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ICRA COMMENTS ON RBI’S DECEMBER 2022 MONETARY POLICY MEETING

MPC raised repo rate by expected 35 bps in non-unanimous decision; future policy action to be highly data dependent

DECEMBER 2022

HIGHLIGHTS

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As expected, the MPC voted for a repo hike of 35 bps (5:1 votes) in its Dec 2022 policy review, while keeping the stance unchanged (4:2), both in non-unanimous decisions

While the CPI inflation projection for FY2023 was retained at 6.7%, that for GDP growth was revised mildly downwards to 6.8% from 7.0%

In a non-unanimous decision, the Monetary Policy Committee (MPC) raised the policy repo rate by an expected 35 basis points (bps; with a majority vote of 5:1) in its December 2022 policy review and kept the policy stance unchanged (4:2). While the FY2023 CPI inflation forecast was retained at 6.7%, the GDP growth projection has undergone a mild downward revision to 6.8% from the 7.0% indicated in the September 2022 policy, amidst intensifying global headwinds such as the slackening of external demand. While we believe that the outlook for future monetary policy action is likely to be highly data dependent, the overall tone of the policy document was hawkish, with the MPC stating that further calibrated monetary policy action is warranted to keep the inflation expectations anchored, break the core inflation persistence and contain second round effects.

- In its December 2022 Monetary Policy meeting, the MPC raised the policy repo rate by an expected 35 bps (with a majority vote of 5:1) to 6.25% 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' (with a vote of 4:2). Accordingly, the standing deposit facility (SDF) rate stands adjusted to 6.00% and the marginal standing facility (MSF) rate and the Bank Rate to 6.50%.
- The MPC has mildly reduced its FY2023 growth forecast to 6.8% from the 7.0% indicated in the September 2022 policy, with heightening headwinds stemming from the slowdown in external demand, protracted geopolitical tensions and tightening of global financial conditions. The growth projections for Q3 FY2023 (to +4.4% from +4.6%), Q4 FY2023 (to +4.2% from +4.6%) and Q1 FY2024 (to +7.1% from +7.2%) have undergone downward revisions, compared to what were indicated in the September 2022 policy. Further, the Committee has pegged the growth estimate for Q2 FY2024 at 5.9%.
- On the inflation front, the MPC has retained its FY2023 CPI inflation forecast at 6.7%, taking into account the average crude oil price (Indian basket) at $100/bbl. With geopolitical tensions impacting uncertainty to the food and energy inflation outlook amidst expectations of continued stickiness in the core-inflation, the CPI inflation projections for Q3 FY2023 (to +6.6% from +6.5%) and Q4 FY2023 (to +5.9% from +5.8%) have been revised slightly upwards, relative to the previous policy. While the Committee retained its inflation estimate for Q1 FY2024 at 5.0%, it has placed the Q2 FY2024 forecast at 5.4% on the assumption of a normal monsoon.

Outlook: With the MPC continuing to place more emphasis on inflation relative to growth concerns, another rate hike in 2023 cannot be ruled out. Notwithstanding how much more of hikes are in store from the US Federal Reserve, we believe that the MPC's decision on the repo rate in February 2023 should be driven by the domestic inflation-growth dynamics, including the contours of the Union Budget for FY2024. We foresee the 10-year G-sec yield to range between 7.2-7.6% in the next quarter.

MPC HIKED REPO RATE BY 35 BPS, KEPT POLICY STANCE UNCHANGED IN DEC 2022 POLICY, WITH NON-UNANIMOUS VOTE

The MPC raised the policy repo rate by 35 bps to 6.25% with a vote of 5:1, while highlighting that it would continue to focus on withdrawal of accommodation, with majority of 4:2

In its Dec 2022 meeting, the MPC decided to raise the policy repo rate by 35 bps under the liquidity adjustment facility (LAF) to 6.25% (refer Exhibit 1), albeit with a non-unanimous vote of 5:1. Accordingly, it also increased the SDF, Bank rate and MSF rates by 35 bps each to 6.00%, 6.50% and 6.50%, respectively, in Dec 2022. This is the fifth rate hike in the current fiscal and takes the total increase in the repo rate to 225 bps in the current rate hike cycle. Additionally, the Committee decided with a majority of four out of six members, to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

FY2023 CPI inflation forecast retained at an elevated 6.7%: Post the MPC's September 28-30, 2022 policy meeting, the YoY CPI inflation had eased to a three-month low 6.8% in Oct 2022 from 7.4% in Sep 2022, led by a base-effect led drop in food inflation, especially vegetables. However, it remained above the MPC's 6.0% threshold of the medium-term target range (2.0%-6.0%) for the tenth consecutive month (refer Exhibit 2). Additionally, the share of items in the CPI basket with readings higher than 6.0% had eased to 54.1% in Oct 2022 from 56.0% in Sep 2022.

High and sticky core inflation poses major risk to inflation; while food inflation is likely to soften, uncertain global scenario and adverse weather conditions are likely to act as upside risks to inflation

The MPC indicated that while food inflation is likely to moderate led by the rabi harvest going forward, prices of cereals, milk and spices continue to pose an upside risk in the medium-term. Notably, the Committee highlighted that sticky and elevated core inflation continues to act as the main risk to the inflation trajectory. Additionally, even as the global commodity prices have softened, the near-term outlook remains uncertain owing to the ongoing geopolitical tensions. Moreover, the healthy recovery in the domestic services sector and the consequent pass-through of input costs by firms as well as adverse weather conditions could weigh on the inflation trajectory, going forward.

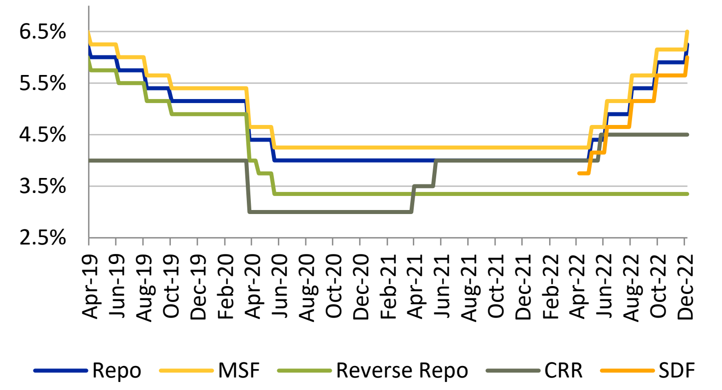
With the assumption of crude oil price of Indian basket at $100/bbl, the MPC retained its CPI inflation forecast for FY2023 at 6.7%, with mild upward revisions in the Q3-Q4 FY2023 projections

Taking into account these factors, as well as the assumption of the price of the Indian crude oil basket averaging $100/bbl, the Committee retained its CPI inflation forecast at 6.7% for FY2023, with risks evenly balanced. Moreover, the projections for Q3 FY2023 (to +6.6% from +6.5% indicated in the Sep 2022 policy) and Q4 FY2023 (to +5.9% from +5.8%) have been revised marginally upwards, relative to the levels indicated in the Sep 2022 meeting. Further, the MPC kept its CPI inflation projection for Q1 FY2024 unchanged at 5.0%, while stating that it is projected to rise to 5.4% in Q2 FY2024.

In our view, the overall tone of the policy document was hawkish, with the Governor highlighting that core inflation remains sticky and elevated, necessitating a continued watch over inflation. Additionally, it was stated that while headline inflation has softened in Oct 2022, it remains above the mid-point (+4.0%) of the MPC's medium target range. The near-term inflation outlook is clouded by risks such as supply disruptions for some perishables owing to excess rains, and a robust demand for services. We expect a high base to soften the YoY CPI inflation to 6.2% in Nov 2022. We project the headline and core CPI inflation to moderate to ~5.2% and 5.4%, respectively, in FY2024 from 6.6% and 6.3%, respectively, in FY2023.

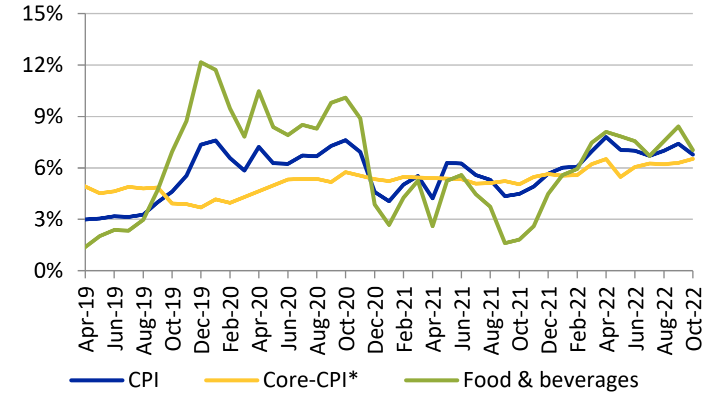
The headline CPI inflation is expected to soften in Nov 2022

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*

The MPC highlighted that urban consumption continues to be supported by discretionary spending, while rural demand is aided by healthy tractor and two-wheeler sales as well as a rise in farm activity

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	**September 2022**	**December 2022**	**September 2022**	**December 2022**
Q3 FY2023	6.5%	6.6%	4.6%	4.4%
Q4 FY2023	5.8%	5.9%	4.6%	4.2%
FY2023	**6.7%**	**6.7%**	**7.0%**	**6.8%**
Q1 FY2024	5.0%	5.0%	7.2%	7.1%
Q2 FY2024		5.4%		5.9%

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

Mild downward revision in the FY2023 GDP growth forecast to 6.8% from 7.0%: As per the data released by the National Statistical Office (NSO), India's GDP growth eased to 6.3% YoY for Q2 FY2023 from 13.5% in Q1 FY2023, slightly lower than our estimate of 6.5%, albeit in line with the MPC's forecast of 6.3% for that quarter.

The Committee stated that healthy credit growth, capex push by GoI, and improved performance of manufacturing and infrastructure firms are likely to support investment activity

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

Led by a downward revision in growth projections for Q3-Q4 FY2023, the FY2023 growth forecast has been pared to 6.8% from 7.0% indicated in the Sep 2022 policy

The MPC highlighted that urban consumption has gained momentum as reflected by the recovery in service-related activities such as travel and tourism. This is indicated by the healthy YoY growth in domestic air passenger traffic and passenger vehicle sales. Additionally, the rural segment continues to be supported by healthy tractor and two-wheeler sales, as well as an uptick in farming activity. Moreover, the Committee highlighted that the performance of the manufacturing and service sectors remains healthy and is likely to pick up going forward, with construction activity improving post the monsoon season. Going ahead, the MPC expects investment activity to be aided by a rise in government capex, healthy credit growth, as well as an increased share of fixed assets in total assets of manufacturing companies. Moreover, the prospects of a good rabi harvest are likely to support the agricultural sector. In addition, the recently conducted surveys by the RBI on consumer confidence as well as the performance of manufacturing, infrastructure and service sector firms depicts an optimistic business outlook. However, the impact of a global slowdown on merchandise exports, protracted geopolitical tensions and tightening global financial conditions continue to act as headwinds to the current growth trajectory.

Taking all these factors into consideration, the GDP growth forecasts have been revised downwards for Q3 FY2023 (to +4.4% from +4.6% indicated in the Sep 2022 policy) and Q4 FY2023 (to +4.2% from +4.6%), relative to the projections provided in the Sep 2022 policy, with risks evenly balanced. With this, the FY2023 GDP growth projection has been pared to 6.8% from 7.0%. Moreover, the MPC has mildly cut the Q1 FY2024 GDP growth estimate to 7.1% from the 7.2% indicated earlier in Sep 2022, while projecting growth to moderate to 5.9% in Q2 FY2024. Notably, the Governor stated that while India's growth forecast for FY2023 has been revised downwards, the country continues to remain among the fastest growing major economies in the world.

While the sequential momentum of several high frequency indicators was healthy in Oct 2022, the YoY growth eased due to the early onset of festive season, as seen in the muted 0.1% rise in the core sector in Oct 2022. We believe that the average trends for Oct-Nov would provide a better gauge to assess the growth momentum in the ongoing quarter given the shift in the festive calendar in 2022. Further, the pick-up in rabi sowing, rise in paddy procurement by the GoI as well as healthy farm cash flows is likely to support the agri sector. In addition, the robust recovery displayed by the services sector and an expected increase in output volumes of some industrial sectors after the end of monsoon season should support growth in H2 FY2023. However, the sustenance of demand for goods after the festive season is uncertain given the continued preference towards the consumption of services, and this would guide the trend for private capex announcements going forward. Overall, we maintain our FY2023 growth forecast at 7.2%, slightly higher than the MPC's projection of 6.8%.

The daily average liquidity surplus under the LAF has moderated to Rs. 0.4 trillion in Q3 FY2023 (till Dec 6, 2022; refer Exhibit 4) from Rs. 1.29 trillion in Q2 FY2023. This was partly on account of an increase in the currency with the public (to Rs. 30.9 trillion as on Nov 18, 2022 from Rs. 30.4 trillion as on Sep 23, 2022) amidst a higher demand during the festive season, even as there was an increase in forex reserves (to $561.2 billion on Dec 2, 2022 from $532.7 billion on Sep 30, 2022) and a moderation in the GoI cash balances (to Rs. 1.9 trillion as on Nov 18, 2022 from Rs. 3.5 trillion as on Sep 23, 2022). As a percentage of NDTL, the average daily net systemic liquidity surplus eased to a mild 0.2% in Q3 FY2023 (till Dec 6, 2022) from 0.8% during Q2 FY2023, while sharply trailing the ~4.5% seen in early-April 2022. On a monthly basis, *The daily average liquidity surplus under the LAF has moderated to Rs. 0.4 trillion in Q3 FY2023 (till Dec 6, 2022) from Rs. 1.29 trillion in Q2 FY2023, partly on account of an increase in the currency with the public owing to festive demand*

While the systemic liquidity surplus has fallen to Rs 0.4 trillion in Q3 FY2023 (till Dec 6, 2022), the durable liquidity surplus stood at a comfortable Rs. 2.6 trillion as on Nov 18, 2022

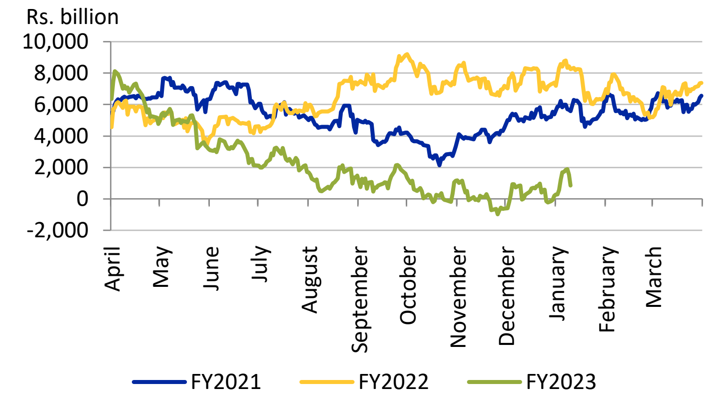
the daily average liquidity surplus dipped from Rs. 0.7 trillion in September 2022 to a marginal Rs. 0.1 trillion in the festive month of October 2022 with several instances of liquidity deficits in the system. Subsequently, the average liquidity surplus has risen to Rs. 0.5 trillion in November 2022, and further to a sharp Rs. 1.6 trillion in December 2022 so far (till Dec 6).

While the systemic liquidity surplus has fallen to Rs. 0.4 trillion in Q3 FY2023 (till Dec 6, 2022), the durable liquidity surplus stood at a comfortable Rs. 2.6 trillion as on Nov 18, 2022, albeit lower than the Rs. 3.6 trillion recorded as on Sep 23, 2022.

The RBI did not conduct OMO sales/purchases in Oct-Nov 2022 after having sold net G-secs worth Rs. 145 billion in Q2 FY2023.

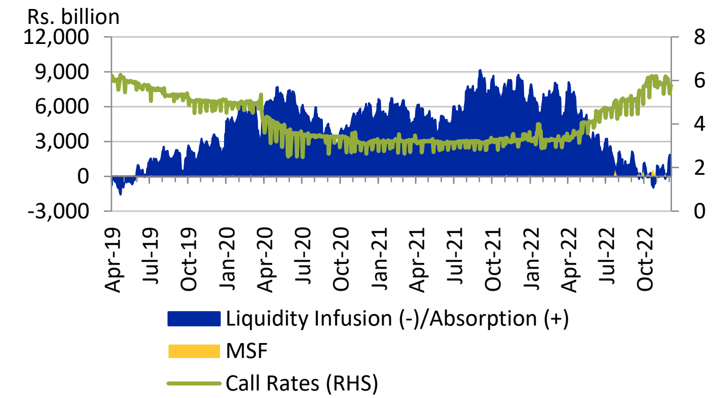
Reflecting the sustained moderation in surplus liquidity, the daily weighted average call money rate rose from 5.15% in September 2022 to 5.95% in October 2022. Subsequently, it eased mildly to 5.91% in November 2022 owing to a sequential uptick in the average systemic liquidity surplus in the month after the end of festive season. Thereafter, the daily WACR has averaged at 5.63% in Dec 2022 (till Dec 6, 2022). Similarly, the average rates for the 91-day T-bills, 182-day T-bills, and 364-day T-bills rose from 5.60%, 6.03% and 6.34%, respectively, in Q2 FY2023 to 6.38%, 6.74% and 6.91%, respectively, in Oct-Nov 2022. Notably, there were several instances in October-November 2022 when the weighted average call money rate exceeded the then repo rate (5.90%) - during Oct 10-13, 2022 (6.01% on an average), Oct 17-27, 2022 (6.15%), Oct 31-Nov 2, 2022 (6.09%), and Nov 21-29, 2022 (6.11%), largely during the episodes of liquidity deficit in the system amid festive demand.

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



Data for FY2023 is available upto December 6, 2022; **Source: RBI; ICRA Research*

EXHIBIT 5: Call money rates



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

Although the RBI remains in absorption mode, the Governor emphasised that the Central Bank continues to be nimble and flexible in its liquidity management operations to meet the credit requirements of the productive sectors

Banks will have more head room in terms of classifying securities under the held to maturity category although this is un-likely to generate a meaningful incremental demand for government securities as banks are likely to prioritize credit growth and returns over deploying resources in comparatively lower yielding securities

While tax outflows and currency demand may temporarily cause tight liquidity conditions, the Governor stated some factors, which are likely to improve the liquidity conditions going forward, such as the typical moderation in currency in circulation after the end of festive season, a pick-up in the spending by the Government during H2 of a fiscal year, and an improvement in forex reserves amid the resumption of FPI equity inflows. Although the RBI remains in absorption mode, the Governor emphasized that the Central Bank continues to be nimble and flexible in its liquidity management operations to meet the credit requirements of the productive sectors. In addition, he highlighted that the Central Bank would look for a durable sign of a turn in the liquidity cycle when banks draw down large part of their SDF and variable rate reverse repo (VRRR) balances, before it injects liquidity via LAF operations.

Highlights from the RBI's statement on development and regulatory policies

1) **SLR holding in the Held-To-Maturity (HTM) category extended by a year**

Earlier, in its policy statement on April 8, 2022, the RBI had enhanced the HTM limit for banks to 23% of Net Demand and Time Liabilities (NDTL) from 22%. Banks were allowed to include eligible securities acquired between September 1, 2020 and March 31, 2023 for the purpose of the enhanced limits, which were to be subsequently trimmed down gradually to 19.5% between June 30, 2023 and March 31, 2024.

The RBI has now decided to extend the said dispensation by a year. Accordingly, the enhanced HTM requirement of 23% will remain in place till March 31, 2024. Banks will be allowed to include securities acquired in FY2024 as well for these limits before the restoration begins from June 30, 2024.

Impact: ICRA expects overall NDTL levels for the banking system to grow by 7-8% in FY2024 (following an estimated YoY expansion of 8.5-9.1% in FY2023). Consequently, banks are estimated to be in a position to hold an incremental stock of eligible securities amounting to Rs.6.7-6.8 trillion on March 31, 2024, under the HTM category, by virtue of an extension of these limits till the said date. However, these measures may not create a meaningful incremental demand for government securities. The buoyancy in credit growth is expected to sustain over the medium term and banks may continue to prefer and push credit growth over deploying their resources in comparatively lower yielding assets. Further, as the yields on G-secs are higher than that seen in the last few years, banks would have chosen to acquire these securities in normal course of business without concerns of mark-to-market losses if these investments were not to be classified as HTM securities. As a result, banks may remain indifferent to utilizing the enhanced HTM limits.

Single block and-multiple debits expected to enhance ease of payments for UPI users while encouraging merchants to adopt the platform for accepting payments

2) Enhancements made to unified payment interface (UPI)

UPI utility enhanced for making single block and multiple debits

Impact: The RBI has decided to allow customers using UPI to create a payment mandate against a merchant by blocking funds in their bank account, which can be subsequently debited/utilised for making payments in the future. Similarly, the mechanism will allow users to make payments for purchase of securities using the RBI's retail direct scheme or purchasing securities in the secondary market. As funds will be appropriated to the merchants at the time of the delivery of goods or services, the added optionality brings about ease of making payments for users while assuring payment to merchants. Although the move by itself may not translate into a large increase in the number of users, many of the existing users may choose to use the facility given the ease of making recurring/multiple payments, while merchants will be encouraged to adopt UPI for accepting payments.

3) Expanding the scope of Bharat Bill Payment System (BBPS)

Wider range of payments/collections included in the ambit of permissible payments/collections under BBPS

Impact: The RBI has allowed payment and collection of professional fees, education fees, rent taxes etc., which are usually in the nature of non-recurring payments or represent the collection/payment requirements of individuals. The expansion in the scope of payments/collections augurs well for encouraging the usage and acceptability of the BBPS system going forward.

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