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ICRA COMMENTS ON RBI'S SEPTEMBER 2022 MONETARY POLICY MEETING

MPC raised repo rate by 50 bps and maintained policy stance by 5:1 votes; Dec 2022 policy decision to take cue from CPI and GDP prints

SEPTEMBER 2022

HIGHLIGHTS

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The MPC voted for a repo hike of 50 bps in its Sep 2022 policy review, while keeping the stance unchanged, both in a non-unanimous decision (5:1)

While the CPI inflation projection for FY2023 was retained at 6.7%, that for GDP growth was revised mildly downwards to 7.0% from 7.2%

We expect the MPC to turn data dependent in its Dec 2022 policy meeting, taking cues from the latest CPI prints and the Q2 FY2023 GDP print

With a majority vote of 5:1, the Monetary Policy Committee (MPC) raised the policy repo rate by an expected 50 basis points (bps) in its September 2022 policy review and kept the policy stance unchanged. While the FY2023 CPI inflation forecast was retained at 6.7%, the GDP growth projection has undergone a mild downward revision to 7.0% from the 7.2% indicated in the August 2022 policy. The cut in the FY2023 growth projection has been driven by the lower-than-expected GDP print for Q1 FY2023; the quarterly growth forecasts for Q2-Q4 FY2023 and Q1 FY2024 have been revised upwards. With a high base and moderating commodity prices to dampen the CPI inflation below 6% in the early part of H2 FY2023, we expect the MPC to be data dependent in its December 2022 policy decision, taking a cue both from the latest CPI prints and the strength of the Q2 FY2023 GDP growth.

- In its end-September 2022 Monetary Policy meeting, the MPC raised the policy repo rate by 50 bps to 5.90% while maintaining its policy stance 'to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth'. Accordingly, the standing deposit facility (SDF) rate stands adjusted to 5.65% and the marginal standing facility (MSF) rate and the Bank Rate to 6.15%. Interestingly, the vote on the quantum of the rate hike and the framing of the policy stance was not unanimous, with Dr. Ashima Goyal voting for a lower 35 bps hike and Prof. Jayanth Varma voting against the stance.
- The MPC retained its FY2023 inflation forecast at 6.7%, while assuming the price of the Indian basket of crude oil to average at US$100/bbl in H2 FY2023. Although its quarterly inflation projections for Q2 and Q4 FY2023 were unchanged at 7.1% and 5.8%, respectively, the Q3 FY2023 estimate was revised upwards marginally to 6.5% from 6.4% earlier. Further, it also kept its Q1 FY2024 CPI inflation projection unchanged at 5.0%.
- The MPC highlighted that prospects for aggregate supply have improved while the outlook for aggregate demand remains positive. However, there are downside risks to the growth outlook emanating from geopolitical tensions, tightening global financial conditions, and slowing external demand. While the MPC cut its FY2023 real GDP growth projection to 7.0% from 7.2%, this was largely on account of the lower-than-expected Q1 FY2023 GDP print. It raised the quarterly projections for Q2, Q3 and Q4 FY2023 to 6.3%, 4.6% and 4.6%, respectively from 6.2%, 4.1% and 4.0%, earlier. Further, it also increased the Q1 FY2024 growth forecast to 7.2% from 6.7%.

Outlook: Today's policy decision of a 50 bps repo rate hike was prudent and along expected lines, with the outlook for future monetary tightening likely to be largely dependent on the pace of moderation in upcoming CPI inflation prints as well as the strength of the GDP growth. With this, and the H2 borrowing calendar of the Government of India being broadly on anticipated lines, G-sec yields are likely to stabilise in spite of the delay in the bond index inclusion. We foresee the 10-year G-sec yield to range between 7.2-7.7% in the next quarter.

WITH A MAJOIRTY VOTE OF 5:1, MPC HIKED REPO RATE BY 50 BPS, KEPT POLICY STANCE UNCHANGED IN SEP 2022 POLICY

The MPC raised the policy repo rate by 50 bps to 5.90%, while highlighting that it would continue to focus on withdrawal of accommodation, both with non-unanimous votes of 5:1

In the September 2022 meeting, with a non-unanimous vote of 5:1, the MPC decided to raise the policy repo rate by 50 bps under the liquidity adjustment facility (LAF) to 5.90% (refer Exhibit 1) with immediate effect. After a 40 bps rate hike in an off-cycle meeting in May 2022, the Committee has increased the repo rate by 50 bps each in the scheduled June 2022, August 2022 and September 2022 policy meetings, translating to a total hike of 190 bps in the current rate hike cycle. Accordingly, it also increased the SDF, Bank rate and MSF rates by 50 bps each to 5.65%, 6.15% and 6.15%, respectively, in September 2022. Additionally, the Committee decided with a majority of five out of six members, to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

While inflationary pressures have eased, food and energy prices remain elevated; upside risk to food prices exists due to lower kharif sowing and delayed monsoon withdrawal

FY2023 CPI inflation forecast retained at an elevated 6.7%: Post the MPC's August 3-5, 2022 policy meeting, the YoY CPI inflation had eased to a five-month low 6.7% in July 2022 from 7.0% in June 2022, before reversing to 7.0% in August 2022. Moreover, it remained above the MPC's 6.0% threshold of the medium-term target range (2.0%-6.0%) for the eighth consecutive month (refer Exhibit 2). Additionally, the share of items in the CPI basket with readings higher than 6% rose to a four-month high of 53.7% in August 2022 from 50.7% in July 2022.

The MPC indicated that while inflationary pressures arising from external factors have eased relative to the beginning of the fiscal year, food and energy prices continue to remain elevated. Going forward, edible oil prices are likely to be contained on account of improved supply conditions as well as measures taken by the Government. However, with a strong recovery in the services sector, risks of higher pass-through of input costs continues to remain a key monitorable. Additionally, the decline in kharif rice output is likely to put an upward pressure on prices. Moreover, a delayed withdrawal of the monsoon and heavy rains in certain regions have pushed up vegetable prices, primarily for tomatoes. Such factors are likely to have an adverse impact on inflationary expectations.

With the assumption of crude oil price of Indian basket at US$100/bbl in H2 FY2023, the MPC retained its CPI inflation forecast for FY2023 at 6.7%, with mild upward revision in the Q3 FY2023 projection

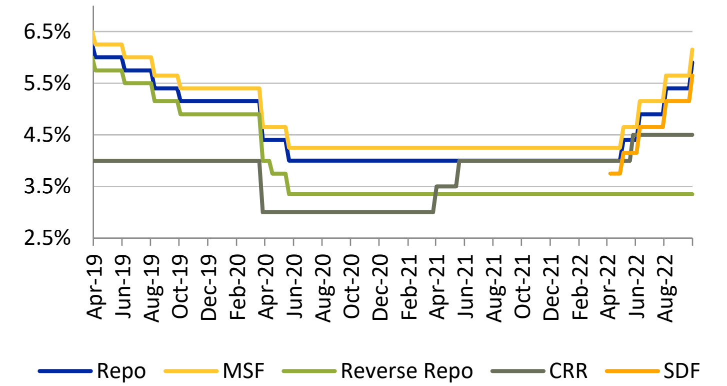
Taking into account these factors, as well as the assumption of the price of the Indian crude oil basket averaging US$100/bbl in H2 FY2023 (US$104/bbl in H1 FY2023), the Committee retained its CPI inflation forecast at 6.7% for FY2023, with risks evenly balanced. While the projections for Q2 FY2023 (+7.1%) and Q4 FY2023 (+5.8%) were kept unchanged, that for Q3 FY2023 (to +6.5% from +6.4%) was revised marginally upwards, relative to the levels indicated in the August 2022 meeting. Further, the MPC kept its CPI inflation projection for Q1 FY2024 unchanged at 5.0%.

The overall tone of the policy document was neutral, in our view. The outlook for future monetary policy action is likely to be dependent on the upcoming domestic inflation and growth data. Going forward, we expect the CPI inflation readings to moderate to sub-6% levels in November-December 2022, given the high base, suggesting that additional repo hikes from the MPC are likely to be modest. We expect the MPC to be data dependent in its December 2022 policy decision, taking a cue both from the latest CPI print and the strength of the Q2 FY2023 GDP growth.

With the headline CPI inflation expected to soften in early-H2 FY2023, we expect the MPC to be data dependent in its Dec 2022 policy decision

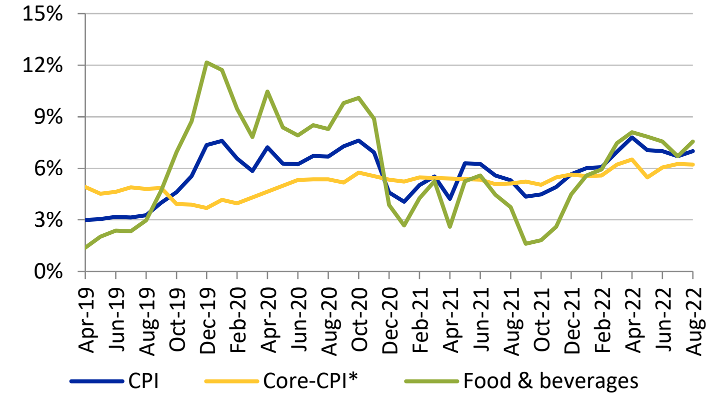
Notwithstanding the upward revision in estimates for Q2-Q4 FY2023, the FY2023 growth projection has undergone a mild downward revision to 7.0% from 7.2% indicated in the Aug 2022 policy, owing to the lower-than-expected print came in for Q1 FY2023

EXHIBIT 1: Movement in Key Rates



Source: RBI; CEIC; ICRA Research

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



**Due to unavailability of data for March-May 2020, we have not excluded petrol and diesel indices for vehicles in computation of core CPI index for these months; Source: NSO; CEIC; ICRA Research*

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	**August 2022**	**September 2022**	**August 2022**	**September 2022**
Q2 FY2023	7.1%	7.1%	6.2%	6.3%
Q3 FY2023	6.4%	6.5%	4.1%	4.6%
Q4 FY2023	5.8%	5.8%	4.0%	4.6%
FY2023	**6.7%**	**6.7%**	**7.2%**	**7.0%**
Q1 FY2024	5.0%	5.0%	6.7%	7.2%

Assuming average crude oil price (Indian basket) for H2 FY2023 at US$100/bbl; **Source: RBI; ICRA Research*

Mild downward revision in the FY2023 GDP growth forecast to 7.0% from 7.2% earlier: India's GDP growth was pegged by the National Statistic Office (NSO) at 13.5% YoY for Q1 FY2023 (base-effect led jump from 4.1% in Q4 FY2022 owing to the Covid 2.0 impact in Q1 FY2022), broadly in line with our projection (+13.0%), but sharply below the MPCs' forecast of 16.2%. On the expenditure side, private final consumption expenditure (PFCE: +25.9%) and gross fixed capital formation (GFCF: +20.1%) powered the YoY GDP expansion in Q1 FY2023, amidst an anaemic growth in government final consumption expenditure (GFCE: +1.3%) and a sizeable drag from net exports in the quarter. The GVA growth rose to 12.7% in Q1 FY2023 from 3.9% in Q4 FY2022, largely driven by services.

The MPC sees the strengthening in the urban consumption has been driven by discretionary spending ahead of the festival season, while the recovery in rural demand is gradual

In terms of the outlook, the MPC believes that the strengthening in the urban consumption has been driven by discretionary spending ahead of the festival season, while the recovery in rural demand is gradual, and expects this trend to continue in the H2 of FY2023, as typically seen in the past. The rebound in demand for services and improving outlook for agri and allied activities have brightened the growth prospects, according to the Committee. Further, it expects the Government's capex push, improvement in seasonally adjusted capacity utilisation levels (to +74.3% in Q1 FY2023 from +73.0% in Q4 FY2022) and the uptrend in non-food bank credit to support the investment activity, and may result in a rebound in the industrial activity after the subdued performance in July 2022 (+2.4%, as per the IIP data). In addition, the recently conducted surveys by the RBI depict an optimistic outlook on demand and sales prospects in firms engaged in manufacturing, services and infrastructure sectors. Nevertheless, headwinds from geopolitical tensions, tightening global financial conditions and the slowing external demand pose downside risks to the net exports and accordingly, India's GDP growth in FY2023.

The committee expects the Government's capex push, improvement in seasonally adjusted capacity utilisation levels and the uptrend in non-food bank credit to support the industrial activity after the subdued performance in July 2022

Taking all these factors into consideration, the GDP growth forecasts have been revised upwards for Q2 FY2023 (+6.3% from +6.2% indicated in the Aug 2022 policy), Q3 FY2023 (to +4.6% from +4.1%), and Q4 FY2023 (to 4.6% from +4.0%), relative to the projections provided in the August 2022 policy, with risks broadly balanced. However, with the lower-than-expected print for Q1 FY2023, the FY2023 growth projection has undergone a mild downward revision to 7.0% from 7.2% earlier. Moreover, the MPC has increased the Q1 FY2024 GDP growth estimate to 7.2% from the 6.7% indicated in August 2022.

The MPC's growth projection of 6.3% for Q2 FY2023 is slightly lower than our expectations of 6.5-7.0% for the quarter. We believe that the ongoing robust demand for services owing to pent-up demand, and favourable impact of commodity price correction on business margins is likely to support growth in Q2 FY2023. Further, the record generation of average daily GST e-way bills in August 2022, owing to pre-festive stocking, indicates a revival in confidence and this coupled with softening commodity prices bodes well for the upcoming festive season. However, the decline in output of key kharif crops such as rice and flagging external demand pose risks to growth and remain the key monitorables. For H2 FY2023, we expect a higher growth of 5.0-5.5% vis-à-vis the MPC's revised projection of ~4.6%, partly based on our view that private and Government capex will witness a back-ended pickup. Overall, we maintain our FY2023 growth forecast at 7.2%.

Headwinds from geopolitical tensions, tightening global financial conditions and the slowing external demand pose downside risks to the net exports and accordingly, India's GDP growth in FY2023

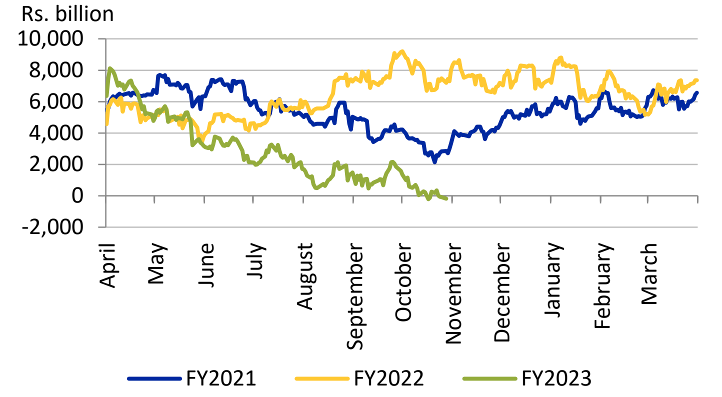
The daily average liquidity surplus under the LAF has moderated to Rs. 1.29 trillion in Q2 FY2023 (till Sep 29, 2022; refer Exhibit 4) from Rs. 4.54 trillion in Q1 FY2023, largely reflecting the fall in foreign currency assets (to US$484.9 billion on Sep 16, 2022 to US$525.7 billion on July 1, 2022). While liquidity continued to tighten in Q2 FY2023, the extent of the dip in the surplus was modest as compared to the sharp fall seen in Q1 FY2023. As a percentage of NDTL, the average daily net systemic liquidity surplus eased to 0.4% during September 1-29, 2022 from ~1.4% at end-June 2022 and ~4.5% in early-April 2022. On a monthly basis, the daily average liquidity surplus dipped from Rs. 1.9 trillion in July 2022 to Rs. 1.2 trillion in August 202, and further to Rs. 0.7 trillion in September 2022 (till Sep 28).

The daily average liquidity surplus under the LAF has moderated to Rs. 1.29 trillion in Q2 FY2023 (till Sep 29, 2022) from Rs. 4.54 trillion in Q1 FY2023, owing to the fall in foreign currency assets

Systemic liquidity turned to a deficit during Sep 20-21, 2022 after a gap of 40 months, and again on Sep 27-29, 2022, owing to frictional stress related to the GST and advance tax payments coupled with forex outflows

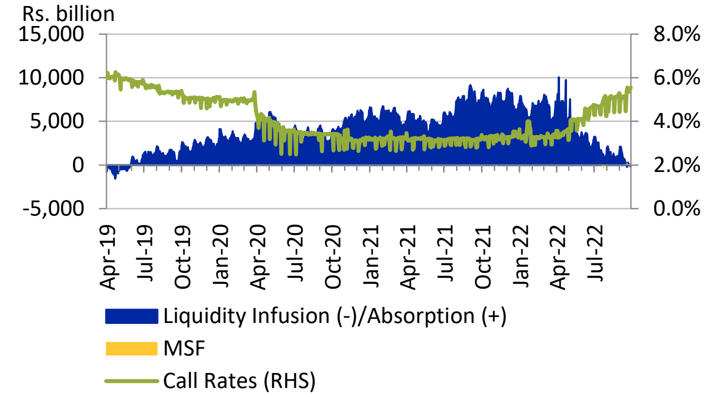
In view of the moderation in surplus liquidity, the RBI has decided to merge the 28-day VRRR auctions with the fortnightly 14-day main VRRR auction

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



Data for FY2023 is available upto September 29, 2022; **Source: RBI; ICRA Research*

EXHIBIT 5: Call money rates



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

Notably, systemic liquidity turned to a deficit during September 20-21, 2022 after a gap of 40 months, and again on September 27-29, 2022, owing to frictional stress related to the GST and advance tax payments coupled with forex outflows. This warranted the banks to avail higher funds through the MSF route and necessitated the RBI to conduct variable rate repo operation worth Rs. 500 billion on Sep 22, 2022, similar to the situation that was witnessed during the end of July 2022, when the VRR auction of the equivalent amount was conducted following the drop in surplus liquidity owing to tax outflows. The durable liquidity surplus has declined to Rs. 3.7 trillion as on September 9, 2022 from Rs. 6.0 trillion as on July 1, 2022. In the view of moderation in surplus liquidity, the RBI decided to merge the 28-day VRRR auctions with the fortnightly 14-day main auction; in other words, only the 14-day VRRR auctions will be conducted from now on. **We expect the RBI to also focus on VRR auctions if there are more instances of liquidity deficits in the coming months. If the liquidity deficit enlarges sustainably, there is a small likelihood of a reversal of the CRR hike (happened in May 2022) in the Dec 2022 policy, although this is not our base case scenario to address the liquidity concerns.**

The Governor also highlighted that the typical pick-up in Government spending in the second half of the year may improve the surplus liquidity going forward from the temporary moderation that has been witnessed at present. Moreover, he stated that the liquidity can be augmented through the drawdown of excess CRR and SLR holdings of the banks.

The RBI conducted net outright OMO sales of Rs. 41.4 billion in July 2022, Rs. 67.4 billion in August 2022, and Rs. 35.9 billion in September 2022 (till Sep 14), resulting in net sales of Rs. 144.6 billion in Q2 FY2023, vis-à-vis Rs. 66.2 billion during Q1 FY2023.

Reflecting the decline in surplus liquidity, the daily weighted average call money rate rose from 4.42% in June 2022 to 4.69% in July 2022, and further to 4.95% in August 2022. Thereafter, it inched up slightly to 4.96% in September 2022 (till Sep 29). Similarly, the average rates for the 91-day T-bills, 182-day T-bills, and 364-day T-bills rose gradually from 4.60%, 5.13% and 5.59%, respectively, in Q1 FY2023, to 5.60%, 6.04% and 6.34%, respectively, in Q2 FY2023. Interestingly, the weighted average call money rate exceeded the then repo rate (5.40%) during Sep 20-22, 2022 (5.51% on an average) and recently on Sep 27-29, 2022 (5.50%), largely during the episodes of liquidity deficit in the system.

RBI signaled its intent to migrate towards IND-AS. In our view, the impact will be comparatively higher for banks operating with a higher share of SMA/restructured book although considering high provision on legacy stress and better capitalization banks should largely be able to absorb the same

Highlights on RBIs statement on development and regulatory policies

1) **First steps towards expected credit loss (ECL) based approach for Loan loss provisioning and transitioning banks to IND-AS**

Impact: After being put off for implementation multiple times, the RBI is likely to consider rolling out IND-AS for banks over the medium term. In our view, with comparatively better capitalization levels compared to recent past, particularly for public sector banks, and meaningfully high provision coverage levels on legacy stressed assets/NPAs (at ~72-73%), incremental credit costs on NPAs arising out of implementation of IND-AS are likely to remain at manageable levels. However, considering elevated overdue/Special Mention Account (SMA) balances and standard restructured advances, incremental provisioning on these could remain materially higher than the 0.4% and 10% currently required on standard loans and standard restructured loans, respectively.

Investor interests in the stress assets continues to deepen and any potential move to widen investor participation will be beneficial to banks in terms of better price realization for stressed assets

Additionally, the implementation of IND-AS in its entirety may also necessitate marking to market that part of the investment book that is classified as held to maturity (HTM), which could impact some banks. In our view, the implementation of IND-AS is likely to be rolled out only at a time when banks are viewed to be better placed to absorb its impact. Moreover, the impact of high inflation and rising interest rates on relatively vulnerable borrowers and asset quality levels of banks will also be a monitorable while assessing the right time to transition.

2) Discussion paper on securitization of Stressed asset framework (SSAF)

Widening the possibilities of recoveries and investor participation in stressed assets by using a framework similar to securitization of standard assets

Impact: There has been active interest from investors in stressed asset markets. These investors do invest in such stressed assets by participating in security receipts issued by ARCs. Enhancing participation to a larger set of investors could widen the investor base for direct purchases of stressed loans from banks and could lead to better price discovery for banks.

In ICRA's view, the rationalising of criteria for RRBs to extend internet banking to their customers augurs well for encouraging digital payments in parts of the country covered by RRBs

3) Internet banking facility for customers of Regional Rural Bank (RRBs)

Extension of internet banking facilities by RRB to their customers eased

Impact: The RBI continues its push towards facilitating digitalization of payments while also widening its scope of regulation to entities that are part of the payment eco-system. RRBs are largely present in rural or far flung/remote districts with weaker banking presence. Accordingly, in ICRA's view, the rationalising of criteria for RRBs to extend internet banking to their customers augurs well for encouraging digital payments in parts of the country covered by RRBs.

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