

August 10, 2023



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*MPC maintains a 3<sup>rd</sup> consecutive pause on policy rates with continued comfort on external resilience and core inflation. Recent uptick in food inflation is expected to be short lived and is looked through as of now with monsoon picking up well. Stance still maintained as “withdrawal of accommodation” to keep flexibility against any negative surprises on domestic inflation. Incremental CRR requirement a tad negative, though for a short time only. Overall, a well-balanced policy on expected lines with remote likelihood of any more rate hikes for now. A long wait for rate cut cycle as MPC re-iterates its commitment on 4% inflation target.*

## Key decisions/Highlights

Monetary Policy Committee (MPC) members unanimously decided to **keep the policy rate unchanged at 6.50%**.

The **standing deposit facility (SDF)** rate remains **unchanged at 6.25%** and the **marginal standing facility (MSF)** rate and the **Bank Rate at 6.75%**.

MPC by a majority of five out of six members voted to remain focused on **“withdrawal of accommodation”** to ensure that inflation progressively aligns with the target, while supporting growth.

Consumer Price Index (CPI) inflation projected at **5.4% (up from 5.1%) in 2023-24 with, Q2 at 6.2% (up from 5.2%), Q3 at 5.7% (up from 5.4%), Q4 at 5.2% (retained) and Q1: 2024-25 at 5.2%.**

Real GDP growth projections for **2023-24 at 6.5% (retained) with Q1 is projected at 8% (retained), Q2 at 6.5% (retained), Q3 at 6% (retained), Q4 at 5.7% (retained) and Q1: 2024-25 at 6.6%.**

With effect from the fortnight beginning August 12, 2023, scheduled banks shall maintain an **incremental cash reserve ratio (CRR) of 10% on the increase in their net demand and time liabilities (NDTL)** between May 19, 2023 and July 28, 2023.

## MPC maintains status quo on rates and policy stance – largely a non-event policy

Post the last monetary policy announcement we saw mix set of global central bank actions; US FOMC (Federal Open Market Committee) resumed rate hike after a pause while indicating data-driven future policy actions, European Central Bank (ECB) & Bank of England continued to hike rates while Bank of Japan surprised the market by widening their yield curve control policy to enhance flexibility. On the other hand, China and Brazil adopted monetary easing stance by cutting rates.

At home, as was widely expected, MPC maintained a pause on policy rate for third consecutive time on back of external resilience and moderation in core inflation. However, the recent surge in inflation due to uptick in food prices was a matter of concern to the committee members. The policy statement sounded hawkish with inflation taking the center-stage and continued to emphasize MPC's focus on reigning in inflation & bringing it closer to target of 4%. Given the global uncertainties coupled with spike in domestic food inflation, MPC decided to maintain the stance as “withdrawal of accommodation” to retain flexibility against any negative surprises on inflation front.

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## **MPC maintains caution on inflation trajectory as global & El Nino uncertainty remains**

The CPI inflation rose to a 3-month high of 4.81% in June on back of rising food prices specifically vegetable prices. In July, inflation is expected to sharply inch upwards given the surge in vegetable prices especially tomato and further increase in prices of cereals & pulses. This inflationary trend is primarily attributed to erratic monsoon patterns and subsequent flooding in certain country regions. Accordingly, the headline inflation projection for Q2FY24 has seen a significant uptick of 1% compared to the projections made in June policy. However, the committee believes the hike in food prices is transitory and might see a significant correction in few months given the improvement in progress of monsoon and arrival of new crop in 2 months. The FY24 projections have seen an upward revision of 30 bps to 5.40% which by itself is not very alarming for now as is largely driven by transitory food prices and Q4FY24 inflation is still maintained at 5.2%. The core inflation has moderated by more than 100 bps from its peak in January 2023 which is a positive sign and is expected to remain moderate. However, the uncertain weather conditions, possibility of El Nino, uptick in crude oil prices, and global uncertainties pose a risk to anchoring of inflation expectations and warrants continuous vigil on inflation trajectory.

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## **Growth dynamics remain resilient to global backdrop**

India's growth momentum continues to remain stable and resilient. The growth dynamics remain strong and draws strength from various factors such as healthy balance sheet of corporates and banks, expanding services purchasing managers' index (PMI), robust high frequency indicators, strong urban demand, double digit credit growth, continued focus of government on capital expenditure and revival in private capex. The upcoming festival season is also expected to provide further support to economic growth. The downside risks to growth outlook may emanate from geopolitical tensions and weak external demand. The healthy growth momentum gives room to RBI to remain resolute on its commitment of anchoring inflation closer to 4% target.

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## **Higher Incremental CRR requirement came as a surprise; though expected to be for a short time**

The surprise announcement of a higher incremental Cash Reserve Ratio (CRR) requirement has caught the industry by surprise, even though it is anticipated to be a short-term measure beginning from the 12<sup>th</sup> of August to end on the 8<sup>th</sup> of September or earlier. Estimated additional CRR requirement of around Rs 1 lakh crore is expected to reduce systemic liquidity. This move has primarily been orchestrated to counterbalance the surge in liquidity stemming from the influx of INR 2000 deposits and foreign exchange inflows. This action has potential for a notable impact on the money market rates, given that going forward overnight rates might move from 6.25%-6.50% range to 6.50-6.75% range. This will lead to a moderation in the availability of funds for banks and hence increase in supply in shorter maturity papers. The temporary nature of this action underscores its role as a tactical maneuver to stabilize the overnight rates and minimize any adverse impact of excess liquidity on inflation. We believe RBI will ensure an optimal level of liquidity by ad hoc variable rate repo (VRR)/ variable rate reverse repo (VRRR) operations and liquidity will eventually align with the requirements of the upcoming festive season and credit growth.

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## Stance maintained as “Withdrawal of accommodation”, to retain flexibility against domestic inflation & global backdrop; we expect no more rate hikes as external situation remains resilient

MPC has delivered a pause in August policy and maintained its policy stance of “withdrawal of accommodation” as expected, although it sounded more hawkish on inflation trend especially over next few months as also reflected in now higher inflation projections for FY24 at 5.4%. India's external strength remains healthy given the improving current account deficit, increasing FPI inflows, stable INR, moderating external debt to GDP ratio etc. If this sustains, India is in a good place to withstand global pressures, and this should provide comfort to MPC on monetary policy front. While the uncertainty on various fronts has increased over last month, we believe India will decouple itself from rate hike cycle in major economies on the back of comfortable situation on external front and maintain a pause on policy rates at current 6.50%. Despite a narrowing policy rate differential, healthy spread in real interest rates is expected to give cushion to MPC to keep policy rates stable. Current policy rate at 6.50% and future CPI inflation projection at ~5.40% gives ~1.10% positive real interest rate, which is adequate for now, although the cushion has reduced.

RBI's policy stance of “withdrawal of accommodation” & re-iteration of 4% inflation target guides the market expectations towards “higher rates for longer”. The possibility of any rate cuts atleast over next 6 to 9 months appears low, with a risk of even longer. It also gives flexibility against any extreme negative surprises on domestic inflation as El Nino impact and global commodity prices are still uncertain. In the interim, domestic rates will rather be influenced by incoming data points especially on inflation front as well as by fiscal supply side factors in FY24 which remains a challenge amidst record high borrowing program.

## Market Movement

Segment	Broad movement of yields in bps (as on August 10, 2023)	
	G-Sec	AAA Corporates
3 Months	+2 bps to +5 bps	+5 bps to +10 bps
6 Months	+1 bps to +3 bps	+2 bps to +5 bps
1 year	+1 bps to +3 bps	+2 bps to +5 bps
2 -3 years	-1 bps	0 bps to +1 bps
4 - 5 years	-1 bps	0 bps to +1 bps
10 years	-2 bps	-1 bps to -2 bps
14 years	-3 bps	NA

Source: Bloomberg

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**With stable interest rates for now, investors can explore opportunities across the curve; active management better suited as many uncertainties may unfold and as rate cut cycle is still far away**

We believe policy rates have peaked out which opens the space for entire yield curve. This gives investors an opportunity to look at various points of rate curve to meet their asset allocation requirements. Investors can look at across the rate curve as elevated yields are expected to deliver positive returns over inflation.

Our fund positioning will be guided by evolving market dynamics as well as individual fund's mandates. We believe recent hardening in interest rates provides an attractive entry point especially in 2 to 5 year segment. There might be near term volatility led by evolving factors, but it is expected to be range bound and should be ignored. Over the medium term as the market builds expectations on rate cut cycle at some point in time, it will enhance overall returns through mark to market gains. Having said that, active fund management is critical as uncertainties may emanate from domestic inflation, fiscal supply and global backdrop which may influence various yield curve segments differently. Credit environment remains healthy and selective AA / AA+ rated exposure can be explored at fair credit spreads.

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