

MONETARY POLICY WILL BE WATCHED FOR LIQUIDITY GUIDANCE



EXPERT
VIEW

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Oflate, Indian fixed income markets are witnessing heightened nervousness due to many factors. Retail inflation quickened to 7% in August after easing for three straight months until July. The banking system's liquidity slipped into deficit after 40 months on 21 September, led by advance tax outflows for the second quarter and payments for government bonds. On the same day, the US Federal Reserve raised rates by 75 basis points, as expected, and flagged more hikes in future. In response to the Fed's third aggressive move, countries such as the UK, Switzerland, Norway, Indonesia, the Philippines, and Hong Kong raised rates

as the dollar surged. Rupee-dollar rate posted a sharp depreciation of 1.3% in just two days (21-23 September) amid a lack of significant dollar sales by the Reserve Bank of India. One of the reasons why RBI did not intervene in the forex market could be inadequate liquidity in the banking system. RBI's foreign exchange reserves have fallen from almost \$642 billion to \$546 billion. Between 21 and 23 September, the yield on India's 10-year benchmark paper (7.26%, 2032) rose by 13 bps to 7.39%. Borrowing costs in the short-term debt market have surged to the highest level in more than 38 months. Large weekly borrowings by the government and continued pick-up in bank credit are weighing on liquidity.

In the coming policy review, the monetary policy committee (MPC) will have to address many concerns, besides inflation management and external sector stabilization. The most recent data points on factory activity are not very encouraging. Sequentially, industrial production growth turned negative again (at -2.8%) in July, dragged down by capital and consumer goods. While there is some cheer in agricultural and rural belts due to better water reservoir levels and improved crop realizations, growth remains patchy in the industrial and export

sectors. The urban unemployment rate, too, remains elevated near 9-10%.

On the positive side, the central government's borrowing programme progressed well in the first half of the current fiscal. Out of the total gross borrowings of ₹14.31 trillion, the government raised ₹7.72 trillion smoothly until 16 September, thanks to good demand from com-

The MPC will have to focus on matters more than inflation management at its coming meet

mercial banks amid sufficient liquidity. But now, with a strong pickup in bank credit (16.2%, y-o-y for the fortnight ended 9 September) and with more currency in circulation (due to the festive season and the impending state elections), liquidity in the system has been shrinking faster. As a result, there is also the possibility that state governments will borrow more in the second half of FY23 as they are running out of their cash balances.

So far, the CPI (Consumer Price Index) inflation trajectory in the second quarter of FY23 is in line with MPC's expectations. With an expected normal rabi crop

season and timely government measures to control the retail prices of rice and wheat, food inflation need not be a threat in the second half of FY23. Brent crude prices, too, have eased from \$123 per barrel in May to \$87 per barrel in September.

As the US Federal Reserve is setting the pace of interest rate rises and transmitting pressures to other central banks through the foreign currency markets, India is left with no alternative but to raise the repo rate by 50 basis points on 30 September. However, RBI may like to provide "assurance" on the liquidity front by specifying select measures that can offset temporary liquidity mismatches or announce a few sector-specific liquidity measures to ensure economic recovery in India does not stall. As Moody's rating agency aptly said, keeping interest costs below the rate of economic growth will help India in its fiscal consolidation and bring down the disproportionately high debt-GDP ratio. While a repo rate hike of 50 bps is a given, the monetary policy on 30 September will primarily be watched for RBI's liquidity guidance.

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