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RBI MONETARY POLICY

FEBRUARY 2024

HIGHLIGHTS

MPC holds rates as expected and signals a readiness for further action if inflation persists.

MPC's sixth bi-monthly Monetary Policy Review: 2023-24
The MPC voted 5-1 to hold both, rates and stance.

The language on growth remained upbeat and inflation continued to highlight risks from food prices and geopolitical developments. Comments on liquidity indicated to keep rates above the policy midpoint even when liquidity eases on government spending in the next few months, to further yet-incomplete transmission to credit markets. Reiteration of an actively disinflationary stance, risks of food price generalisation and emphasis on vigilance suggest meaningful easing of language is still far away.

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

For FY25, inflation projections are at 4.5%, with Q1 projections lowered from those given in Dec'23 policy.

The MPC comments acknowledged steady improvement in core inflation, though it expressed caution on multiple overlapping food price shocks, as well as risks emanating on commodities from geopolitics and global policy developments.

For FY25, GDP growth was projected at 7.0% which is somewhat higher than that seen by markets. This is due to the pickup in consumption amid bright investment climate and increased external demand for India's goods and services.

Risks were seen from global factors given the geopolitical conditions and financial developments with uncertainty around global rate cuts, demand, trade policy, etc.

LIQUIDITY AND EXTERNAL SECTOR

The RBI acknowledged a shift in liquidity operations from absorption to provision through variable rate auctions. However, it indicated that credit transmission was still incomplete, and even if the quantum of liquidity were to increase from exogenous factors, management operations would keep conditions for the credit sector tight.

Comments continued to repose confidence in manageable current account deficits in FY24 and FY25, with enough in terms of financial inflows to manage these.

POLICY STANCE AND GUIDANCE

There was no major shift in the policy stance or guidance, though this might be a conscious choice as indicated in media calls as to prevent speculation and volatility of the kind seen in global markets over the last few months.

KEY MEASURES ANNOUNCED BY THE RBI

Measures announced in chronological order in last 1 year.

Date	Measures Announced
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

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

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Measures announced in chronological order in last 1 year.

Date	Measures Announced
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
December 8, 2023	• 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.
February 8, 2024	• Review of the Regulatory Framework for Electronic Trading Platforms (ETPs) • Allowed resident entities to hedge their price of gold in the OTC segment in the IFSC. • Introduction of Programmability and Offline Functionality in Central Bank Digital Currency (CBDC) Pilot. • RBI will put in place a system of principal-based authentication to promote alternative authentication mechanisms. • Banks to provide Key fact statement for all retail and MSME borrowers.

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 MPC comments indicated that liquidity was driven by exogenous factors, but that liquidity management was with the view to ensure orderly evolution of money market rates, to further yet-incomplete transmission to credit markets and efforts to bring inflation back to 4%. Taken along with actively disinflationary comments, these indicate that even with government spending and easier liquidity in the next 2-3 months, management of liquidity will target overnight rates above the repo level and drive continued tightness in money market and other credit spreads.

Globally, bond yields hardened in Jan'24 after strong US economic data diminished hopes of early rate cuts by the US Fed. The 10-year US Treasury bond yield rose in Jan'24, touched an intra month high of 4.18% before receding to 3.92% on 31st Jan'24, up by 6 bps MoM. In contrast, yields on the 2-year treasuries fell by 4 bps. Fed in its Jan'24 policy meeting, kept rates on hold but noted that it won't be appropriate to cut rates until it has gained greater confidence that inflation is approaching its 2% goal.

GDP growth for FY25 was projected at 7.0%, which is above market and budget projections, with expectations of improving consumption and bright capex, as well as improvement in global trade and India's share, though exposed to geopolitical and financial market spillovers. Inflation for FY25 was projected at 4.5%, with downward revisions to Q1. Considerable uncertainty was seen on the food outlook, given adverse weather and inadequate winter vegetable disinflation, though comfort was drawn from well-behaved core inflation.

Overnight rates consistently stayed above the upper end of the RBI's policy corridor throughout Jan '24 owing to a widening banking system liquidity deficit. To address the liquidity issues, the RBI conducted several variable-rate repo (VRR) auctions during the month. Tight liquidity has led to significant rise in yields across the short end of the curve. The 10-year bond yields softened by 17 bps at 7.07% from last policy, while for the day it remains unchanged (at the time of writing the note).

Indian bond yields could see a push-and-pull effect during CY2024 that could lead to an increase in market volatility in the short term. In the

IMPACT ON THE MUTUAL FUND INDUSTRY:

medium term, India's growth and stability, falling inflation and inclusion in key global bond indices could lead to a change in stance by the RBI which will eventually lead to gradual rate cuts over FY25. Liquidity conditions are expected to remain tight, likely keeping 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:

It was hoped that the shift in liquidity management signaled an easing of the liquidity stance given easier inflation as well as easing in implied future global rates. However, with focus on furthering yet-incomplete credit market transmission, liquidity operations are likely to push back against meaningful easing in CP/CD/corporate bond spreads. These might also act against expected easing of liquidity over the next few months with GOI spending, limiting increase of AUM in liquid funds.

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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