Monetary policy | First cut

Easing the pace

December 07, 2022

Uncertainty on inflation and growth means the RBI keeps its options open

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) raised the policy rate today by 35 basis points (bps) to 6.25%. The decision to slow the pace of rate hikes (compared with the previous three instances of 50 bps hikes) was largely expected, given that upside risks to inflation are moderating, and it is forecast to come within the RBI's target range by next fiscal. Yet, as the governor mentioned, the battle against inflation is not over (core inflation being the biggest problem), and hence, a calibrated monetary policy action is the need of the hour. The MPC has so far raised rates by a cumulative 225 bps this fiscal.

The MPC maintained its stance on 'withdrawal of accommodation' as liquidity conditions remain in surplus and the policy rate adjusted for inflation remains negative. Interestingly, though, the accommodative stance was decided by a 4-2 majority (compared with 5-1 in the September meeting), reflecting the increasing divergence in views of MPC members.

Pressures on inflation are slowly shifting from the supply side to the demand side as food and fuel inflation moderates (owing to climb down in global commodity prices and arrival of kharif crop/winter vegetable harvest), but core inflation remains sticky (from recovering demand for services and pass-through of input costs to consumers). The MPC's decision to slow its rate hikes was thus predicated on inflation moderating, which does not require the central bank to tighten monetary policy as much as earlier. But tightening continues as inflation remains elevated vis-à-vis its target, and uncertainty abounds. The US Federal Reserve (the Fed) is also considering a slower pace of rate hikes (albeit with a higher terminal rate than previously indicated), which could imply lower spill-over risks to the rupee and domestic financial conditions, and thus a lesser need to tighten.

Highlights of the December meeting

- The MPC voted with a 5-1 majority to raise the policy rate by 35 bps, taking the repo rate to 6.25%, standing deposit facility rate to 6.0% and marginal standing facility rate to 6.5%
- The monetary policy stance was maintained at 'withdrawal of accommodation', with a 4-2 majority
- The MPC maintained its forecast for Consumer Price Index (CPI) inflation at 6.7% for the current fiscal
- Gross domestic product (GDP) growth forecast for this fiscal was revised downwards to 6.8% from 7.0% earlier, due to marked downside risks to global growth and uncertainties from geopolitical tensions

What were the key considerations for the MPC's decision?

Uncertainty around inflation and growth was the dominant narrative this time[1] in the governor's statement. Controlling elevated inflation remains key for the MPC. Inflation is expected to come within the RBI's target range of 4-6% by next fiscal, but sticky core inflation is a major concern. Further, with global growth forecasts undergoing a downward revision, supporting domestic growth was 'obviously kept in mind', as per the governor's statement.

- **Inflation expected to ease in the coming quarters, but risks present:** Consumer price inflation eased sharply to 6.77% in October from 7.4% in September. The MPC expects CPI inflation to remain above its upper tolerance band of 6% in the third quarter as well (projected at 6.6%), but it is expected to come within the target range from thereafter (fourth quarter at 5.9%, first quarter of fiscal 2024 at 5%).

  Inflation remains elevated currently due to higher cereal and vegetable prices, and sticky core inflation. On the food inflation front, things are expected to get better with harvest of kharif crop, seasonality in vegetable inflation coming down with winter arrivals, and robust rabi sowing (second-quarter GDP data did not show much impact of unseasonal rains/delayed monsoon withdrawal on agricultural activity). Fuel inflation is also expected to inch down on moderating crude oil prices and base effect.

  Core inflation, though, remains a point of concern. Our analysis of disaggregated Wholesale Price Index suggests that, though input prices have eased in the past few months, the pass-through to consumer prices remains a monitorable.[2] Further, persistent geopolitical tensions and uncertain outlook on dollar index mean continued uncertainty on imported inflation.

  The MPC also indicated that it intends to evaluate the impact of rate hikes so far on inflation (owing to its long and variable lags) — hence the slower, calibrated rate action this time around.

- **Signs of slowing momentum in domestic growth:** Second-quarter real GDP growth print of 6.3% on-year was in line the RBI's forecast. Yet, in the current quarter, some signs of weakening are apparent: exports have contracted on-year, core imports are slowing and industrial production (particularly in export-intensive sectors) has taken a beating**.** This contrasts with robust demand conditions as evidenced through urban consumption firming up (uptick in auto sales, air passenger traffic) and some recovery in rural demand (pickup in tractor sales).

  Global growth is expected to decelerate faster next year, and India will not remain unscathed from this. Accordingly, the MPC revised downwards its GDP forecast for the current fiscal to 6.8% (from 7% earlier). Thus, the MPC's actions can also be seen through the prism of not wanting to tighten policy too much, which may clamp the current impulse in domestic demand as rate hikes take effect.

- **Systemic liquidity remains in surplus:** Systemic liquidity was in surplus at ~0.3% of net demand and time liabilities (NDTL) in November, compared with a neutral level of 0% in October. Given the surplus liquidity conditions, the RBI's daily absorptions under the liquidity adjustment facility went up to Rs 2.6 lakh crore as on December 5, compared with Rs 1.6 lakh crore in November.

  The objective of the monetary policy stance of 'withdrawal of accommodation' is to facilitate monetary policy transmission (as surplus liquidity conditions hinder transmission during tightening). With moderation in currency in circulation post the festive season, a likely increase in government expenditure in the last

[1] In fact, the governor's statement mentioned the word 'uncertainty' (or its derivative) 6 times today, compared to 2 times in the September meeting

[2] For details, refer to CRISIL Quickonomics *'The passthrough effect'* (December 05, 2022)

quarter of the fiscal, and return of foreign portfolio inflows, liquidity conditions are expected to improve further.

Thus, given the current accommodative liquidity conditions, the RBI considered it necessary to continue to focus on withdrawal (instead of going 'neutral').

Our view

Global growth forecasts have been marked down since the last MPC meeting. S&P Global (December 2022) expects the world economy to grow 3.4% in 2022 and decelerate to 2.2% in 2023. This, together with tightening global financial conditions and geopolitical tensions, has created a downside risk to India's growth outlook.

Globally, monetary policy tightening is becoming less aggressive — the US Fed has indicated a relatively slow pace of rate hikes going ahead. The Bank of England's November guidance indicated further rate hikes, but at a lower peak than priced by financial markets. A few emerging markets have slowed tightening, while others have announced a pause (Brazil, Hungary).

Domestically, inflation has climbed down, on base effect and moderation in supply-side factors. But core inflation remains a key risk, which does not permit the RBI to lower its guard.

Amid this scenario, the RBI's actions are addressing uncertainty around both inflation and growth: a rate hike was warranted as inflation remains elevated, but the pace could be brought down (from 50 bps earlier to 35 bps now) as risks have moderated somewhat.

The RBI has kept its options open on the future course of the monetary policy; hence, future rate hikes cannot be ruled out if risks to inflation rise.

Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Limited
dharmakirti.joshi@crisil.com

Amruta Ghare
Economist, CRISIL Limited
amruta.ghare@crisil.com

Media Contacts

Aveek Datta
Media Relations
CRISIL Limited
M: +91 99204 93912
B: +91 22 3342 3000
aveek.datta@crisil.com

Riddhi Savla
Media Relations
CRISIL Limited
M: +91 98199 57423
B: +91 22 3342 3000
Riddhi.Savla1@crisil.com

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