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

February 08. 2023

In line with our expectations, the Reserve Bank of India (RBI) today raised the repo rate by 25bps to 6.5%. This time the decision was voted by the committee with a 4:2 majority as compared to a 5:1 majority in last meeting. In aggregate, the repo rate has increased by 250bps in the current financial year, from 4% to 6.5%.

Highlights of the Policy:

- Repo rate hiked by 25bps, stance maintained at 'withdrawal of accommodation'.
- The standing deposit facility (SDF) rate stands adjusted to 6.25% while the marginal standing facility (MSF) rate and the bank rate now stands increased to 6.75%.
- Cash Reserve Ratio (CRR) remains at 4.50%.
- Inflation projection for FY23 lowered to 6.5% from 6.7% earlier. The downward revision was attributed to earlier than anticipated seasonal decline in vegetable prices. The RBI expects inflation to moderate in FY2023-24 but is likely to rule above its 4% target.
- Growth forecast for FY24 projected at 6.4%, with Q1 FY24 growth projected at 7.8%(from 7.1% earlier), Q2 at 6.2% (from 5.9% earlier)

Regulatory measures on climate risk and sustainable finance:

- Broad framework for acceptance of Green Deposits
- Disclosure framework on Climate-related Financial Risks
- Guidance on Climate Scenario Analysis and Stress Testing

Payments and Settlement Systems:

- Extending the Unified Payment Interface (UPI) for inbound travelers to India: Proposed to permit all inbound travelers to India to access UPI for their merchant payments while in the country.

Currency Management:

- Introduction of a QR code based Coin Vending Machine (QCVM), a cashless coin dispensation machine which would dispense coins against a debit to the customer's bank account using the UPI payment network.

RBI assessment on Global economy:

- The outlook on global growth has improved in recent months, despite the persistence of geopolitical hostilities and the impact of monetary policy tightening by central banks across the world. Nonetheless, global growth is expected to decelerate during 2023.

- Inflation seems to be softening from elevated levels, prompting global Central banks to moderate the size and pace of rate actions

RBI assessment on domestic economy:

- The first advance estimates released by the National Statistical Office (NSO) on January 6, 2023, placed India's real gross domestic product (GDP) growth at 7.0 % y-o-y for FY23, driven by private consumption and investment. On the supply side, gross value added (GVA) was estimated at 6.7%.

- High frequency indicators suggest that economic activity has remained strong in Q3 and Q4FY23. Capacity utilization in manufacturing is now above its long period average. Port freight traffic, e-way bills and toll collections were buoyant in December. Purchasing managers' indices (PMIs) for manufacturing as well as services remained in expansion.

- Domestic demand has been sustained by strong discretionary spending. Urban demand exhibited resilience as reflected in healthy passenger vehicle sales and domestic air passenger traffic.

- Going ahead, the stronger prospects for agricultural and allied activities are likely to boost rural demand. The rebound in contact-intensive sectors and discretionary spending is expected to support urban consumption. On the other hand, external demand is likely to be dented by a slowdown in global activity, with adverse implications for exports.

- CPI headline inflation moderated to 5.7% in December 2022 – after easing to 5.9% in November – on the back of double digit deflation in vegetable prices. On the other hand, core CPI (i.e., CPI excluding food and fuel) inflation rose to 6.1% in December due to sustained price pressures in health, education and personal care and effects.

- The outlook for inflation is mixed. While prospects for the Rabi (winter) crops have improved, risks from adverse weather events remain. Commodity prices are expected to face upward pressures with the easing of COVID related mobility restrictions in some parts of the world. The ongoing pass-through of input costs to output prices, especially in services, could continue to exert pressures on core inflation.

- The overall liquidity remains in surplus, with average daily absorption under the LAF increasing to INR 1.6tn during December-January from an average of INR 1.4tn in October-November. On a y-o-y basis, money supply (M3) expanded by 9.8% as on January 27, 2023, while non-food bank credit rose by 16.7%.

- India's foreign exchange reserves were placed at USD 576.8bn as on January 27, 2023.

Our Analysis & Outlook

- The 10-year G-Sec Bond yield increased slightly to 7.34% (previous day closing: 7.32%) and the 5-year bond yield rose to 7.21% (previous day close: 7.16%) following the rate hike announcement.

- The RBI's target overnight weighted average call rate has moved up from 6.11% as on Feb 7, 2023 to ~6.40% after the MPC announced rate hikes, indicating the transmission of hikes on the target yields.

- The MPC meeting today was on expected lines with announcement of 25bps repo rate hike. The MPC remained focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

- Headline inflation has moderated in the past few months due to decline in vegetable prices. Core inflation, however, remains entrenched and of concern.

- We expect inflation to remain above the RBI's comfortable range and hence remain watchful of cues like global central banks actions, commodity prices, energy prices and geo-political developments that may impact the overall macro environment. Keeping the stance unchanged to withdrawal of accommodation, is a signaling tool adopted by RBI, that they would like to be sure about the inflation, especially core inflation aligning closer to the inflation corridor, i.e. 4% +/- 2%. This gives the flexibility to the RBI to either raise rate or change the stance in the next meeting, which the RBI can decide by looking at incoming data for the next couple of months.

- System liquidity may remain in surplus in the foreseeable future, owing to Government spending and anticipated return of forex flows.

- Indian fixed income as an asset class has become more attractive due to higher yields across duration and across credit ratings. It is a good time to allocate more to fixed income and gradually increase exposure to credit spread assets.

- Yields on spread assets (AA and below) have become attractive, thereby improving accruals from these bonds. Credit spreads over G-Secs have widened due to softer transmission of G-Sec yield movements onto corporate bond yields. Wide spreads are a feature of the growth phase of the economic cycle. In this phase, accrual strategy is more attractive compared to duration.

- We prefer to be invested on the shorter end of the curve and continue with our recommendation that accrual strategy will be the key driver of returns for fixed income investors going forward.

Data source: RBI's Monetary Policy Meet statement for FY2022-23 dated 8th February, 2023

Note: FY refers to 1-year period ending March

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