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Inflation Trends Made a Case for a Reverse Repo Hike

Expert Take

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The RBI's latest Monetary Policy Committee meeting was set in the backdrop of an inflexion point in the global monetary policy cycle. More and more central banks have begun either the tapering of the stimulus or talking hawkish and/or raising rates. This is more to do with the underlying inflationary pressures, which are both staying more persistent, as well as at levels that are higher than earlier imagined.

India has not been an exception though we can quibble about the extent of the problem. Our CPI inflation averaged 6% over the last two years. While initially the bump up in inflation was on account of higher food prices, now it is led by fuel and core inflation, which have averaged 12.3% and 5.9% in FY22.

RBI has hence raised its inflation forecast but the raise is a little underwhelming. Though the estimate for Q3 has been raised to 5.1% from 4.5%, it has kept its overall forecast for FY22 at 5.3%. With wholesale or producer price inflation running in double digits, firms have little choice but to pass on higher prices to consumers in the coming months. In addition to this, recent price hikes by telecom firms and changes in the GST structure for the textile sector will also impart an inflationary impulse into the economy in the coming months. We expect inflation to be a bit higher at 5.4% in FY22.

On growth, the MPC has retained the estimate for FY22 at 9.5% with the Governor emphasising the need to be cautious. With GDP growth already at 13.7% during the April-September period, we believe the actual outcome for FY22 is likely to be higher at 9.8% followed by an above-trend growth of more than 8% for FY23 as well.

The above backdrop made a case for increasing the reverse repo from the current levels of 3.35%. Instead, the RBI again chose to increase the effective rate indirectly by announcing that it will increasingly absorb most of the surplus liquidity with the banking system through variable-rate reverse repo (VRRR) window in continuation of the path that it began last policy. RBI has said that it is looking at absorbing as much as ₹7.5 lakh crore through the variable rate window in end-December without any assurance on the amount that it will leave on the table on a daily basis.

Notably, overall liquidity absorption through overnight and VRRR window yesterday was at ₹9.5 lakh crore. Out of this, absorption at the fixed window was at ₹2.3 lakh crore. This suggests the absorption under fixed overnight rate may come down

from ₹2-3 lakh crore indicated in the October policy.

What will be the impact of this move on short-end interest rates in January 2022? If RBI starts absorbing most of the liquidity through 1-day and 3-day auctions in addition to the existing 14-day and 28-day VRRR, then overnight market traded rates should align closer to the repo rate. However, if most of the absorption is done via 14-day operations, then overnight rates may not move much as banks might still want to retain some overnight liquidity to take care of short-term liquidity mismatches.

On the longer duration bonds, the initial reaction on the 10-year yield was to head lower by less than 5 bps. For yields to fall from here, fiscal policy will play an even more important role. The government is looking to spend an additional ₹2.99 lakh crore in the coming months. While this is positive for growth and a large part of this will be financed through buoyant tax collections, we believe this implies nominal fiscal deficit is likely to be higher than budget estimates. While the government may still maintain the deficit target in percentage terms as nominal GDP will be higher than budget estimates, this raises the risk of additional borrowing in the coming months. Thus, the 10-year yield may remain in the 6.25-6.5% band in the remaining months of FY22.

Finally, on the currency front. The dollar index has risen by 7% this calendar year on the back of an impending monetary policy shift seen by global currency markets that has made the US central bank relatively more hawkish than the rest. The rupee, too, has weakened by 3.2% with rising oil prices and strong non-oil imports leading to record trade deficits. An expansionary monetary policy when the US Fed is looking at bringing its rate hike cycle forward along with higher trade deficit and equity outflows implies that further depreciation for the rupee could be in the offing.

We do believe that the RBI could look to act on the reverse repo in the February policy while the repo rate is likely to remain stable at 4% until Q1FY23.

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