

## RBI begins to give priority to inflation over growth in monetary policy

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In a surprise move, the RBI in its policy action announced the introduction of a special deposit facility (SDF) as a key tool to manage systemic liquidity, wherein it would absorb excess liquidity at 3.75 per cent, and also narrowed the policy corridor to 50 basis points (bps).

While the RBI has been absorbing almost 80 per cent of the surplus liquidity through variable rate reverse repo (VRRR) auctions closer to repo rate of around 4 per cent during last few months, the overnight call money rates were generally closer to reverse repo rates and short-term 91 days treasury bills rates were below the VRRR rates.

With the introduction of SDF, we expect the call money rates and short-term T-bill rates to rise. In another move, though the Monetary Policy Committee (MPC) of the RBI maintained the accommodative policy stance it articulated its intent to focus on withdrawal of the current accommodative stance, effectively signaling a change in policy stance to neutral in the coming policy

review. Effectively, without tinkering with the policy rates at this juncture, the RBI has started on the path for gradual withdrawal of monetary stimulus given as part of Covid relief measures.

The actions of the RBI were driven by a sharp rise in its inflation projections to 5.7 per cent for FY23 as compared to its previous estimates of 4.5 per cent and are driven by rise in global commodity prices after the Russia-Ukraine conflict. Despite a downward revision in the growth estimates to 7.2 per cent from 7.8 per cent in previous policy review, the RBI has stated to prioritise inflation over the growth to determine future policy actions.

### Bond yields

With sharp upward revision in inflationary guidance, the yield on the 10-year government bond has jumped by over 15 bps to over 7.05 per cent, the sharpest single day increase in recent times. This could be driven by market expectations of higher than earlier expected rate hikes of 50 bps during the year. The RBI may, however, continue its attempts to prevent any sharp run-up in the



bond yields as well as balance both the inflationary expectations and growth-related challenges. The 10-year G-sec yield could rise to as much as 7.4 per cent over the course of H1 FY23, based on our forecast of a total repo increase of 50 bps in this fiscal year.

Even as the MPC maintains a status quo on the repo rate, the retail borrowers can breathe a sigh of relief for a couple of months as most of the retail loans are linked to repo rate as an external benchmark.

Supported by the competitive mortgage rates from lenders, the demand for home loans has been

robust and though the property prices have been on an increasing trend, the continuation of relaxed risk weights on home loans reflects the RBI's view to support the housing market growth and reap benefits of the multiplier effect the housing market provides.

However, the wholesale loans are generally linked to short-term T-bill rates, and the RBI's action today shall translate into a higher borrowing cost for corporates.

An increase in borrowing costs for corporates from banks coupled with rise in risk-free rates on Government securities will also translate into an increase in yields on corporate bonds, even though the credit spreads may still remain lower than long-term averages because of surplus liquidity.

### Banks to benefit

Rising interest rates typically are beneficial for banks as the liabilities do tend to price with a lag for banks.

Higher income on surplus liquidity coupled with our expectations of better credit growth of 8.9-10.2 per cent in FY23 as compared to around 8.3 per cent for

FY22 augurs well for the interest income of banks. However, at the same time, the rising interest rate poses challenges for the investment book for the bank with mark-to-market (MTM) losses on bonds held outside the held-to-maturity (HTM) bucket.

With an increase in HTM limits for banks by 1 per cent of net demand and time liabilities (NDTL) to 23 per cent, the RBI has created an additional headroom for banks to hold up to ₹1.6-1.7 trillion of G-secs in HTM category.

This shall improve banks' appetite to invest in G-secs without fearing MTM losses and facilitate the large borrowing programme of Central and State governments.

Reducing the excess systemic liquidity with minimal disruptions remains a key challenge for the RBI.

Overall, the policy had elements of surprises, but a shift in focus to prioritise inflation while staying focussed on growth is a welcome move.

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