*SBI RESEARCH*
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# TO BE OR NOT TO BE!
# IT'S TIME FOR LOUDER ACTION BY THE RBI IN TANDEM WITH THE GOVERNMENT TO CATCH THE BULL BY THE HORNS AND ENSURE FINANCIAL STABILITY AS THE LYNCHPIN OF POLICY MAKING

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The cataclysmic slurry of little anticipated events, starting in early 2025 appear to have come full circle as the lifelines of finance have been choked by rising concerns on food and commodities supplies, public debt reaching unstable proportions, AI related borrowings spiking through the roof and the wild gyrations in yields mirroring the new found world realism on how the risk-rewards pendulum is wildly oscillating.

While the recent action on rate front by the RBI is a welcome step indeed, its effect had already been priced in by the markets and thus a real impact remains absent on either yields or exchange rate front just as the needle moves forward on two aspects; **the timing and quantum of the next rate action**. **On that front, we are of the limited opinion** that the peculiar situation, where the world itself is caught in a tailspin but EMs would remain at the receiving end more than their DM counterparts, necessitates a shift in strategy; **widening the interest rate corridor, a larger rate hike sooner than later (at best, akin to committing a Type-I error) co-terminus with other measures that ensure the return of semblance of order.**

**Amidst the other measures suggested, we understand the asymmetric widening of the corridor could be the most effective (as tested in the past times of turbulence in 2013/2020/2022) which the Central Bank has exclusive authority of, by dint of regulatory prescriptions. While amendment in RBI act (Section 45ZB) entails the MPC to determine the policy rate (i.e. Repo rate) required to achieve the inflation target, the day to day liquidity management function is solely in the domain of RBI, *an asymmetric LAF corridor in exceptional times enshrined in its very purpose*.**

**RBI's Report on Currency and Finance (2020-21) clearly mentions that**, "*As the marginal standing facility and the fixed rate reverse repo windows are essentially instruments of liquidity management, they are **in the remit of the Reserve Bank**. In its endeavor to achieve the policy rate voted upon by the MPC, decisions involving a change in the reverse repo rate and the MSF rate and announcements thereof may be shifted out of the MPC resolution to the Reserve Bank's Statement on Developmental and Regulatory Policies.'*

Also, the needle of market narratives are moving tightly with exchange rate management (as much as inflationary expectations management) and NDF markets are reflecting the current mayhem most as shorter end of the curve is vaulting through the roof, the annualized cost at times double that of longer end, with action concentrating around 1-3M.

The toolkit needs to be fine tuned where exporters need to increasingly and optimally match the proceeds and remittances with importers' needs and hedging patterns, any undue, purposeful delay attracting some punitive deterrence mechanism as markets are closely watching the developments on exchange rate, and its implications against Mint Street's interventions. **The generous time lines allowed for bringing export proceeds (say 15M) can not be a carte blanche scheme for all. The time line may be reduced to 6 months as a norm, with extensions exceptions on case-to-case basis.**

**Last, the Government also needs to support the RBI in its quest**. There is a serious need to relook at enhancing flows of **patient capital in debt, as also equities** tweaking the tax and capital gains structure suitably as the fight for capital is just getting murkier globally and non-AI heavyweights put us on the wrong end of the see-saw.

**Finally, let the RBI take a prudent call on the extent of rate hikes in the current cycle. While the consensus in the market is a shallow rate hike cycle, its the prerogative of the RBI to decide on the extent, quantum and duration of rate hikes. We continue to believe a larger rate hike in December policy as growth will continue to be strong and top 7.5% again.**

**In uncertain times, a good central bank should be systematic enough to preserve credibility, flexible enough to adapt, and transparent enough that uncertainty about the economy does not become uncertainty about the central bank itself. This is exactly what was also conveyed by RBI Governor very recently in his Princeton address.**

## POLICY CORRIDOR & MONETARY MARKSMANSHIP

- In his seminal 2010 BIS Working Paper, titled "The changing role of central banks," prominent economist Charles Goodhart argued that **while maintaining a symmetric corridor serves standard macroeconomic environments, moving to an asymmetric corridor yields distinct strategic advantages during financial stress**. He noted that an asymmetric corridor gives a central bank the flexibility to alter its liquidity policy and its interest rate policy largely independent of one another. By adjusting one side of the corridor more aggressively than the other, the central bank can steer money market volumes without necessarily changing its headline macro-policy stance.
- And hence the practice of asymmetric corridor has gained wide acceptability among some AEs after the GFC. In India too, the RBI asymmetrically widened the corridor to 400 bps in mid-July 2013 in response to the taper tantrum. At the time of COVID-19 pandemic, the RBI once again asymmetrically widened the corridor during March-April 2020 (the corridor was asymmetrically widened to 65 bps in March and further to 90 bps in April 2020), operating a de facto floor system as various conventional and unconventional measures flooded liquidity into the system and kept financial conditions ultra-easy to counter the pandemic (Report on Currency and Finance, 2020-21).
- The regulation regarding the change in policy corridor is also very clear. While amendment in RBI act (Section 45ZB) entails the MPC to determine the policy rate (i.e. Repo rate) required to achieve the inflation target, the day to day liquidity management function is solely in the domain of RBI.
- During normal times, the reverse repo rate and the MSF rate move in sync with repo rate changes as they are pegged to the repo rate in an equidistant manner under a symmetric corridor. In exceptional times, however, the corridor itself becomes an instrument for managing liquidity conditions as it happened in 2013 and 2020.
- Hence **we propose RBI to change the corridor width from the current 50 bps to** higher levels for a limited period as the situation is intrinsically challenging. **This could be done without disturbing the repo rate at 5.5%.**

**Recent episodes of Off cycle policy meetings and LAF Corridor width**

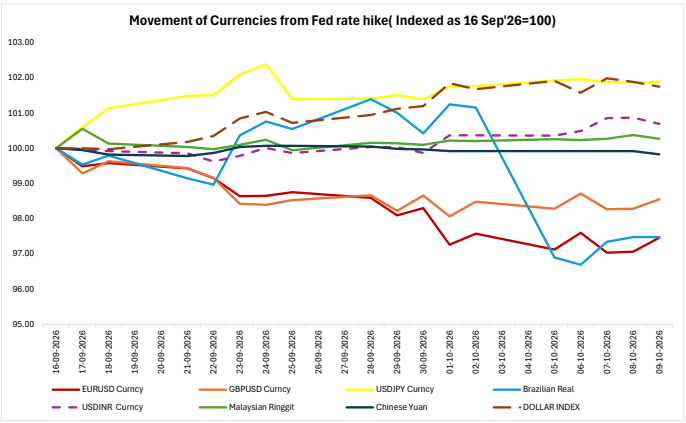
| Action | Date | Repo rate | Cut/ hike in bps | Reverse Repo | Bank rate/ MSF | Actual Corridor width in bps | LAF corridor |
|---|---|---|---|---|---|---|---|
| Change in Corridor | 15-07-2013 | 7.25 | - | 6.25 | 10.25 | 400 | 100 |
| | 27-03-2020 | 4.4 | -75 | 4.00 | 4.65 | 65 | 50 |
| | 17-04-2020 | 4.4 | - | 3.75 | 4.65 | 90 | 50 |
| Off-cycle policy | 22-05-2020 | 4.0 | -40 | 3.35 | 4.25 | 90 | 50 |
| | 04-05-2022 | 4.4 | 40 | 4.15 | 4.65 | 50 | 50 |

- **RBI's Report on Currency and Finance (2020-21)** clearly mentioned that, "*As the marginal standing facility and the fixed rate reverse repo windows are essentially instruments of liquidity management,* ***they are in the remit of the Reserve Bank****. In its endeavour to achieve the policy rate voted upon by the MPC,* ***decisions involving a change in the reverse repo rate and the MSF rate and announcements thereof may be shifted out of the MPC resolution to the Reserve Bank's Statement on Developmental and Regulatory Policies****. The RBI may also clarify for the purpose of anchoring expectations that in normal times it will work with a symmetrical corridor with the MSF rate and the fixed rate reverse repo rate at prespecified alignment with the policy repo rate and that* ***it reserves the option of operating with an asymmetric LAF corridor in exceptional times***."
- We believe the current regime well fits the playbook of exceptional/extraordinary times and hence apart from the change in corridor we also believe that the evolving situation warrants an agile and tactile response on rate front and that may warrant a **jumbo rate hike of 50 bps, sooner than later**. That incidentally implies not waiting till the next MPC meet for the next rate action. **An off-cycle policy or a widening of the corridor is thus looking like a *sine qua non* for dealing with the current state of affairs**.

## THE EXCHANGE RATE CONUNDRUM

- The needle of narratives now seems to be moving towards managing the Exchange rate mechanism, equally if not more, than inflationary expectations management given how the world order of financial liquidity flows, its availability (Just-In-Time basis) and most important, its pricing has undergone rapid and tumultuous changes.
- The conversation has moved decisively to how various jurisdictions have been affected by the resurgent Dollar Index, its momentum gaining further vigor from two variables; the probability of Fed hiking rates beyond 50 bps through 2026/2027 considering it may dismantle a 'QUIET' Fed theory of Kevin Warsh led Federal Reserve Board and signal superiority of markets in nudging the Fed to follow suit rather than it setting the template.
- **Second, the US economy has been growing strongly and its equity markets are charting new highs, a not-so-virtuous loop of circularity feeding its unsatiable hunger for AI-led dominance which means a self fulfilling fallacy of new money following old money is taking the stock markets to new highs, despite looming threats over other sectors, consumer confidence, daily essentials prices and Japan play unfolding (which many Pundits believe may be joined by economies like mainland in curtailing their US Treasuries holdings, accentuating the sell-off and pushing yields still higher).**
- The rise in longer tenor yields (say 30 years) as also benchmark yields has a cascading effect on key consumer essentials on two extreme ends; housing mortgages like ARM (Adjustable Rate Mortgage) where fixed 30 year mortgage rates are trading above 7.50% per annum while credit card spends are attracting charges around 22% (19.5-23.75% band). This is apart from high spend on energy and its secondary order impacts.
- The precarious situation has meant cost of capital reaching abnormally high levels, apart from a great squeeze in availability, with EMs likely to witness a refined form of Taper Tantrum going ahead that impacts investments and consumption both.

| NDF Movement (% change over USD INR) | | | |
|---|---|---|---|
| | 1 yr NDF | 3 M NDF | 1 M NDF |
| Last 3 Months (9 Jul to 9th Oct) | | | |
| Average | 3.27 | 0.87 | 0.29 |
| Max (8 Oct' 26) | 4.02 | 1.40 | 0.67 |
| Min (2 Sep'26) | 2.62 | 0.20 | -0.31 |
| 27 Mar to 10 Apr 26 | | | |
| Average | 4.51 | 1.77 | 0.69 |
| Max (2 Apr'26) | 5.59 | 2.43 | 0.95 |
| Min (27 Mar'26) | 3.43 | 0.97 | 0.17 |




## THE FORWARD MARKET FACES THE HEAT

- The recent spike in risk sentiments has meant EM currencies coming under a tail spin, their vulnerability to energy shocks and its embedded volatility (getting supplies on FOB basis means a considerable mark-up in these challenging times) getting a larger-than-life print.
- The NDF markets are reflecting the mayhem most as shorter end of the curve is vaulting through the roof, the annualized cost at times double that of longer end, with action concentrating around 1-3M. It may generously imply the importers harried demand in congruence with opaque yet impressive speculators' position, a dangerous duet that may drive the spot levels, detached from fundamentals materially.
- The toolkit thus needs to be fine tuned where exporters need to increasingly and optimally match the proceeds and remittances with importers need and hedging patterns, any undue, purposeful delay attracting some punitive deterrence mechanism as markets are closely watching the developments against Mint Street's interventions.

**COMMUNICATION IN TIMES OF UNCERTAINTY**

- In many of our reports we have mentioned that there is a growing disconnect where market participants have had to place a "premium on pragmatic action" rather than taking RBI communication at face value. For example: actual operations such as variable rate reverse repos or liquidity management, did not always match verbal guidance.
- A 2023 Banque De France paper titled "A Pitfall of Cautiousness in Monetary Policy" argues that, for central banks too much caution can backfire because if people expect the central bank to respond weakly, inflation expectations can move further away from target, forcing the central bank to act later anyway, but from a far worse position. Thus Brainard's (1967) principle - creates a "cautiousness bias" that de-anchors inflation expectations.
- In principle, while caution works for temporary, small shocks, it fails for persistent shocks. A gradual, cautious response as underlined in Brainard could create long-term damage, whereas aggressive action keeps expectations better anchored.. The 2023 paper further argues that society would be better off appointing a central banker who discounts concerns over uncertainty relative to society, even if this means responding to unforeseen shocks too aggressively
- **In uncertain times, a good central bank should be cautious about false precision, forceful against high-cost tail risks, systematic enough to preserve credibility, flexible enough to adapt, and transparent enough that uncertainty about the economy does not become uncertainty about the central bank itself. This is exactly what might have been also conveyed by RBI Governor very recently in his Princeton address and hence such communication may be also construed as a forward guidance.**

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