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ICRA COMMENTS ON RBI'S FIRST BI-MONTHLY MONETARY POLICY STATEMENT FOR 2022-23

MPC normalises width of LAF corridor, stance change signaled for June 2022 meeting

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HIGHLIGHTS

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While the MPC maintained status quo on the repo rate and policy stance, it normalised the width of the LAF corridor to pre-pandemic levels

MPC raised its CPI inflation forecast for FY2023 sharply to 5.7% from 4.5%, while paring its GDP growth to 7.2% (in line with our est.) from 7.8% earlier

In the first Bi-Monthly Monetary Policy review for FY2023, the Monetary Policy Committee (MPC) maintained status quo on the repo rate and policy stance, in a unanimous decision, while deftly changing its tone to signal an imminent change in stance ahead, as inflationary pressures now dominate the economic landscape. It normalised the width of the Liquidity Adjustment Facility (LAF) corridor to pre-pandemic levels by introducing the Standing Deposit Facility (SDF) at 3.75% as the floor rate, replacing the fixed rate reverse repo, which was kept unchanged at 3.35%. Further, the MPC raised its CPI inflation forecast and pared its GDP growth projections for FY2023, echoing our own estimates. The modified wording of the comment on the stance, focusing on the upcoming withdrawal of accommodation, with a unanimous vote, has clearly telegraphed the intent to change the stance to neutral in the June 2022 policy review. We continue to expect the stance change to be followed by a shallow rate hike cycle, with the repo rate being increased by 25 bps each in August and September 2022. The 10-year G-sec yield breached 7.1% after the policy announcement. We anticipate it to rise to as much as 7.4% during H1 FY2023, as the market's views on the number and timing of rate hikes crystallise.

- In the April 2022 policy review, the MPC maintained status quo on the repo rate (4.0%), and retained the accommodative stance, in a unanimous decision, even as it normalised the LAF corridor to pre-pandemic levels by introducing the SDF at 3.75% as the floor rate. While the Bank rate and Marginal Standing Facility (MSF) were kept unchanged at 4.25% each, the floor of the LAF corridor will now be the SDF.
- With the assumption of a normal monsoon in 2022, and Indian basket crude oil price averaging US$100/bbl, the MPC sharply raised its CPI inflation forecast for FY2023 to 5.7% from 4.5% earlier, with an upward revision in all quarters of FY2023.
- Given the ongoing geopolitical tensions and the resultant surge in commodity prices, the MPC has cut its real GDP growth forecast for FY2023 to 7.2% (in line with our estimates), from 7.8% indicated in the Feb 2022 review. All quarters of FY2023 have undergone a downward revision compared to its Feb 2022 projections - Q1 FY2023 (to +16.2% from +17.2%), Q2 FY2023 (to +6.2% from +7.0%), Q3 FY2023 (to +4.1% from +4.3%) and Q4 FY2023 (to +4.0% from +4.5%).

Outlook: We see a near certainty of the policy stance being revised to neutral from accommodative in the June 2022 policy review. We see this as being followed by a shallow rate hike cycle, with the repo rate being increased by 25 bps each in August and September 2022, entailing a negative real policy rate throughout FY2023.

The increase in HTM limits by 1% could create an additional headroom of Rs. 1.6-1.7 trillion for banks to hold the government securities without marking them to market in a rising bond yield scenario, improving the demand for the same from banks. However, given the overall size of the government borrowings, the absorption of the large supply could remain a challenge. We had predicted that the 10-year G-sec yield would cross 7.0% in April 2022, and it surpassed 7.1% after the policy announcement. We anticipate it to rise to as much as 7.4% over the course of H1 FY2023, based on our forecast of a total repo increase of 50 bps in this fiscal year.

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AS EXPECTED, MPC MAINTAINED STATUS QUO ON REPO RATE AND STANCE IN APR 2022 POLICY REVIEW, WHILE DEFTLY CHANGING THE TONE TO SIGNAL AN IMMINENT STANCE CHANGE

As expected, the MPC maintained status quo on the repo rate and stance, while changing its tone to signal an imminent change in stance ahead, as inflationary pressures now dominate the economic landscape

In the April 2022 policy review, the MPC voted unanimously to keep the repo rate unchanged at 4.0% (refer Exhibit 1). However, it normalised the width of the LAF corridor to pre-pandemic levels by introducing the SDF at 3.75% as the floor rate, replacing the fixed rate reverse repo which was kept unchanged at 3.35%. Further, while it unanimously retained the policy stance, it changed the wording of the comments on the stance, clearly stating that it would focus on the withdrawal of accommodation while remaining accommodative. The Bank rate and MSF were kept unchanged at 4.25% each.

CPI inflation forecast for FY2023 revised sharply upwards to 5.7% from 4.5% earlier: After the MPC's last meeting in February 2022, the data released by the National Statistical Office (NSO) had revealed a sharp uptick in the headline YoY CPI inflation from 5.7% in December 2021 to 6.01% in January 2022, which further inched up to 6.07% in February 2022 (refer Exhibit 2). The CPI prints for January 2022 and February 2022 were higher than the MPC's medium term forecast range of 2.0-6.0%. The sequential rise in the YoY CPI inflation in February 2022 relative to January 2022 was chiefly led by the uptick in food and beverages, and clothing and footwear. The core-CPI (CPI excluding food and beverages, fuel and light, and petrol and diesel index for vehicles) inflation rose marginally to 5.86% in February 2022 from 5.81% in the previous month.

Even as record foodgrain output and buffer stock may help in keeping domestic prices of cereals in check, the Committee expects the elevated prices of edible oil, poultry items, etc. to impact upside risks to food inflation outlook

Going forward, the Committee expects the inflation trajectory to take cue from the evolving geopolitical situation and its impact on global commodity prices and logistical costs. While the domestic prices of cereals have risen in the past few weeks, mirroring the global trend, the MPC believes the record foodgrain production and buffer stock levels to prevent a sharper hardening in the domestic prices. However, the ongoing global supply crunch has intensified price pressures in key food items such as edible oils and animal and poultry feed, which will impart uncertainty to the food inflation outlook, and warrant continuous monitoring, according to the MPC. Given this backdrop, the pro-active supply management is key to contain these inflationary pressures. Moreover, the Committee anticipates that input price pressures are likely to linger for longer than what it expected earlier (also indicated by the manufacturing sector firms polled in the RBI's industrial outlook survey), following the surge in prices of crude oil as well as other key industrial inputs amid global supply disruptions. The pass-through into retail prices, albeit limited, at the current juncture given the subdued demand, remains a key monitorable, going forward.

Input price pressures to linger for longer than what MPC had expected earlier, following the surge in prices of crude oil as well as other key industrial inputs amid geopolitical tensions

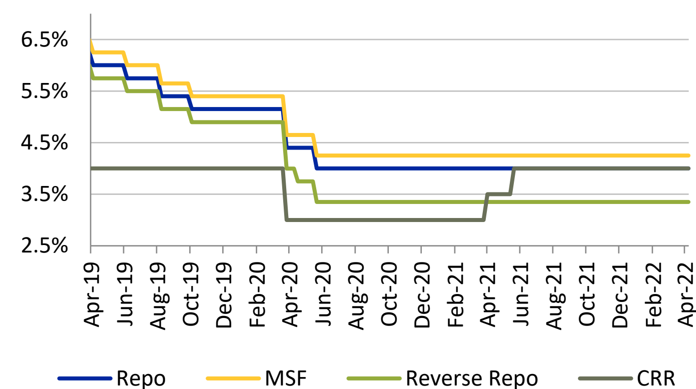
Considering these factors, as well as the assumption of a normal monsoon in 2022 and crude oil price, in Indian basket terms, averaging at US$100/bbl, the MPC raised its CPI inflation forecast for FY2023 to 5.7% from 4.5% earlier (refer Exhibit 3). Compared to its Feb 2022 quarterly projections, it has now raised the CPI inflation forecast for all quarters of FY2023 - Q1 FY2023 (to +6.3% from +4.9%), Q2 FY2023 (to +5.8% from +5.0%), Q3 FY2023 (to +5.4% from +4.0%) and Q4 FY2023 (to +5.1% from +4.2%). We expect the CPI inflation to average at 5.6% in FY2023, with risks titled to upside, similar to the MPC's latest forecast of 5.7%. Our projection of the CPI inflation of 6.3% for Q1 FY2023 assumes a full pass through of the pending transmission of the crude price hike to petrol and diesel, without any excise cut.

With assumption of crude oil averaging US$100/bbl and a normal monsoon season, the MPC sharply upped its CPI inflation forecast for FY2023 to 5.7% from 4.5% earlier

The MPC stated that available high frequency indicators exhibit signs of recovery with the fast ebbing of the third wave, but the picture is mixed

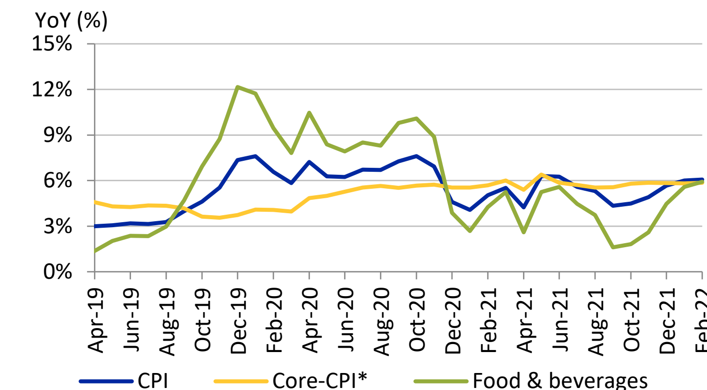
The MPC outlined a few factors that pose downside risks to its FY2023 growth outlook - escalation of the geopolitical tensions, tightening of global financial conditions, persistence of supply-side disruptions and significantly weaker external demand

EXHIBIT 1: Movement in Key Rates



Source: *RBI; CEIC; ICRA Research*

EXHIBIT 2: CPI Inflation, CPI-food and core-CPI inflation (YoY)



Since detailed data is not available for March-April 2020, we have not excluded prices for petrol and diesel of vehicles in the calculation of the core-CPI index for the YoY inflation rates in March-May 2021;* ***Source**: NSO; CEIC; ICRA Research*

GDP growth forecast for FY2023 pared to 7.2%, in line with our estimates: The Second Advance Estimates (SAE) released by the NSO placed the real gross domestic product (GDP) growth for FY2022 at 8.9%, surpassing the FY2020 level by a mild 1.8%. Available high frequency indicators for Q4 FY2022 point to a recovery in some sectors after the rapid abatement of the third wave of Covid-19, although the trend appears somewhat mixed.

Looking ahead, the Committee believes that favourable prospects for the rabi crop augur well for rural demand. Further, in line with our expectations, the MPC foresees a continued pick-up in the contact-intensive services and urban demand, with declining Covid-19 cases as well as widening vaccination coverage. Moreover, it reiterated that the GoI's capex target for FY2023 and production-linked incentive scheme will support in improving private investment activity, following the healthy rise in capacity utilisation levels, deleveraging balance sheets of corporates, higher credit offtake, as well as congenial financial conditions. However, the MPC outlined downside risks to its FY2023 growth outlook stemming from the escalation of the geopolitical tensions and associated surge in international crude oil and other commodity prices, tightening of global financial conditions, uncertainties owing to policy normalization in major advanced economies, persistence of supply-side disruptions and significantly weaker external demand.

Taking aforesaid factors into consideration, the MPC has cut its real GDP growth forecast for FY2023 to 7.2%, in line with our estimates, from the 7.8% indicated in the Feb 2022 policy review. It has lowered projections for all quarters of FY2023 - Q1 FY2023 (to +16.2% from +17.2%), Q2 FY2023 (to +6.2% from +7.0%), Q3 FY2023 (to +4.1% from +4.3%) and Q4 FY2023 (to +4.0% from +4.5%).

As a result, the MPC has revised its real GDP growth projection for FY2023 downwards to 7.2% in Apr 2022 from 7.8% indicated earlier, with a downward revision in all quarters of FY2023

The MPC's revised GDP and inflation forecasts of 7.2% and 5.7%, respectively, for FY2023 (with crude averaging US$100/bbl) are echoed by our own projections (7.2% and 5.6%, respectively, with crude @US$105/bbl)

With the focus shifting to inflation management over supporting growth, and the modification in the wording on the policy stance, the MPC has clearly telegraphed an imminent change in the stance

EXHIBIT 3: RBI's earlier and current GDP growth and CPI inflation forecasts

YoY (%)	CPI Inflation		GDP Growth (at constant 2011-12 prices)	
MPC Policy Reviews	**February 2022**	**April 2022**	**February 2022**	**April 2022**
Q1 FY2023	4.9%	6.3%	17.2%	16.2%
Q2 FY2023	5.0%	5.8%	7.0%	6.2%
Q3 FY2023	4.0%	5.4%	4.3%	4.1%
Q4 FY2023	4.2%	5.1%	4.5%	4.0%
FY2023	**4.5%**	**5.7%**	**7.8%**	**7.2%**

*Note: Assuming average crude oil price (Indian basket) of US$100/bbl; **Source**: RBI; ICRA Research*

We believe that higher prices of fuels and items such as edible oils are likely to compress disposable incomes in the mid to lower income segments, constraining the demand revival. However, the prescient extension of free foodgrains under Pradhan Mantri Garib Kalyan Ann Yojana until September 2022 may continue to offer some respite to the food budgets of vulnerable households. In the mid to upper income segments, normalisation of behaviours after the third wave are set to result in a pivot of consumption towards the contact-intensive services that were avoided during the pandemic, again constraining the growth in demand for goods in FY2023.

While healthy reservoir levels provide insurance to a potentially below normal rainfall in 2022, we believe that as economic activity normalises, there could be a shift in availability of agricultural labour across different regions, affecting acreage in some states, which has been the key driver of agri output during FY2021 and FY2022. Moreover, the inadequate availability of fertilisers amid the geopolitical conflict poses a concern for agriculture, with significantly lower systemic inventories. Accordingly, the GVA growth of agriculture, forestry and fishing is unlikely to exceed 3.0% in FY2023, in our view.

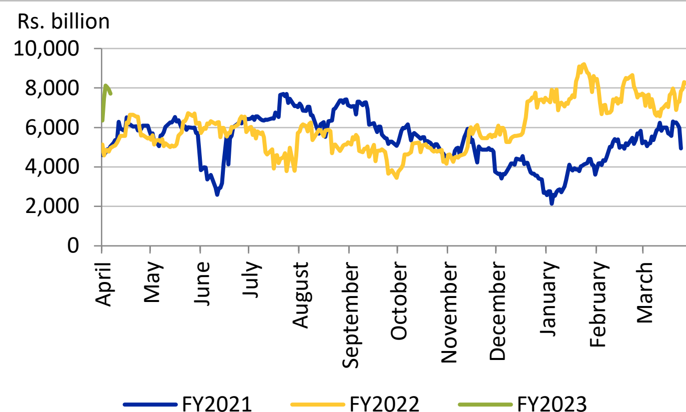
The MPC's revised GDP and inflation forecasts of 7.2% and 5.7%, respectively, for FY2023 (with crude averaging US$100/barrel) are echoed by our own projections (+7.2% and +5.6%, respectively, with crude @US$105/barrel). While our annual growth forecast is in line with the MPC's, we are somewhat more optimistic on the outlook for H2 FY2023. At the same time, we foresee a lower growth in Q1 FY2023, given the expected adverse impact of high commodity prices on corporate margins.

Presciently, the monetary policy document chose to prioritize inflation over growth in its outlook statement, in contrast with the previous policy documents, wherein the commentary on growth preceded inflation. Given the consistency in the sequencing of commentary seen in the past policy statements, this signals a shift in the ordering of the MPC's concerns. This corresponds to the changes in the economic landscape following the Russia-Ukraine conflict, with inflationary pressures at the fore following the spike in global commodity prices. We expect the stance to be changed to neutral in June 2022, followed by repo hikes of 25 bps each in August 2022 and September 2022.

The daily average liquidity surplus under the LAF has eased from Rs. 7.49 trillion in Q3 FY2022 to Rs. 6.54 trillion in Q4 FY2022

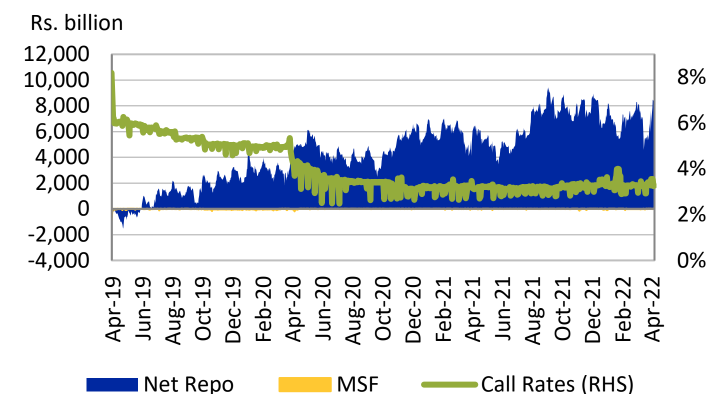
The proportion of VRRR auctions in total reverse repo auctions decreased to 70% in Mar 2022 from over 80% in Feb 2022 and Jan 2022

EXHIBIT 4: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; MSS)



Data for FY2023 is available upto April 7, 2022; **Source: RBI; ICRA Research*

EXHIBIT 5: Call money rates



***Source:** RBI; ICRA Research*

The daily average liquidity surplus under the LAF has eased from Rs. 7.49 trillion in Q3 FY2022 to Rs. 6.54 trillion in Q4 FY2022 (refer Exhibit 4), driven by a decrease in foreign currency assets (from US$569.9 trillion on Dec 31, 2021, to US$550.5 trillion on Mar 25, 2022), and an increase in currency with the public (from Rs. 28.8 trillion on Dec 31, 2021, to Rs. 30.2 trillion on Mar 11, 2022), partially offset by a decline in GoI cash balances (from Rs. 3.2 trillion as on Dec 31, 2021, to Rs. 2.1 trillion on Mar 11, 2022).

On a monthly basis, the daily average liquidity surplus increased from Rs. 6.37 trillion in January 2022 to Rs. 6.88 trillion in February 2022, before easing to Rs. 6.42 trillion in March 2022. During February 2022, the RBI conducted two 2-day variable rate reverse repo (VRRR) auctions worth Rs. 3.0 trillion, one 3-day VRRR auction worth Rs. 4.0 trillion, two 4-day VRRR auctions worth Rs. 5.5 trillion, two 7-day VRRR auctions worth Rs. 7.0 trillion, two 14-day VRRR auctions worth Rs. 13.5 trillion and one 28-day VRRR auction worth Rs. 500.0 billion.

Subsequently, during March 2022, the RBI conducted one 2-day VRRR auction worth Rs. 3.0 trillion, one 3-day VRRR auction worth Rs. 1.0 trillion, one 7-day VRRR auction worth Rs. 3.0 trillion, one 8-day VRRR auction worth Rs. 2.0 trillion, two 14-day VRRR auctions worth Rs. 5.5 trillion each and one 28-day VRRR auction worth Rs. 500.0 billion. However, the proportion of VRRR auctions in total reverse repo auctions decreased to 70% in Mar 2022 from over 80% in Feb 2022 and Jan 2022.

The MPC normalised the width of the LAF corridor to pre-pandemic levels, by unexpectedly introducing the SDF at 3.75% as the floor rate

We anticipate the 10-year yield to rise to as much as 7.4% over the course of H1 FY2023

Additionally, the RBI has conducted net open market operations (OMO) sales of Government of India securities (G-secs) worth Rs. 230.0 billion during H2 FY2022. Out of this, net outright OMOs sales of Rs. 78.9 billion were conducted in January 2022. No OMO operations were conducted during February 2022. Further, during March 2022, the RBI conducted simultaneous OMO sale and purchase of mild Rs. 0.1 billion on March 11, 2022.

Subsequently, the daily average liquidity surplus stood at Rs. 7.6 trillion in April 2022 (till April 7, 2022). Moreover, the RBI conducted one 3-day VRRR auction worth Rs. 6.0 trillion on April 5, 2022, and one 14-day VRRR auction worth Rs. 8.0 trillion on April 8, 2022. With the muted credit growth for large industries and general risk aversion in the system, the surplus liquidity parked by banks under reverse repo window stood at Rs. 9.0 trillion as on April 7, 2022.

With VRRRs accounting for the bulk of reverse repo operations and the increase in cut-off yields thereof, money market rates surged in recent months. The average rates for the 91-day T-bills, 182-day T-bills, and 364-day T-bills rose gradually from 3.54%, 3.81% and 4.09%, respectively, in Q3 FY2022, to 3.74%, 4.24% and 4.56%, respectively, in Q4 FY2022, and further to 3.87%, 4.27% and 4.56%, as on April 6, 2022. Moreover, the daily weighted average call money rate rose from 3.27% in Q3 FY2022, to 3.32% during Q4 FY2022, but remained lower than the reverse repo rate.

In today's policy review, MPC normalised the width of the LAF corridor to pre-pandemic levels, by unexpectedly introducing the SDF at 3.75% as the floor rate, even as the fixed rate reverse repo (FRRR) was kept unchanged at 3.35%. With 80% of surplus liquidity being absorbed under the variable rate reverse repos (VRRR) at rate closer to the repo rate of 4.0%, the introduction of SDF at 3.75% will improve the returns on the balance liquidity that was being placed by banks at reverse repo rate of 3.35%. This could also lead to an increase in the overnight call money rates and boost the profitability of banks. At the same time, it could lead to a further increase in short-term rates, increasing the borrowing costs linked to such rates.

The RBI Governor highlighted that the liquidity overhang will be withdrawn in a gradual and calibrated manner over a multi-year time frame. Moreover, the increase in HTM limits by 1% could create an additional headroom of Rs. 1.6-1.7 trillion for banks to hold the government securities without marking them to market in a rising bond yield scenario, and thereby preventing any losses. This could improve the appetite of banks for government securities and facilitate the large borrowing programme of central and state governments while moderating the rising in yields. However, given the overall size of the government borrowings, the absorption of the large supply could remain a challenge.

The 10-year G-sec yield breached 7.0% after the policy announcement and rose further to above 7.1% over the course of the day. We anticipate the 10-year yield to rise to as much as 7.4% over the course of H1 FY2023, as the market's views on the number and timing of rate hikes crystallise.

The RBI, as part of its statement on developmental and regulatory policies announced a set of measures targeted towards liquidity management including the introduction of the Standing Deposit Facility (SDF) as well as the restoration of the symmetric LAF corridor. On the regulatory and supervision front, the RBI has announced the continuation of its policy on rationalization of risk weights on individual housing loans as well as increasing the limits of eligible securities held under Held To Maturity (HTM) category. Besides this, the RBI continued with its policy of extending support towards facilitating payment and settlement systems. The measures announced by the RBI and their expected impact are as follows:

Establishing the Standing Deposit Facility (SDF) as the effective reverse repo rate is expected to lead to a rise in the overnight call money and T-bill rates, which in turn will result in an increase in lending rates that are linked to these benchmarks

1) <u>Introduction of the Standing Deposit Facility (SDF) and restoration of the symmetric LAF corridor</u>

The RBI has decided to introduce the Standing Deposit Facility as a means of liquidity absorption, which unlike the fixed rate reverse repo (FRRR) used for overnight liquidity absorption can be utilized without requiring eligible securities as collateral. While the necessary legislative amendments to introduce SDF was made in 2018, the RBI has refrained from utilizing the facility for a few years now. The regulator has now decided to put the same into force by instituting SDF at 3.75% with immediate effect, which will effectively replace the fixed rate reverse repo as the floor of the LAF window. Moreover, with SDF and MSF fixed at 3.75%, and 4.25% respectively, the width of the LAF corridor has been narrowed to 50 bps from 90 bps, which is similar to levels prevailing prior to the onset of the pandemic.

Impact: With 80% of surplus liquidity being absorbed under VRRR at rate closer to repo rate of 4.0%, the introduction of SDF at 3.75% will improve the returns on the balance overnight liquidity that was being placed by banks at reverse repo rate of 3.35%. This will be positive for profitability of banks and could also lead to an increase in overnight call money rates. This will however also lead to a further increase in short-term rates such as T-bill and consequent increase in borrowing costs linked to such rates. While wholesale loans are generally linked to the T-bill rates, we expect a sharper rise in T-bill rates to translate into a higher borrowing cost for corporates. On the other hand, the borrowing cost for retail borrowers could remain unchanged for a couple of months as MPC maintains a status quo on Repo rate, which is the external benchmark for most of the retail loans. We also expect banks to raise deposit rates in short-term buckets as they can park the liquidity so generated at better overnight rates.

2) <u>The Statutory Liquidity Ratio (SLR) holding in the HTM category increased for FY2023</u>

The RBI has decided to allow banks to maintain a higher percentage of eligible securities/investments as held to maturity. Banks can now maintain SLR eligible securities upto 23% (as against 22%) of the net demand and time Liabilities (NDTL) till March 31, 2023, which will also include securities acquired during FY2023. The RBI plans to gradually un-wind the limits from this level to 19.5% (levels prior to September 1, 2020) in a gradual manner from Q1 FY2024 onwards.

Increase in HTM limits by 1% in a rising bond yield scenario will help banks limits any losses. Further, this could improve the appetite of banks for government securities and facilitate the large borrowing programme of central and state governments while moderating the rising in yields

Impact: Amidst an expected increase in interest rates during FY2023, hardening of G-Sec yields are likely to drive a moderation in bond gains/losses for banks in the available for sale (AFS) and held for trade (HFT) categories. The decision to expand/enhance the HTM limits for banks, in our view, will allow banks the flexibility to limit MTM losses for the bank in FY2023. Furthermore, as per our estimates, the additional headroom for bank to hold G-Sec under HTM will expand by Rs.1.6-1.7 trillion, which will also help absorb a part of the Central and State government borrowing, which will also aid in moderating rising yields.

3) Rationalisation of risk weights for individual housing loans

The RBI in its earlier circular in October 2020, de-linked the capital charge for fresh individual housing loans from the ticket-size of the loan. Accordingly, all new housing loans sanctioned on or after the date of the circular were to be risk weighted on the basis of the loan to value (LTV). The RBI has now decided to extend the validity of the circular by one year (till March 31, 2023).

Impact: The continuation of the lower risk weights for individual housing loans is a welcome measure, for lenders and borrowers alike. While lenders will be willing to grow their granular home loan portfolio that continues to attract a relaxed risk weight, the same is likely to translate into continuation of competitive pricing for borrowers. Given the multiplier effect of housing, continued flow of credit to the housing segment augurs well for all the economy.

4) Other regulatory and supervision announcements

The RBI intends to solicit comments/feedback from various stakeholders by way of a discussion paper on 'Climate Risk and Sustainable Finance'. Besides this, the RBI has also expressed its intent to set up a committee to evaluate and review the state of customer services rendered by the RBI regulated entities.

Impact: Given the growing risk of climate related impact on the safety and soundness of lending institutions, the discussion paper is likely to help the RBI understand the impact of climate change on regulated entities, which in turn will be useful in framing policies that are appropriate to address climate related risk on regulated entities.

The landscape within which the RBI regulated entities operate is also undergoing rapid changes in terms of technology, platforms, service providers etc. The setting up of the committee may help identify gaps in meeting customer services and redressal of grievances thereof, in an evolving environment within which these entities operate.

The continuation of relaxed risk weights on home loans reflects RBI's view to support the housing market growth and the multiplier effect the housing market has

5) **Measures on payment and settlement systems**

The RBI has proposed to allow/ facilitate interoperability of card less cash withdrawal at all banks and all ATMs, which currently is being offered only by some banks to their own customers. Further, the net worth requirements for non-bank Bharat Bill Payment Operating Units (BBPOUs) has been scaled down from Rs.100 crore to Rs. 25 crore.

Impact: Allowing interoperability of card less cash withdrawal for customers between all banks and ATMs will largely help address the risk of card related frauds including skimming and cloning etc., which in our view is a positive move at easing cash withdrawal, while limiting risk of fraud. Furthermore, the lowering of the net worth requirements for BBPOUs will support the widening of reach and throughput on Bharat Bill Payment System (BBPS) over time.

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