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RBI MONETARY POLICY

DECEMBER 2023

HIGHLIGHTS

MPC holds rates, indicates continued wait and watch
Macroprudential the new avenue of tightening

MPC's fifth bi-monthly Monetary Policy Review: 2023-24
The MPC unanimously voted to keep the policy rate unchanged.

Stance of withdrawal of accommodation retained, given still-incomplete transmission as well as inflation risks requiring actively disinflationary.

Policy Actions
Repo rate maintained at 6.50%.

Consequently, SDF is at 6.25% and MSF is at 6.75%.

RBI has kept CRR unchanged at 4.50%.

GROWTH-INFLATION DYNAMICS

FY24 inflation projections maintained ,inflation in FY25 seen returning towards 4% by Q2 on the high base before rising back. Our own inflation expectations are higher than MPC's until Sep'24.

The MPC noted well-behaved core inflation, but expressed concern around repeated transitory food price shocks, especially in vegetable, that could pose risks of second round effects on headline inflation in a good growth environment.

GDP projections for FY24 revised higher to 7.0% YoY in line with stronger H1 prints and strong high-frequency indicators, while projections for the first three quarters of FY25 indicate a bias for growth just above 6.5%

Strong high frequency indicators across manufacturing and services, including trends for electricity, e-way bills, credit growth, foreign trade, transportation, travel, retail sales, capital goods, etc. seen as drivers of growth, offsetting risks from slower global growth and geo-economic fragmentations.

LIQUIDITY AND EXTERNAL SECTOR

Weak demand for currency notes and limited liquidity absorption through FX intervention have added to the maturity of incremental CRR in the near term. This was earlier balanced by high government holding of funds. The expected government expenditure will push liquidity back into surplus shortly, thus necessitating OMO sales by the RBI thus offsetting potential positive from India bond index inclusion.

Q1 CAD at 1.1% of GDP along with good FX accretion in Q1FY24 was noted with confidence on comfortably meeting external financing requirements.

POLICY STANCE AND GUIDANCE

There were action-oriented references to doing more than keeping an eye on inflation developments in the last MPC. This has been replaced by indications of a long hold with importance of inflation to overall stability.

Language on liquidity management was in sync with the stance of the monetary policy indicating a bias for tightening with any additions through FX reserves likely to be offset by bond sales.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order in last 1 year.

Date	Measures Announced
December 7, 2022	• Banks will now be allowed to include securities acquired between Sept 1, 2020 and Mar 31, 2024. The HTM limits would be restored from 23% to 19.5% in a phased manner starting from the quarter ending June 30, 2024. • The capabilities in UPI will be further enhanced by introducing single-block-and-multiple-debits functionality. • With a view to providing greater flexibility, resident entities will now be permitted to hedge their gold price risk on recognised exchanges in the IFSC.
February 8, 2023	• Regulated Entities (REs) are required to have a policy for levy of penal interest on advances. • Decided to issue guidelines for REs on i. a broad framework for acceptance of Green Deposits; ii. disclosure framework on Climate-related Financial Risks; and iii. guidance on Climate Scenario Analysis and Stress Testing. • Proposed to expand the scope of TReDs by i. providing insurance facility for invoice financing; ii. permitting all entities/institutions undertaking factoring business to participate as financiers in TReDS; and iii. permitting rediscounting of invoices (that is, developing a secondary market in TReDS). These measures are expected to improve the cash flows of the MSMEs. • Launch a pilot project on QR Code based Coin Vending Machine in 12 cities.
April 6, 2023	• Proposed to permit banks with IFSC Banking Units (IBUs) to offer non-deliverable foreign exchange derivative contracts (NDDCs) involving INR to resident users in the onshore market. • To develop a web portal to enable search across multiple banks for possible unclaimed deposits. • Proposed to expand the scope of UPI by permitting operation of pre-sanctioned credit lines at banks through the UPI.
June 8, 2023	• Allowing issuance of RuPay prepaid forex cards, also enabled for issuance in foreign jurisdictions. • Rationalizing licensing framework for Authorized Persons (AP) under FEMA, last revised in 2006. • Extension of timelines by another 2 years up to March 2026 for achieving the targets of Priority Sector Lending (PSL) for Primary (Urban) Cooperative Banks. • Proposed to issue comprehensive guidelines on compromise settlements and technical write-offs which will now be applicable to all regulated entities including co-operative banks. • Decided that SCBs can set their own limits for borrowing in Call and Notice Money Markets within the prescribed prudential limits for inter-bank liabilities to provide greater flexibility for managing their liquidity. • Allowing PPI issuers to issue e-RUPI vouchers, and enabling issuance of vouchers on behalf of individuals

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August 10, 2023	• To revise the extant regulations issued in June 2019 and put in place a comprehensive, risk-based framework for administration of financial benchmarks.
	• Consolidation and harmonization of instructions for Supervisory data submission
	• Public tech platform for seamless delivery of credit and digital information, banks can plug and play
	• UPI: Conversational payments, offline payments, and higher limit for small value payments
	  • Users to be able to pay in conversation with AI-powered system
	  • Offline transactions on UPI-Lite system through near-field communications
	  • Transaction limit of Rs. 200 raised to Rs. 500 for small value digital payments in offline mode
	• Transparency in interest rate reset of EMI based floating rate loans
	  • Clear communication on changes, available options including converting to a fixed rate, and schedule of fees
	• NBFC-infrastructure debt funds – easing of regulatory framework
	  • Withdrawal of requirement for sponsor
	  • Permission to finance toll-operate-transfer projects as direct lenders
	  • Access to ECBs
	  • Making tri-partite agreements optional for PPP projects

October 6, 2023	• Project Finance: Comprehensive regulatory framework for projects under implementation to be issued • NBFC middle and base layers to now be able to offset exposures with risk transfers – upper layer NBFCs can already do this • Review of regulatory framework for Financial Benchmark Administrators • Monetary ceiling for gold loans (bullet repayment) at UCBs to be doubled to Rs. 4 lakh, where UCB has met PSL targets and sub-targets by Mar'23 • Omnibus framework for recognizing Self Regulatory Organisations (SROs) for various REs – draft to be issued • Extension of Payments Infrastructure Development Fund to PM Vishwakarma scheme beneficiaries – to enable emerging modes of payments and expansion in small markets • Card on file tokenization to be moved directly to the issuing bank level • Master direction on Internal Ombudsman mechanism for REs – harmonising guidelines for various categories currently in force

KEY MEASURES ANNOUNCED BY THE RBI

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Date	Measures Announced
December 8, 2023	• The regulatory framework for foreign exchange derivative transactions was reviewed after 2020, refined and consolidated under a single master direction thus deepening the forex derivatives market. • There will now be a unified regulatory framework on connected lending for all regulated entities of the RBI to strengthen the pricing and management of credit. • Introduction of a regulatory framework for web-aggregation of loan products to enhance customer centricity and transparency in digital lending. • Proposal to set up a Fintech Repository which will be operationalized by the Reserve Bank Innovation Hub in April 2024 or earlier. This will help in the increasing partnerships between Banks and NBFCs and FinTechs. • Proposal to increase UPI transaction limit from ₹1 lakh to ₹5 lakh for payments to hospitals and educational institutions. • E-Mandate limit increased to ₹1 lakh per transaction for mutual fund subscriptions, insurance premiums, and credit card repayments. • Establishment of a cloud facility in India for the financial sector to enhance data security, integrity, privacy, scalability, and business continuity. It is intended to be rolled out in a calibrated fashion over the medium term.

IMPACT ON THE MUTUAL FUND INDUSTRY:

Liquid Funds:

These schemes will continue to generate returns around the operating rate due to their portfolio composition i.e. being invested at the shorter end of the money market segment. Liquid funds have low average maturity as they concentrate more on high quality papers including CPs, CDs and other debt securities with residual maturity of upto 3 months.

Ultra Short Term / Low Duration / Money Market Funds (Maturity Up to 1 Year):

These schemes predominantly invest in below 1 year maturity paper. The strategy adopted by these schemes is to hold the paper till maturity and capitalize on the running yield. Hence, returns in this category will continue to remain relatively attractive depending on the positioning of the fund.

Short Duration Funds:

Schemes in this category are predominantly invested in Corporate Bonds, CPs and CDs while a few of them also have some exposure to G-Secs. We continue to remain bullish at the shorter end of the curve. Investors may consider these funds (with an investment horizon commensurate with the maturity profile of such funds) and gain from current accruals and capital appreciation in the event of a fall in yields.

Medium Duration:

Given the flattened yield curve there are sufficient buffers in the intermediate duration (3-6 years) segment. Till the time RBI is anchoring the long end of the yield curve, the current yield curve may provide some cushion even if there are mark-to-market losses. Investors may consider those funds with high quality portfolios and where the investment horizon is commensurate with the maturity profile of the funds and also gain from current accruals and capital appreciation in the event of a fall in yields.

Credit Risk Funds:

We remain cautious on Credit Risk Funds as they have failed to prove their mettle in the last 2-3 years with the overhang of defaults and erosions of NAV on the back of mark-to-market impacts due to the aforementioned. The uncertainty around credit funds which are in an open ended avatar continues to pose risks to investors. Much also depends on the liquidity conditions in the market and redemption pressure on these funds. Thus, we think there is a systemic risk in the market within the credit space. Hence, it makes sense for one to stay away from these funds.

IMPACT ON THE MUTUAL FUND INDUSTRY:

Long Term Income Funds / Gilt Funds / Dynamic Bond Funds:
The RBI kept the repo rate unchanged at 6.50% for the fifth consecutive time and continued with its stance to remain focused on withdrawal of accommodation despite the tight liquidity conditions. However, they have revised their forecast on growth for FY24 on the back of strong GDP prints. This pause on rate hike is aimed at financial stability and any future course of action shall be data dependent. The stance taken by the RBI has been linked to liquidity conditions as well as attaining the 4% inflation target on a durable basis.

US Treasury yields relented in November and edged lower amidst optimism that the US Fed could be at the peak of its interest rate hike cycle and market expects no more future hikes. The current yields on the 10-year Treasury fell to 4.15%, a significant decline of 78 bps from the previous month's close of 4.93% (Nov'23). Meanwhile, the yields on the 2-year Treasuries have fallen lesser than the longer end leading to the yield curve getting less inverted to flat. Markets expect the Fed to remain on hold in its December policy meeting. Incrementally, data such as housing, unemployment and inflation has started to gradually soften indicating a slowdown on the horizon. Meanwhile, other developed markets like Europe are showing more concrete signs of economic momentum loss.

Inflation for November is likely to rise back above 6%, despite subdued core inflation trends given continued food price shocks across different food categories. Arrival of winter crop should help bring food prices back down but risks of these impulses filtering through to hitherto-well behaved core inflation remains very real. While strong capex is commensurate with long-term disinflation, good activity growth early in the cycle is likely to support demand, while supply benefits are still distant. In line with this, the proximate inflation projection that needs to be watched will be that of H1FY25. An increase in this projection from those made in October is likely, indicating slow progress towards the 4% inflation target that has repeatedly been emphasized by the MPC/RBI.

IMPACT ON THE MUTUAL FUND INDUSTRY:

As compared to the other economies, India remains on a stronger growth trajectory. Incoming data has been strong and likely to continue in near future. The likely inclusion of government bonds in Bloomberg indices could boost inflows. Most part of the fixed income curve is pricing in no cuts for the next few quarters. The benchmark yields are down by 7 bps at 7.27% from last policy, while for the day it is up by 3 bps to close at 7.27%. We expect yields to continue to remain volatile in the near term and oscillate in a tight range. Being cognizant of the environment, we remain Neutral and constructive on the short to medium end of the yield curve, with the quality approach on bonds as the risks on inflation prevails. Investors can consider investing in Medium/Long Duration funds as per their risk appetite with an investment horizon of at least 2-3 years to avoid any intermittent volatility. Liquidity conditions are expected to remain tight, which is likely to keep interest rates at the shorter end high while the longer end may be anchored.

Conservative Hybrid Funds *(Erstwhile: Monthly Income Plans (MIPs)*:
With a 10% to 25% allocation to equity, returns of CHFs are largely determined by the vagaries of the equity markets as against the debt markets. These funds are therefore suitable for investors who have a reasonably long-time horizon & are comfortable with taking exposure to equities.

OUTLOOK

IMPACT ON THE MUTUAL FUND INDUSTRY:

Continued tightness on liquidity and macroprudential policy have led to spreads widening across CPs, CDs and bond markets. With liquidity policy likely to remain tight and credit to the NBFC sector likely help back by higher provisioning, money market rates might be higher for some time, especially if growth in the medium term keeps demand supported and policy on the tighter side.

We remain constructive on the short to medium end of the yield curve. **Short Duration funds, Banking & PSU Debt funds, Corporate Bond funds, Debt Index funds (Target Maturities), Medium Duration funds, Floating Rate funds, Money Market funds, Low Duration funds and Ultra Short Duration funds** can be considered by investors with an investment horizon commensurate with the maturity profile of the schemes. Investors can consider investing in **Medium/Long Duration** funds as per their risk appetite with an investment horizon of at least 2-3 years to avoid any intermittent volatility.

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