Monetary policy | First cut

Ramping up the inflation fight

June 8, 2022

RBI frontloads one more rate hike, sees inflation breaching target this fiscal

The Reserve Bank of India's (RBI) Monetary Policy Committee (MPC) raised the policy rates by 50 basis points (bps) today, bringing the repo rate to 4.90%, standing deposit facility (SDF) to 4.65%, and marginal standing facility (MSF) to 5.15%. This is the second rate hike this fiscal, following the surprise 40 bps hike in May. Nevertheless, the repo rate is still below the pre-pandemic level of 5.15% in February 2020. The back-to-back hikes signal that inflation has been reinstated as the focus of the MPC, amid recovering growth and tightening global financial conditions.

We expect the RBI to raise rates by another 75 bps this fiscal, bringing repo rate 50 bps above the pre-pandemic level by end-fiscal. The hikes will be front-loaded this year, given heightened inflationary pressures at present. While the rate hikes will not be enough to tackle inflation, which is largely supply-driven, they could curb the second-round effects by capping excess demand and anchoring inflation expectations. Monetary policy tightening is also warranted to reduce pressure on the rupee stemming from a widening current account deficit (CAD) and capital outflows by foreign portfolio investors (FPIs).

Highlights of the June MPC meeting

- The MPC voted unanimously to raise policy rates by 50 bps, bringing repo rate to 4.90%, SDF to 4.65%, and MSF to 5.15%
- The monetary policy stance was changed from 'accommodative' to 'withdrawal of accommodation', with a unanimous vote
- The MPC raised its forecast for consumer price index-based (CPI) inflation to 6.7% for fiscal 2023 from 5.7% projected in April, with risks evenly balanced
- Projection for gross domestic product (GDP) growth was retained at 7.2% for this fiscal, with risks broadly balanced

What drove the RBI's decision?

- **Rising inflation risks**: CPI inflation has been rising for the past seven months and has stayed above the upper threshold of RBI's 2-6% target range since January 2022. The latest inflation print showed it reaching an 8-year high of 7.8% in April, with the rise being broad-based. The MPC stated that the upside risks to inflation envisaged in April have materialised earlier than expected. It also noted the pass-through of cost pressures to

retail prices is increasing.

The MPC also believes inflation continues to face upside risks from high international commodity prices. Besides, food inflation faces an upside from the unusual heatwave this year impacting production, which might offset the benefits for kharif from a normal monsoon, and the lifting of Indonesia's ban on palm oil exports. Fuel inflation continues to face pressure as crude oil prices have risen further to $120 per barrel, while electricity tariffs are due for upward revisions this year.

The RBI welcomed the excise duty cuts on petrol and diesel by the central government, and urged state government to cut value added tax (VAT) on these fuels to help ease inflation. However, the RBI's surveys of manufacturing, services, and infrastructure sectors show expectations of further rise in input and output prices going forward, which will put pressure on core inflation.

Taking these factors into account, the RBI revised up CPI inflation by 100 bps to 6.7%, on average, in fiscal 2023, with 7.5% in the first quarter (Q1), 7.4% in Q2, 6.2% in Q3 and 5.8% in Q4. Including the fourth quarter of last fiscal, this implies four straight quarters of headline inflation overshooting RBI's target range of 2-6%.

While the MPC noted inflationary pressures remain largely supply-driven emanating from external factors, it believes rate hikes would help in reducing second-round effects and keeping inflation expectations in check.

- **Mitigating tightening global conditions**: The RBI governor acknowledged emerging markets like India are facing growing challenges from tightening global financial conditions, as major global central banks step up on rate hikes to fight inflation. This has put pressure on currencies and hit economic recovery in these markets. While the rupee has depreciated this year, he noted it has fared better than other emerging market currencies. In the present global risk-off environment, the RBI's rate hikes and normalisation of liquidity conditions is expected to help improve investor confidence regarding central bank's credibility to fight inflation and prudently manage the domestic financial system.

- **Growth on track:** The MPC believes India's economic recovery is gaining strength. The latest GDP numbers showed growth slowing to 4.1% on-year in Q4 of fiscal 2022 compared with 5.4% previous quarter. Private consumption growth slowed, while government consumption and fixed investment picked up. RBI's surveys indicate an improvement in capacity utilisation in manufacturing in the last quarter.

  Available information for Q1 of the current fiscal shows broadening recovery. S&P Global's purchasing managers' index (PMI) indicates expansion in both manufacturing and services in April and May. Other high-frequency indicators such as bank credit, railway and freight traffic, Goods and Services Tax collections, and steel consumption also indicate an improvement.

  The MPC expects economic recovery to improve further as normal monsoons augur well for agriculture production, rebound in contact-based services boosts urban consumption, and investment activity gains momentum with government's capex push and improving capacity utilisation. However, growth faces risks from high commodity prices, global supply disruptions, and tightening global financial conditions.

  Considering these factors, the MPC expects GDP growth at 7.2% in fiscal 2023, with 16.2% in Q1, 6.2% in Q2, 4.1% in Q3, and 4% in Q4, with risks broadly balanced.

Our view

We expect the RBI to aggressively tighten monetary policy in the next few months, to tackle surging inflation and

adverse external spillovers.

Inflation has faced a series of shocks this year — from the Russia-Ukraine war to the unusual heatwave seen in parts of the country. A wide-ranging surge in international prices of food, energy and industrial items has not abated since the Russia-Ukraine war began, which will put broad-based pressure on food, fuel and core inflation. The outlook on food inflation has worsened considerably with the heatwave's adverse impact on production of critical items like wheat and vegetables. While normal monsoon is expected to cool prices in the second half, its intensity and spread will need to be monitored. Hence, we expect a CPI inflation print of 6.8% this fiscal.

The RBI's policy tightening is also warranted to reduce pressure on the rupee from widening CAD and FPI outflows. So far, the rupee has weakened 4.3% since the start of 2022, compared with 12.9% in 2013 (when the rupee went into a major tailspin during 'taper tantrum').

Currently, the economy is facing significant adverse external spillovers. Most central banks are hiking rates. S&P Global expects the US federal funds rate to be hiked to 3-3.25% in 2023, higher than the pre-pandemic level of 1.5-1.75% in February 2020, and the highest since early 2008. Meanwhile geopolitical risks from the Russia-Ukraine war remain high.

India's external vulnerability, though lower than in 2013, has started rising. We expect CAD to rise to 3% of GDP this fiscal, which would be the highest since fiscal 2013. Foreign exchange reserves remain adequate, but have reduced in the recent months given RBI's interventions to control the rupee's depreciation. Import cover, or foreign exchange reserves as a proportion of imports, reduced to 9.9 in May 2022, the lowest since 2019 but higher than 7.4 on average, in 2013.

Due to these factors, we expect another 75 bps hike in repo rate this fiscal, bringing repo rate 50 bps above the pre-pandemic level. We do not expect this to affect growth this fiscal, as monetary policy action reflects in the real economy with a lag. We expect the impact to show from the last quarter of this fiscal and play out to a greater extent in fiscal 2024.

Impact on the banking and financial services sector

- **Increase in cost of borrowings:** A rising interest rate scenario, in line with the increase in repo, will lead banks to continue increasing their deposit rates, to help them meet the expected growth in credit this fiscal. That said, the increase in the repo rate by an additional 50 bps will crank up the cost of borrowing of both, banks and non-banks.
- **Reduction in net liquidity surplus**: The net liquidity surplus as on June 7, 2022 declined to ~Rs 3.1 lakh crore from ~Rs 5.7 lakh crore as on May 04, 2022. This reduction of ~Rs. 2.5 lakh crore was a function of various interventions by the RBI such as introduction of SDF in April 2022, absorption through variable rate reverse repo (VRRR) route, increase in cash reserve ratio (CRR) by 50 bps in May 2022 (that resulted in reduction in liquidity by ~Rs 80000 crore), and an increase in credit offtake with improving utilisation across sectors.
- **Linking of RuPay credit cards to UPI:** The Unified Payments Interface, or UPI, has gained traction in recent years, with over 70% of the total digital payment volumes processed via UPI in April 2022 as against 58% in April 2021. It is proposed to allow linking of RuPay credit cards on the UPI platform to provide additional convenience and enhance the scope of digital payments.
- **Increase in cooperative banks' housing loan limits:** The limits for extension of housing loans by urban cooperative banks (UCBs) has been increased from Rs 30 lakh (tier I UCBs) and Rs 70 lakh (tier II UCBs) to Rs

60 lakh and Rs 1.40 crore, respectively. Similarly, the limit for rural cooperative banks (RCBs) has been increased from Rs 20 lakh (tier I) and Rs 30 lakh (tier II) to Rs 30 lakh and Rs. 75 lakh, respectively. Further, on account of growing need for affordable housing and potential in providing credit facilities to the housing sector, the RCBs are now allowed to extend credit to commercial real estate with aggregate exposure to housing finance limited at 5% of their total assets.

CRISIL Research expects credit growth at 10-12% for banks and 11-12% for NBFCs during fiscal 2023. This will be supported by a visible improvement in credit utilisation across retail and wholesale segments.

On the retail front, healthy credit growth was envisaged due to higher consumption growth and post-pandemic recovery across manufacturing and services sectors. However, with inflationary pressures across products and services, volume/consumption growth this fiscal 2023 may be impacted as affordability deteriorates.

On the wholesale front, increasing capacity utilisation of corporates is a positive sign, supported by the deleveraging by large corporates in the past few fiscals. In addition, strong balance sheets of banks due to improving asset quality, profitability and capital adequacy will help them continue maintain market share in the rising interest rate scenario. Some of the small/mid-sized NBFCs would continue to grapple with asset quality concerns.

From the overall lending perspective, faster and higher quantum of increase in interest rates is expected to impact cost of funds for players. However, impact on yields, and hence, on returns will be limited for banks in comparison with NBFCs, since the former hold more time deposits with an average tenure of 2-3 years, for which they are paying lower interest rates.

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