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MPC may Favour Repo at 6%; Inflation, US Fed Moves to Decide Terminal Rate

ET Q&A

The Monetary Policy Committee (MPC) would like to take policy rates to 6% given its own inflation projections before reassessing the future repo rate trajectory, **B Prasanna**, group executive and head of global markets at ICICI Bank, tells **Saikat Das**. Separately, the central bank never let the rupee appreciate in 2021, he said, giving Mint Road the elbow room now to use its firepower and reduce volatility. Edited excerpts:

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B PRASANNA
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What do the minutes of the MPC released last week tell you about the direction of policy rates?
I can sense some level of discomfort with the extent of rate increases currently priced in the markets. The MPC is likely to reach a reasonable level of repo rate before pausing and reassessing the growth-inflation dynamics. I think the markets are pricing in a little more than the Reserve Bank of India's comfort level, primarily due to a stress case of very high oil price or a very high terminal US Fed funds rate. The central bank possibly wants to be more nuanced.

There's a lot of debate about the terminal policy rate. Where do you see it in this cycle?
Domestic inflation is the overarching factor which would ultimately determine the terminal rate. For now, I think that the MPC would like to take rates to 6% given their own inflation projections before reassessing the future repo rate trajectory. However, there are also a number of other factors such as the global commodity price cycle, and supply shocks...US Fed policy cycle all of which could impact the view on the terminal policy rate in this cycle. So 6% could well be a pause.

What's your outlook for the rupee?
The rupee has not depreciated as much as some of the global currencies against the dollar and especially against emerging market currencies. We have definitely outperformed in the immediate past. This plus the widening current account deficit and fiscal deficit do make us feel that the time is ripe for some depreciation. However, bear in mind that the RBI never let the rupee appreciate in FY21 amid sizable inflows even when all other EM currencies were gaining against the dollar. That forex accumulation is now yielding a dividend with the RBI using it liberally to support the currency.

How much real rate is ideal for ensuring financial stability and preventing misallocation of financial resources?
Given the current rate hike trajectory, the RBI should be close to positive real rates in the March quarter. It should also be noted that we are not living in a vacuum and what matters is relative real rates. If global real rates are positive, then Indian real rates should be on the higher side of the band. However, if global real rates continue to be negative, this gives us room to keep our real rates on the lower side.

Given the current situation, how long can liquidity be in excess?
We currently estimate the core liquidity – comprising systemic liquidity and government surplus – to be around ₹6.25 lakh crore now. Over the course of the year, we see this excess whittle down to somewhere around ₹1.25 lakh crore due to various reasons like demand for currency in circulation, and foreign outflows.

Does Variable Reverse Repo Rate play any role?
(RBI Deputy Governor) Dr Michael Patra has made an interesting observation that an accommodative stance is when call money is below the repo rate and a tightening stance when it is higher. I think RBI might, at some point during the course of this year, use short-term VRRR auctions to ensure that the call money rate starts hugging the repo rate more closely.

What are the risks of excess liquidity when the rate cycle is going up? Will that make policy rate changes irrelevant?
Going forward, as liquidity is drained from the system over time, we will possibly see the overnight rates hugging the repo rate and possibly trade in the repo-MSF (marginal standing facility) corridor. When liquidity is gradually reverting to normal levels, policy rate changes are expected to be instantly transmitted to overnight rates on a one-to-one basis. Overnight rates can also go above the repo rate when liquidity is less than ₹1 lakh crore.

What does the RBI need to do to keep the interest rate differential between India and the US high?
The trend of EM outflows is likely to continue and if oil prices remain elevated into next year, we believe RBI's job would get tougher. They will have to let the rupee gradually depreciate and keep rates on the higher side to keep the rate differential at an attractive level to penalise the rupee sellers.