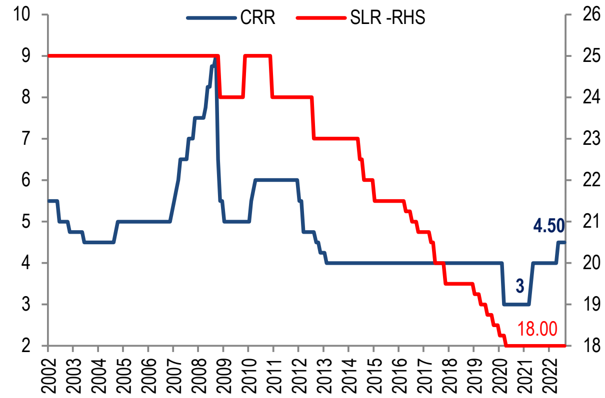
RBI raises rates fourth time by 50 bps with cumulative hike of 190 bps since May-22

Exhibit 1: RBI raised rates by 50 bps in Sep-22 policy



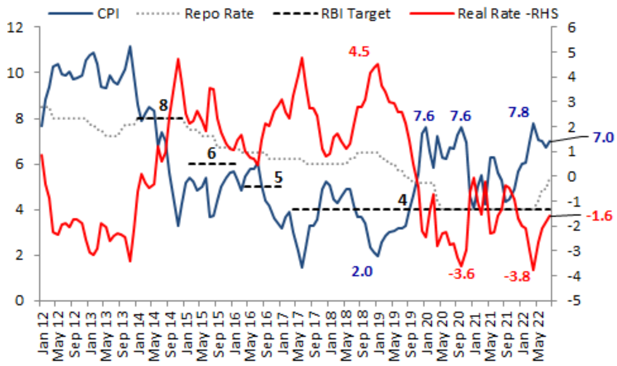
Source: RBI, ASKWA Research

Exhibit 2: No hike in CRR, SLR stable now



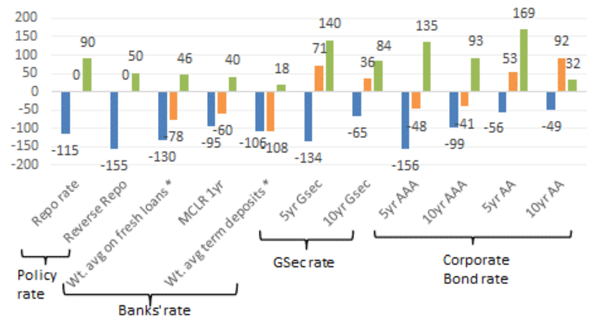
Real policy rate would still be negative; transmission of rate hikes typically slow in credit market

Exhibit 3: Inflation still high; real Repo rate still stays deeply negative and is expected to stay so



Source: CMIE, RBI, ASKWA Research

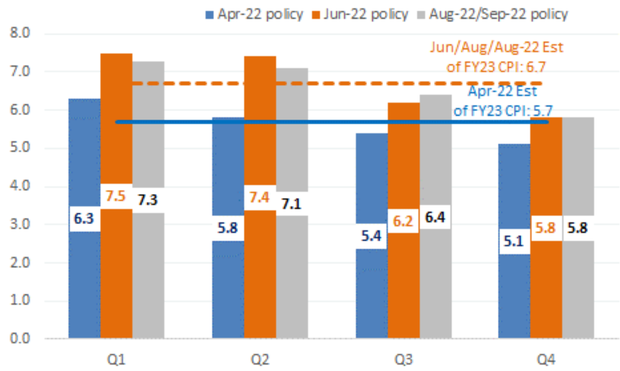
Exhibit 4: Credit market rates have started moving up slowly while G-sec reversed in 2021 itself



Source: CMIE, RBI, ASKWA Research

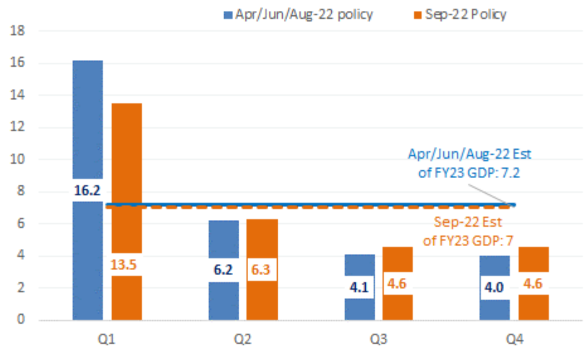
Some alteration in RBI growth-inflation estimates for FY23

Exhibit 5: FY23 CPI inflation forecast stays unchanged along with quarterly estimates



Source: RBI, ASKWA Research

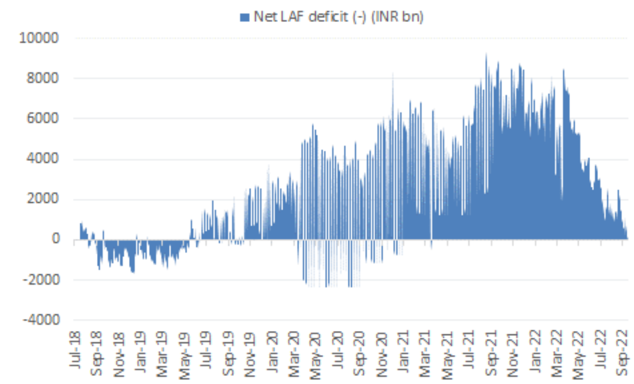
Exhibit 6: FY23 GDP growth forecast has been lowered by 20 bps (cumulative 80 bps downgrade)



Source: RBI, ASKWA Research

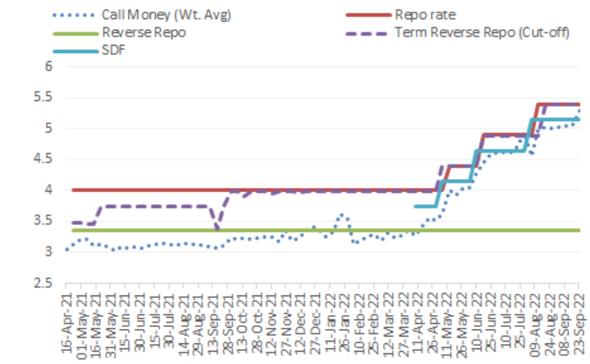
System liquidity moves towards neutral zone; money market rates responding proportionately

Exhibit 7: Liquidity has come down to neutral zone



Source: CMIE, RBI, ASKWA Research

Exhibit 8: Money market rates are firming up too



Source: CMIE, RBI, ASKWA Research

A few considerations of RBI:

A few considerations seem to have guided RBI for the fourth rate hike amidst unchanged stance. Following are the highlights from the speech of RBI Governor.

Inflation: (Global) Inflation continues to persist at alarmingly high levels across jurisdictions. The enduring effects of the pandemic and the geo-political conflict are manifesting in demand-supply mismatches of goods and services. Central banks are charting new territory with aggressive rate hikes, even if it entails sacrificing growth in the near term. (Domestic) Consumer price inflation remains elevated and above the upper tolerance band of the target due to large adverse supply shocks, some firming up of domestic demand, and the spillovers from global financial markets. The recent correction in global commodity prices including crude oil, if sustained, may ease cost pressures in the coming months. The inflation trajectory remains clouded with uncertainties arising from continuing geopolitical tensions and nervous global financial market sentiments.

Growth: While real GDP growth in Q1:2022-23 turned out to be lower than our expectations, the late recovery in kharif sowing, the comfortable reservoir levels, improvement in capacity utilisation, buoyant bank credit expansion and government's continued thrust on capital expenditure are expected to support aggregate demand and output in H2:2022-23. Real GDP grew by 13.5 per cent (y-o-y) in Q1:2022-23, surpassing the pre-pandemic level by 3.8 per cent. The headwinds from extended geopolitical tensions, tightening global financial conditions and possible decline in the external component of aggregate demand can pose downside risks to growth.

MPC decision: the MPC was of the view that persistence of high inflation necessitates further calibrated withdrawal of monetary accommodation to restrain broadening of price pressures, anchor inflation expectations and contain the second-round effects. This action will support medium-term growth prospects.

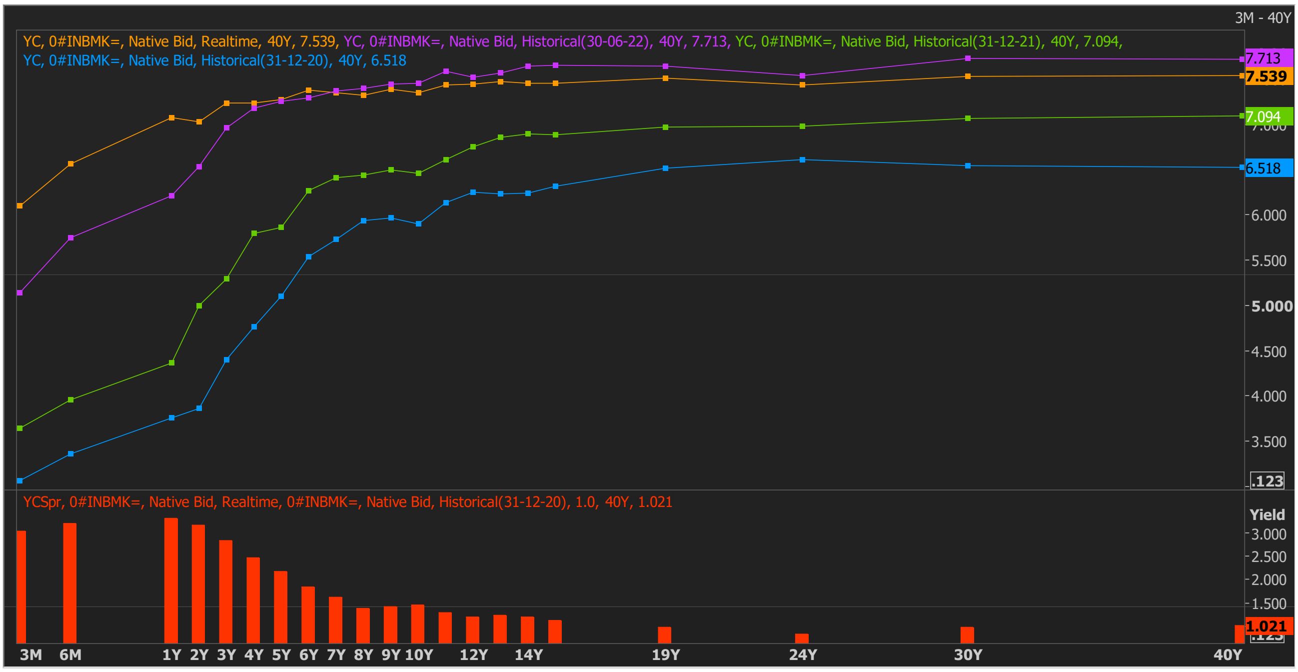
Accommodative" stance: Monetary policy had moved from neutral to accommodative stance in June 2019. At that time, the repo rate was 5.75 per cent; headline CPI inflation was hovering around 3 per cent and was expected to be in the range of 3.4 to 3.7 per cent in H2:2019-20; and, liquidity was in deficit mode, with an average daily net injection of ₹0.3 lakh crore in May 2019 under the liquidity adjustment facility (LAF). Today, inflation is hovering around 7 per cent and we expect it to remain elevated at around 6 per cent in H2:2022-23. Liquidity remains surplus, with average daily net absorption of ₹1.1 lakh crore under the LAF in September 2022 (up to September 28). As government expenditure picks up on the back of high GST and direct tax collections, the system liquidity will go up further. Thus, even as the nominal policy repo rate has been raised by 190 basis points so far (including today's increase), the policy rate adjusted for inflation trails the 2019 levels. The overall monetary and liquidity conditions, therefore, remain accommodative and hence, the MPC decided to remain focused on withdrawal of accommodation.

Implication and outlook: Accommodative stance is the real surprise

RBI kept the monetary policy stance unaltered despite four hikes of 190 bps which takes the rates, just 60 bps short than the pre-covid peak rate. Given that the peak rate ever has been 9% just before the financial crisis there is only a space of 310 bps for a full cycle response for the stance to turn neutral first and then tightening to take effect. However, an important regime shift has taken place as apparent in the rationale for stance provided (see above) where Governor specifically sought to relate stance with the 'real' rate adjusted for inflation. Should inflation persist this may mean policy rates may need to be adjusted still and remain elevated for a longer period than what is being currently factored into. A few factors including rising bank credit growth, irregular weather conditions, possibility of higher state government borrowing, deteriorating balance of payments situation and adverse global developments and falling interest rate differential (with US at 3.6% compared to 4.5 to 5% historical average) would continue to yield upward bias to the interest rates in India. However, many other mitigating factors including softening of oil and major commodities, easing supply chains, slowdown and fear of recession would have a moderating impact on inflation raising hopes that the inflation and interest rates have indeed reached an interim peak. This is also reflected in the yield curve movement that has stopped shifting upwards but rotating reflecting bear steepening making it as flat as possible. Keeping the stance unaltered as 'accommodative' amidst all these may seem somewhat incongruent at the current juncture.

Yield curve is as flat as possible perhaps now

Exhibit 9: Yield curve rotated since June 2022



Source: Refinitiv, ASKWA Research

Towards the end of the rate hike cycle

1. Inflation drivers are coming off globally, especially in the US. While headline prints will follow with a lag, key indicators (energy prices, housing rentals etc.) are already weakening. Reduces pressure on RBI to keep pace with the Fed.
2. Indian CPI handles are also trending down – RBI's own models show 5.2% for FY2024.
3. While the governor did not provide a "terminal rate" indication, a 5.9% Repo already means a positive real interest rate of 70 bps, not too far from the 100 bps widely considered as the "ideal" real rate corridor. For the balance 30 bps, one more rate hike will be good enough.

India's CAD is an issue, but will likely work itself off

1. CAD was $70 bn in the last 4 quarters ending Q1 FY23. That's a high number, but was relatively easily financed, even if it required some depletion in forex reserves.
2. Big drivers, again, like oil are already trending downwards.
3. Another big driver of CAD, India's relatively fast post-Covid recovery, is likely to taper off quite soon. Advance indicators on export growth already demonstrate weakening growth.
4. While $100 bn of forex reserves have been used in one year, there's 500bn + still left. There are lots of non-policy tools to shore up reserves if needed – RIB/IMD/3 year FCNR are established templates.

Monetary contraction is already underway

1. RBI's balance sheet is 9% lower in the last year. Repo has been hikes to above pre-Covid levels now.
2. Growth, while optically fast, hasn't really compensated for 2 years of Covid drag. Last quarter GDP revealed real GDP is barely 5% above the pre-Covid quarter.
3. Above all, growth's slowing down. Will slow faster if exports keep struggling.
4. In short, India's not playing catch-up, but in-step on monetary normalization.

Investment strategy?

1. Déjà vu and ennui – 4-5-year bucket on AAA/Sovereign, 2-3 years on credit.
2. With a flat yield curve and a relatively light borrowing plan for the 2nd half in the 5-year bucket (see table below), expected rates volatility is least here and carry is the same as the longest parts of the yield curve.
3. Something different – there might real value emerging in fixed income, it's the time to embark on the journey!

Exhibit 10: Gross Government Bond Issuance (INR '000 crs)

Indicative Tenor	H1	H2	H2/H1
2 yr	52	36	**69%**
5 yr	117	70	**60%**
7 yr	91	60	**66%**
10 yr	169	120	71%
14 yr	135	110	81%
30 yr and above	229	180	79%

Source: IDFC MF, ASKWA Research

Ends

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