Resolution of the Monetary Policy Committee (MPC) April 6-8, 2022

Monetary and Liquidity Measures:

On the basis of an assessment of the current and evolving macroeconomic situation, the Monetary Policy Committee (MPC) at its meeting today (April 8, 2022) decided to:

- Keep the policy Repo rate under the Liquidity Adjustment Facility (LAF) unchanged at 4.0%.
- The Marginal Standing Facility (MSF) rate and the Bank Rate remained unchanged at 4.25%.
- Introduce Standing Deposit Facility (SDF) rate, which will now be the floor of the LAF corridor, will be at 3.75%.
- The MPC also decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

These decisions were in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2%, while supporting growth.

The RBI also announced measures on Developmental and Regulatory Policies relating to (i) liquidity measures; (ii) Regulation and Supervision; and (iii) Payment and Settlement Systems. Some of the measures announced are as follows:

Liquidity Measures:

- **Introduction of the Standing Deposit Facility**
  The RBI decided to institute the Standing Deposit Facility (SDF) – an additional tool for absorbing liquidity without any collateral, with an interest rate of 3.75% with immediate effect. The SDF would replace the fixed Rate Reverse Repo (FRRR) as the floor of the LAF corridor. The Fixed Rate Reverse Repo (FRRR) rate was retained at 3.35%. It would remain as part of the RBI's toolkit and its operation will be at the discretion of the RBI for purposes specified from time to time.

- **Restoration of the Symmetric LAF Corridor**
  In order to fully restore the pre-pandemic liquidity management framework of February 2020 and in view of the gradual return to normalcy in financial markets, the RBI decided to restore the width of the LAF corridor to its pre-pandemic level. With the introduction of the SDF at 3.75%, the policy Repo rate being at 4.00% and the MSF rate at 4.25%, the width of the LAF corridor was restored to its pre-pandemic configuration of 50 bps.

Regulation and Supervision:

- **SLR Holdings in HTM category**
  With a view to enable banks to better manage their investment portfolio in FY 2022-23, the RBI decided to enhance the limit for inclusion of SLR eligible securities in the HTM category to 23% of NDTL and allow the banks to include securities acquired between April 1, 2022 and March 31, 2023 under the enhanced limit of 23%. The HTM limits would be restored from 23% to 19.5% in a phased manner starting from the quarter ending June 30, 2023.

The RBI also announced measures pertaining to Individual Housing Loans – Rationalisation of Risk Weights, Committee for Review of Customer Service Standards in RBI Regulated Entities, Interoperable Card-less Cash Withdrawal (ICCW) at ATMs, Bharat Bill Payment System – Rationalisation of Net-worth Requirement for Operating Units, and Cyber Resilience and Payment Security Controls of Payment System Operators (PSOs), amongst others.

MPC's Outlook:

Bond market participants were largely expecting the RBI to maintain a status quo on policy rates, but pare down the policy accommodation; however, the RBI surprised the markets by kick starting the monetary policy tightening process, by increasing the floor of the policy rate corridor with the introduction of the SDF rate. Thus, the monetary policy was relatively hawkish, with the RBI focussing on withdrawal of accommodation to ensure that inflation remains within the target. **The policy rate corridor has been narrowed to 50 bps from 65 bps, with the upper end of the corridor being the MSF rate at 4.25% and the lower end being the SDF rate at 3.75%.** Effectively this would raise the floor on interest rates by 40 bps. More importantly the RBI stated it will be focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward. **While the RBI has not explicitly changed the stance to 'Neutral', the words 'focus on withdrawal of accommodation' may mean that the RBI is in favour of keeping the stance neutral but may wait till more clarity emerges on the current geopolitical tensions.** In this policy also (just like the previous policy) the roadmap of measures to support the absorption of the mammoth supply of G-secs in FY23 were not announced. Though the RBI governor did state that the RBI remained focussed on completion of the borrowing programme of the Government. Another important take away, was the withdrawal of high surplus liquidity, wherein the RBI governor mentioned that the RBI will undertake calibrated withdrawal of this liquidity over a multi-year time frame in a non-disruptive manner beginning this year. **More importantly the RBI governor also indicated that the monetary policy will be nimble footed going forward, as there are uncertainties regarding trajectory of economic growth as well as inflation. This could mean that if the situation so warrants the RBI may move faster on monetary policy tightening.** Understandably, the RBI sounded very cautious on the spike in commodity prices and the impact that they could have on domestic prices and macros. **On one hand the RBI has revised the inflation forecast upwards and on the other hand the economic growth projections have been revised downwards, indicating conditions building up for a situation of stagflation if further downside risks materialise.**

As opposed to the some of the recent monetary policies wherein the RBI sounded sanguine on the inflation trajectory, in today's monetary policy, the RBI clearly acknowledged the upside risks to inflation. In line with expectations, the RBI revised its inflation forecast upwards and now expects it to be at 5.7% in FY23, with Q1 at 6.3%; Q2 at 5.8%; Q3 at 5.4%; and Q4 at 5.1%. In the February, the RBI had projected inflation for FY23 to be at 4.5% YoY, with Q1FY23 at 4.9% YoY; Q2FY23 at 5% YoY; Q3FY23 at 4.0% YoY; and Q4FY23 at 4.2% YoY. The RBI highlighted that the factors which are imparting upward pressure to inflation include evolving geopolitical situation and its impact on global commodity prices and logistics, rise in domestic prices of key food items due to elevated global price pressures and global supply shortages. More importantly the RBI highlighted several broad-based factors that are likely to put pressure on the overall inflation.

Also recognizing the impact of the current geo-political tensions on domestic economic growth, the RBI revised the economic growth projections downwards. The RBI highlighted that the escalation of the geopolitical situation and the accompanying surge in international crude oil and other commodity prices, tightening of global financial conditions, persistence of supply-side disruptions and significantly weaker external demand pose downside risks to the outlook. **The RBI now expects real GDP growth for FY23 at 7.2%, with Q1 at 16.2%; Q2 at 6.2%; Q3 at 4.1%; and Q4 at 4.0%, with risks broadly balanced.** In the previous monetary policy the RBI had projected the GDP growth to be at 7.8% YoY for FY23 with Q1FY23 at 17.2% YoY; Q2FY23 at 7% YoY; Q3FY23 at 4.3% YoY; and Q4FY23 at 4.5% YoY. **In the post monetary policy press conference, the RBI governor indicated that taming inflation has now taken precedence over economic growth.**

Impact on the Bond Market and outlook:

Bond markets have reacted negatively to the announcement of the monetary policy, wherein yield on the 10 year benchmark the 6.54% G-sec 2032 bond rose above the crucial psychological level of 7% and was trading at a level of 7.07% at the time of writing this note. **The change in the language and tone of monetary policy today, has brought a sense of clarity on the direction of the monetary policy, taking away the uncertainty. All the factors that the markets felt the RBI was looking through, leading it to being behind the curve, were highlighted in today's monetary policy as risks imparting sizeable upside risks to the inflation trajectory and downside risks to domestic growth.** Going forward the shorter end of the yield curve is likely move up, given the narrowing of the policy rate corridor; and is likely move up further with the subsequent tightening of the monetary policy. However, the high liquidity surplus may prevent any sudden moves. The longer end of the yield curve is also likely to remain elevated and may move up further on account of the heavy supply of G-secs. While the yield curve is expected to remain steep in the near term, we are likely to witness a very gradual flattening of the yield curve, given the RBI's plan of gradual multi-year calibrated withdrawal of the liquidity surplus. The domestic bond markets are likely to remain volatile tracking the expected monetary policy tightening globally and domestically, high supply of G-secs and the impact of the current geopolitical tensions on global as well as domestic macros. We expect the RBI to become more active in liquidity management, in order to normalize the loose monetary policy and manage the government's borrowing program.

Fixed Income Mutual Fund investment strategy:- Thus, considering the expected volatility, investors who would like to lock in current available yields and are not comfortable with volatility, can look at relatively longer tenor Fixed Maturity Plan (FMPs). Investors who have relatively longer investment horizon could look at Target Maturity Index Funds that invest in PSU Bonds plus SDLs, with funds having maturities in the years 2025, 2026 and 2027. Investors with an investment horizon of 12 months and above can look at Short Duration Funds and Corporate Bond Funds. For a horizon of 3 months and above Arbitrage Funds can be considered. Whereas, for a horizon of upto 3 months investors can consider Overnight Funds and Liquid Funds. Investors should invest in line with their risk profile and product suitability.

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