RBI's fifth policy meet for FY2022-23 – Impact Analysis

September 30, 2022

In line with expectations the Reserve Bank of India (RBI) today, raised the repo rate by 50bps to 5.9%, continuing with its frontloaded tightening.

Highlights of the Policy:

- All but one member voted for a 50bps rate hike, while one member voted for a 35bps rate hike, the first such divergence in views in the current hiking cycle
- The Standing Deposit Facility (SDF) rate stands adjusted to 5.65% while the marginal standing facility (MSF) rate and the Bank Rate now stands increased to 6.15%
- The official stance remains 'withdrawal of accommodation'
- Cash Reserve Ratio (CRR) remains at 4.50%
- Real GDP growth forecast for FY23 was trimmed to 7% from 7.2% earlier, with Q2FY23 growth projected at 6.3%, Q3 at 4.6% and Q4 at 4.6%
- Inflation projection for FY23 retained at 6.7% for FY23 with Q2FY23 projected at 7.1%, Q3 at 6.5% and Q4 at 5.8%, considering an average crude basket at USD 100 per barrel

Regulatory measures:

- Proposed shifting to the 'Expected Loss Approach' from the current 'Incurred Loss Approach' for NPA allowances required to be maintained by banks in line with current global practice

- Proposed additional framework to the current 'Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act', for the securitization of stressed assets

RBI assessment on Global economy:

- Global economic activity is weakening under the impact of the protracted conflict in Ukraine and aggressive monetary policy actions and stances across the world. As financial conditions tighten, global financial markets are experiencing surges of volatility, with sporadic sell-offs in equity and bond markets, and the US dollar strengthening to a 20-year high.

- Emerging market economies (EMEs) are facing intensified pressures from retrenchment of portfolio flows, currency depreciations, reserve losses and financial stability risks, besides the global inflation shock.

RBI assessment on domestic economy:

- Real gross domestic product (GDP) grew by 13.5% in Q1FY23. While all constituents of domestic aggregate demand expanded y-o-y and exceeded their pre-pandemic levels, the drag from net exports provided an offset.

- Aggregate supply conditions are improving. With the south-west monsoon rainfall 7 per cent above the long period average (LPA) as on 29th September and its spatial distribution spreading to some deficit areas, kharif sowing (autumn crops) has been catching up. Acreage was 1.7 per cent above the normal sown area as on 23rd September.

- Activity in industry and services sectors remains in expansion, especially the latter, as reflected in purchasing manager's indices (PMIs) and other high frequency indicators. The index of industrial production growth, however, slowed to 2.4% y-o-y in July.

- On the demand side, urban consumption is being lifted by discretionary spending ahead of the festival season and rural demand is gradually improving. Investment demand is also gaining traction, as reflected in rising imports and domestic production of capital goods, steel consumption and cement production.

- CPI inflation rose to 7.0% y-o-y in August 2022 from 6.7% in July as food inflation moved higher, driven by prices of cereals, vegetables, pulses, spices and milk. Fuel inflation moderated with reduction in kerosene (PDS) prices, though it remained in double digits.

- Overall system liquidity remained in surplus, with the average daily absorption under the liquidity adjustment facility (LAF) easing to INR 2.3tn during August-September (up to September 28, 2022) from INR 3.8tn in June-July. Banking system credit continued to expand at 16.2% y-o-y as on 9th September while deposits grew by 9.5% y-o-y.

- India's foreign exchange reserves were USD 537.5bn as on 23rd September, 2022.

Impact on fixed income markets

- The 10-year G-sec yield rose marginally to 7.38% post the rate hike announcement.

- The overnight weighted call rate has now moved up from an avg 3.32% in March 2022 to above 6.1% as of today, indicating steeper transmission of rate hikes on target yields as compared to the longer end of the curve.

- Bank lending rates have increased post the previous rate hike, existing floating rate loans linked to repo or treasury-bill yields have seen an impact of ~180bps.

Our Analysis & Outlook

- Today's 50bps rate hike was on expected lines as the RBI continued its emphasis on containing elevated price pressures.

- We expect liquidity conditions to tighten further on the back of RBI's forex interventions and accelerating credit growth in the banking system.

- Expect rate hikes to continue based on elevated inflation and hawkish global central bank's policy stance.

- We believe that gradually fixed income as an asset class is becoming attractive due to higher yields across duration and credit ratings.

- The curve has flattened considerably as the short end of the yield curve has risen more steeply as compared to the longer end, and thus we are more comfortably in owning lower duration corporate bonds and floating rate assets due to the higher carry.

- The longer end of the yield curve has not moved up by that much in comparison to the shorter end and thus may rise further from current levels.

- Expect inflation to remain more entrenched due to US Dollar strengthening, elevated food prices and robust aggregate demand.

- We continue to be positioned in floating-rate bonds as a defensive stance due to rising-rate environment and expect them to outperform all other fixed-income instruments in the current rising interest rate scenario.

Data source: RBI's fifth Monetary Policy Meet statement for FY2022-23 dated 30th September, 2022

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