## Monetary policy | First cut

# Weathering global storm

September 30, 2022

## Inflationary pressures and risks of global spillover mean the RBI keeps its guard up

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) continues to frontload rate hikes. The MPC raised the policy rate by 50 basis points (bps) in today's meeting, bringing the repo rate to 5.9%. This is the third consecutive 50 bps hike in this cycle, taking the cumulative hike to 190 bps.

The rate hike can be seen as a response to both elevated domestic inflation and spillover risks arising from aggressive monetary tightening by major central banks.

*The frontloading of the repo rate hike was expected, particularly in the light of a sharper rate hike path stated by the United States (US) Fed and continued rate hikes by other major central banks. Further, domestic inflation is still above the RBI's upper tolerance limit and faces pressure from food and core inflation. Against this backdrop, we expect the MPC's future actions to be determined largely by the trajectory of domestic inflation. Developments in the external sector and monetary policy actions of other central banks will also influence its decision on rates.*

## Highlights of the September meeting

- The MPC voted with a 5-1 majority to raise policy rates by 50 bps, taking the repo rate to 5.90%, standing deposit facility to 5.65%, and marginal standing facility to 6.15%
- The monetary policy maintained the 'withdrawal of accommodation' stance
- The MPC maintained its forecast for Consumer Price Index (CPI) inflation at 6.7% for the current fiscal, as risks from food and core inflation remain
- Gross domestic product (GDP) growth forecast for this fiscal was revised downwards to 7.0% (from 7.2% earlier) due to headwinds from tightening global financial conditions and risks to exports, even as domestic activity remains resilient
- The RBI did not give any forward guidance considering the extreme uncertainty

## What has changed since the last MPC meeting?

Monetary policy actions have been a tightrope for the MPC in September, with markedly changing global and domestic conditions since its August meeting. The MPC had to contend with three major challenges – domestic inflation rising again, aggressive monetary policy tightening, than expected earlier, by the major central banks, and strengthening of the US dollar index, leading to further weakening of the rupee.

- **Inflation reversed easing trend:** Consumer price inflation, which had eased during May-July, rose again in August to 7% on-year led by rising food inflation. The MPC expects CPI inflation to remain above its upper tolerance band of 6% in the next quarter as well (projected at 6.5%), trending down thereafter (fourth quarter at 5.8%, first quarter of fiscal 2024 at 5%).

  The RBI governor’s statement today indicates that the MPC is cognizant of persisting inflationary pressures arising from volatile food and sticky core inflation. 1) Food inflation faces pressure from lower kharif sowing in rice and pulses (as evident in the August CPI print) and volatile vegetable prices (owing to delayed monsoon withdrawal). 2) Stronger revival in private consumption demand as per first quarter GDP data for this fiscal along with risks from higher passthrough of input costs, is expected to put pressure on core inflation and keep it elevated. That said, international commodity prices have fallen since June, offering some relief on imported inflation.

  The MPC’s inflation forecast was thus maintained at 6.7% for this fiscal, owing to continued uncertainty on the inflation trajectory – from both domestic supply and demand pressures, and global geopolitical conditions.

  The MPC’s 50 bps hike this time reiterates its resolve to anchor inflation expectations and control second-round effects of elevated cost of living conditions and higher wages which may exacerbate price increases.

- **Increasingly hawkish stance of the US Fed and global growth slowdown concerns:** The US Fed raised its policy rate by 75 bps in its latest September meeting, and its projections for rates in the remainder of 2022 and 2023 indicate a higher rate trajectory than earlier anticipated. Other major central banks, including the European Central Bank, have adopted a similar hawkish stance. Add to the mix are the energy crisis in Europe and Chinese economy slowdown, causing global growth slowdown fears to increasingly get entrenched. This has caused volatility in global financial conditions, including rise in US Treasury yields, sliding global equity markets, and depreciating currencies across advanced and emerging economies.

- **Rupee facing depreciating pressure:** Owing to the strengthening dollar index and risk-off sentiment from global slowdown concerns, the rupee is facing severe depreciating pressure: sliding to 81.9/$ on September 28, compared with an average of 79.6/$ in August. The rupee has depreciated ~7.4% in the fiscal.

  The RBI’s interventions in forex markets to limit volatility in the rupee, have led to the drawdown of reserves. However, the governor in his statement maintained that reserves remain adequate and that the RBI has other tools as well to contain a sharp depreciation.

- **Surplus liquidity in the system moderating:** Liquidity was down to 0.7% of net demand and time liabilities (NDTL) in August, from 2.5% in May 2022 (when the rate hike cycle began) and lower than its corresponding pre-pandemic level of 1% (August 2019). In fact, liquidity had turned into the deficit mode for a few days in September due to advance tax payments coupled with forex outflows.

  The MPC, though, continued its monetary policy stance of ‘withdrawal of accommodation’ in today’s meeting. The governor’s statement indicated that since system liquidity remains in surplus and will continue to be so in the second half of this fiscal (from an expected pick-up in government spending), the central bank remains focused on absorption of liquidity.

## Our view

The economy faces strong headwinds from global shocks: major economic centres, the US, Europe and China, are facing a growth slowdown. A synchronous monetary tightening by both advanced and emerging economy central banks, means interest rates are rising faster than seen in the past two decades and will also stay at relatively elevated levels in the near future. Prospects of a recession is leading to a surge in the safe haven dollar index.

These factors pose spillover risks to India's macros: slowdown in global growth is already reflecting in export slowdown, which poses downside risks to India's GDP. A depreciating rupee raises risks of imported inflation, offsetting some gains from the recent fall in international commodity prices. Volatility in global financial conditions, across assets (equity, debt, rates), is showing its effect domestically too, with equity indices sliding, yields rising, and rupee falling.

Domestically, inflation pressures persist – from rising food and elevated core inflation. At the same time, the pace of economic activity seems to be holding up.

Amid this scenario, the RBI's actions are addressing both domestic conditions and the narrowing inflation-interest differential between India and advanced economies.

Risks to inflation and domestic financial conditions continue to be significant, but uncertainties in the inflation trajectory remain. We expect the RBI's actions going ahead to be guided by domestic supply-demand pressures on inflation, and evolving global financial conditions, including the Fed's actions.

## Impact on the banking and financial services sector

As per the RBI's Weekly Statistical Supplement, banking credit grew at ~15% on-year, vis-à-vis deposit growth of 9.5% as on September 09, 2022, because of faster growth in retail credit and recovery in the wholesale segment. This is evident from the increase in seasonally adjusted capacity utilisation of the manufacturing sector to 74.3% in the first quarter of the current fiscal from 73% in the fourth quarter of fiscal 2022. CRISIL Research expects that continued growth momentum in retail and service segments supported by recovery in industrial credit will help banking credit to grow at 13-15% during fiscal 2023.

Further, the RBI announced the release of discussion paper on convergence of banks' loan provisioning policy to a more prudent and forward-looking expected credit loss (ECL) based approach, which requires banks to make provisions based on an assessment of probability of defaults. It is pertinent to note that bigger non-banking financial companies have adopted the ECL approach since April 2018 under Indian Accounting Standard. Implementation for the banking sector was deferred due to pending necessary legislative amendments and level of preparedness of many banks.

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