23 May 2022

# RBI to front-load rate hikes to tame inflationary pressures; large FX reserves provide a cushion against external shocks

- The global economy continues to reel under the stagflation shock. Growth momentum has been hampered by spillover from the Ukraine-Russia war, supply-side constraints, elevated inflation, and synchronized monetary tightening by major central banks.
- Over the last month, India's high-frequency data showed traction in economic activity, including the contact-intensive services supported by tapering off of the COVID cases and high vaccination coverage.
- However, global growth slowdown, high commodity prices, rising domestic inflation, and expected monetary policy tightening by the RBI will weigh on India's economic outlook.
- In our last month's report, we noted that the RBI's plan to withdraw liquidity gradually would face a huge challenge from the building up of inflationary pressures.
- In April, CPI inflation accelerated to an eight-year high of 7.8% YoY, remaining above the RBI's tolerance level for the fourth consecutive month.
- Inflationary pressures are broad-based, as the share of items in the CPI basket with above 6% inflation rose from 32% in Feb '21 to 59% in Apr '22.
- The Monetary Policy Committee (MPC) assessed that the worsening outlook of inflation warranted timely action to forestall second-round effects and prevent unanchoring of inflation expectations.
- Accordingly, it held an off-cycle meeting on May 4 to announce a hike in repo rate by 40 basis points (bps) to 4.4% and in Cash Reserve Ratio (CRR) by 50 bps.
- In line with our expectation of front loading of rate hikes and the newfound urgency shown by the RBI to tame inflation, we expect the RBI to raise the repo rate by an additional 110 bps in FY23.
- We expect CPI inflation to average 6.3% YoY (with upside risks) in FY23 and the terminal repo rate at 6% by Q1FY24.
- We revise the real GDP growth projection downward to 7% YoY for FY23 from the previous forecast of 7.7% on account of an increase in our base oil price assumption, global growth concerns, higher domestic inflation, and an expected faster pace of monetary policy tightening.
- In this report, we also look at India's external vulnerability, especially from its external debt obligation perspective vis-à-vis FX buffers.
- Our analysis shows that RBI's FX reserves are adequate as per key metrics, which should provide a strong defence against external vulnerability risks.
- However, as options of FX reserves accumulation will be limited in FY23 and even FY24, the RBI should employ FX reserves judiciously and complement these with prudent macro-policy adjustments.


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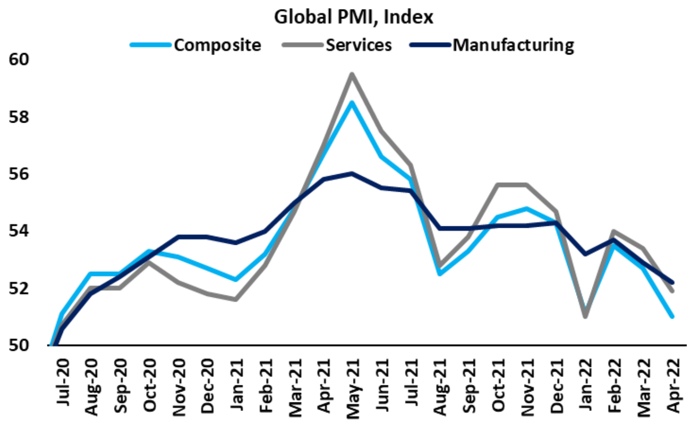
## The global economic outlook worsens amidst elevated inflation

The global economy continues to reel under the stagflation shock. Growth momentum has been hampered by spillover from the Ukraine-Russia war, supply-chain issues, elevated inflation weighing on corporates' earnings outlook and consumers' purchasing power, and synchronized monetary tightening by major central banks. Further, while easing COVID restrictions is supporting the normalization of economic activity in several countries, this has not been broad-based. China is facing a high number of COVID cases leading to the tightening of COVID containment measures in April to the most stringent so far in the pandemic. This has created downside risks for China's economy and fresh challenges for the global supply chains. All these developments have weighed on the global economic growth and worsened the outlook. High-frequency data has started to show moderation in economic activity. The global Composite PMI index fell from 52.7 in March to a 22-month low of 51.0 in April, driven by steep contractions in Russia (due to sanctions and war) and China (due to the strict zero-COVID strategy). Economic activity in other major economies was broadly resilient/slowed moderately but faced a challenging outlook. We see an increasing possibility that global growth for 2022 will be lower than the IMF's projection of 3.6% YoY.

### Global economic activity slowed sharply in April




***Source: IHS Markit, Bloomberg***

The Ukraine-Russia war and COVID related lockdowns in China have worsened the existing supply chain issues, fuelling a broad-based rise in commodity prices and accentuating the inflationary pressures across the globe. US CPI inflation eased slightly from a four-decade high of 8.5% in March to 8.3% in April but came in higher than the market expectation of 8.1%, indicating pressures are likely to be sticky. US core CPI inflation eased by 30 bps to 6.2% in April, but the sequential momentum increased to 0.6% MoM from 0.3% MoM. Inflation in other developed economies also remained elevated. In the UK, inflation surged to a four-decade high of 9% in April and in the Euro Area, inflation rose to a fresh record high of 7.4% in April. Elevated inflation is forcing central banks across the globe to pivot away from active stimulus to the accelerated withdrawal of pandemic-related stimulus. Following a 25 bps rate hike in March, the US FOMC raised the policy rate by 50 bps in early May to a range of 0.75% to 1% to combat soaring inflation. Chair Jerome Powell indicated that an additional 50 bps increase would be on the table for each of the next couple of meetings even though the committee is not actively considering a steeper 75 bps rate hike. The FOMC also announced a plan to reduce its balance sheet starting June 1, initially at a monthly pace of $47.5 bn, rising to $95 bn over three months. The Bank of England, on the other hand, raised the policy rate for a fourth time since December by 25 bps to 1% while projecting inflation peaking above 10% in the last three months of this year and economic contraction in 2023. Meanwhile, ECB President Christine Lagarde signalled that the first interest-rate increase might follow "weeks" after net purchases under the asset purchase programme ends (likely in Q3). Central banks of other countries such as Malaysia, Australia, Hong Kong, Brazil, Mexico, Chile, and Peru also raised their respective policy rates in May. Synchronized monetary policy tightening is leading to deterioration in global financial conditions and correction in equity and bond markets amidst continued high volatility. In recent weeks, some moderation has been witnessed in commodities' prices, but these remain high. With markets' expectation of aggressive rate hikes by the US Fed, the dollar index rose by 8% since January to a two-decade high level by mid-May, putting pressure on EM currencies. EM central banks with low FX buffers will be forced to hike interest rates to support their currencies in addition to tame domestic inflation. The economic cost of taming inflation through monetary policy tightening will critically depend on the easing of supply-side constraints and geopolitical developments.

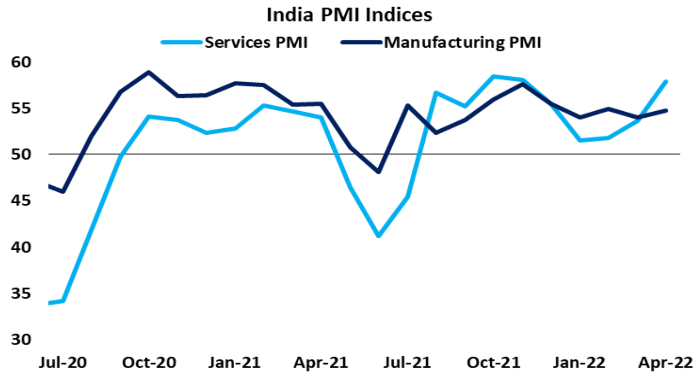
## India's economic outlook deteriorates, driven primarily by global factors

Global growth slowdown, high commodity prices, rising domestic inflation, and expected monetary policy tightening by the RBI will weigh on India's economic recovery. Given diminishing hopes of an early resolution of the Russia-Ukraine conflict, commodity prices are likely to remain elevated even though some fluctuations in prices can happen due to global growth concerns. We now project the Brent oil price to average ~$105/bbl in FY23 compared to the previous assumption of $95/bbl, which will weigh on the economic outlook, and current and fiscal accounts. This comes at a time when a contained COVID situation (with cases below 2.5K by mid-May) and high vaccination coverage (86% of the eligible population received both doses by mid-May) allowed traction in economic activity, as seen in high-frequency data, even though the effect of global developments started to be felt for several sectors/industries. Factoring in these developments, **we revise the real GDP projection downward to 7% YoY for FY23 from the previous forecast of 7.7% YoY. For FY22, we estimate Q4FY22 real GDP growth to be around 4% YoY and for FY22 at 8.7% YoY compared to previous estimates of 4.4% YoY and 8.8% YoY, respectively**.

The industrial activity showed signs of traction, but global disruptions and high commodity prices continue to weigh on the outlook. The Index of Industrial Production (IIP) noted a modest pick-up to 1.9% YoY in March compared to 1.5% YoY in the prior month. This is despite a sequential uptick of 12.5% MoM, typical of FY end acceleration, after two consecutive months of contraction. The expansion in March was led by electricity (18.8% MoM) and mining (17.4% MoM) which benefitted from the heatwave in the country, while manufacturing noted a growth of 10.9% MoM. Potential disruption to electricity supply due to low coal stocks at power plants remains a risk for electricity generation and wider industrial activity. On a positive note, manufacturing PMI remained in the expansionary zone for the tenth consecutive month, though rising only modestly from 54.0 in March to 54.7 in April. Companies noted acceleration in new orders, production, and international demand; however, intensification of the input price pressures continues to pose a concern. Other early indicators provide a mixed picture as E-way bills generation registered a sequential slowdown (-3.7% MoM in April v/s 13% in March) while GST collections noted a robust growth (17.9% MoM in April v/s 6.8% in March). Going ahead, high global commodity prices and supply chain disruptions (stemming from the Russia-Ukraine war and COVID induced lockdown in China) are likely to continue to tamper with the industrial outlook.

In the services sector, several high-frequency indicators suggest a pick-up in the activity, especially for contact-intensive services. The services PMI noted a sharp acceleration from 53.6 in March to 57.9 in April. This was the fastest rate of expansion witnessed since November 2021 due to increased consumer footfall as the COVID cases continue to taper off. Companies also noted renewed hiring efforts for the first time since November 2021. However, the business sentiment contracted in April because of inflationary concerns. Other indicators like national electronic toll collections noted a sequential improvement in value terms (3% MoM in April). Rail freight traffic and port traffic noted a strong growth on an annual basis in April, even though momentum slowed on a sequential basis. Contact intensive sectors like tourism, hotels & restaurants have seen a recovery in credit growth over the past few months, suggesting a broadening of the economic recovery. Domestic air passenger traffic continued to improve sequentially in March-April. With COVID cases at low levels, the outlook for the services sector is improving to allow catch-up to pre-COVID levels, partly hampered by rising inflation.

**India's PMIs show traction in economic activity, led by the services sector**



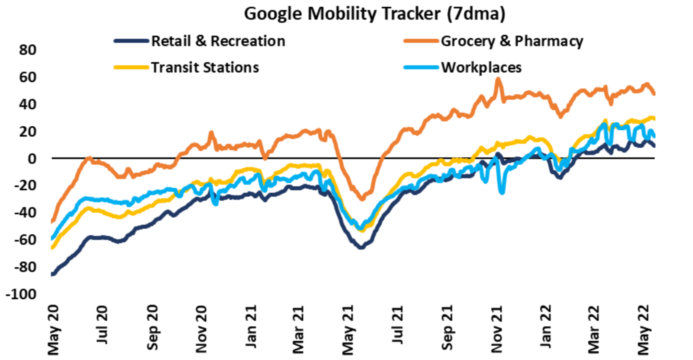

***Source: IHS Market, Bloomberg***

The agriculture sector saw higher rabi sowing, but the near-term outlook for the sector has been impacted by the ongoing heatwave, which will affect the yield and quality of crop production. High fertilizer prices could also impinge on agriculture activity even though the government is expected to cushion part of this impact by raising subsidies and minimum support prices. The government has imposed a temporary ban on wheat exports due to concerns over domestic food security and rising food prices, which will lower the potential for agri-exports in the current year. However, the projection of a normal monsoon this year, adequate reservoir levels, and expected higher MSP prices continue to underpin a positive outlook for the sector.

On the demand front – the high-frequency indicators of private consumption indicate signs of revival as the economic activity normalizes; however, the outlook remains fraught with uncertainty amidst rising prices, uneven labor market recovery, and expected tighter monetary conditions. With the complete removal of the restrictions, google mobility for retail & recreation and grocery & pharmacy continued to improve in April and in the first half of May. As such, the mobility for retail & recreation improved to 9.4% (7dma) above the baseline, and mobility for grocery & pharmacy too inched up to 48% above the baseline levels (data till May 16). This is despite mobility levels tapering off a bit in the last week due to the intense heatwave in parts of the country. Personal credit continued a robust performance as it sustained double-digit growth at 12.7% YoY and improved sequentially by 2% MoM in March. The IIP based consumption index (weighted average of consumer durables and non-durables) noted a sequential pick up of

9.6% MoM after two months of contraction in March as both consumer durables and non-durables noted sequential recovery. Other indicators like two-wheeler sales also improved sequentially in April, reflecting the recovery of the rural demand. Meanwhile, the passenger vehicle sales (wholesale dispatches) faced headwinds from the rising vehicle and fuel prices, falling by 3.8% YoY in April. Consumption of petroleum products slowed sequentially by 4% in April amidst high retail oil prices. While we see tentative signs of recovery in consumption indicators, the outlook remains dependent on the labour market conditions. As per the CMIE data, the greater unemployment rate increased from 11.1% in March to 11.8% in April, even though the total jobs increased by ~7mn. However, it is comforting to note that the deterioration in the unemployment rate was primarily due to an increase in labour force participation. As such, the greater labour force participation rate reached its four-month high of 42% compared to 41% in the prior month. Agriculture employment fell, correcting the outsized increase in the previous month, while the industrial and services sectors noted job gains led by the real estate and contact-intensive sectors like retail trade, hospitality, and tourism. Further, the Naukri JobSpeak Index improved to 125% of pre-COVID (CY19) levels in April from 123% in the last month. Going ahead, high economic uncertainty, global developments, elevated inflation, and expected monetary tightening could weigh on the pace of labour market recovery and households' purchasing power.

### Continued pick-up in mobility indicates recovery in demand conditions and overall economic activity




***Source: Google Mobility Reports; Data is till 16th May***

The investment outlook remains mixed. IIP-Capital goods output rose sharply on a sequential basis by 15.5% in March and surpassed its pre-pandemic levels (~112% of a pre-COVID level) for the first time since March 2021, indicating a recovery in investment. The index for infrastructure and construction goods grew by 7.3% YoY and 11.7% MoM. Credit to the infrastructure sector also remained robust and grew by 9.3% YoY in March. Other high-frequency indicators like steel consumption were flat in April (up by 1% YoY but down 6.3% MoM). Non-oil and non-gold & silver imports were down by 5.4% MoM (+31.9% YoY). Going forward, we expect the government's infrastructure push to continue to support investment activity. However, high economic uncertainty and elevated input costs may lead to companies adopting a wait and watch strategy, delaying the broader pick-up in private investment.

On the external front, the merchandise exports noted a robust growth of 30.7% YoY in April, led by petroleum products, electronic goods, and chemicals. However, exports noted a sequential contraction of 9.6% from their record high levels in the prior month. Meanwhile, imports also kept pace and registered a growth of 31% YoY in April, led by energy products imports. With imports growth outpacing the export growth, the trade deficit widened to $20.1 bn in April against $18.3 bn in the prior month. With dark clouds over the global economic outlook, India's exports are likely to face a challenging operating environment compared to last year.

### Assessing India's external vulnerability in terms of external debt and FX buffers

Given the US Fed's policy guidance of a steep rate hiking cycle, elevated commodity prices (including Brent oil), deteriorating global economic outlook, and global risk-off sentiment, the Indian economy is facing a "perfect storm". These external developments eat into fiscal and monetary policy space by raising the subsidy burden and inflation and also raise concerns about India's external vulnerability. We had previously analyzed India's readiness to withstand a repeat of the 2013 taper-tantrum like shock (Please refer to Oct ’21 report). We had concluded that India is not immune to "taper-tantrum" driven global market volatility. However, policy buffers in terms of large FX reserves and improved external accounts position compared to 2013 provide room to manage the policy response in a non-disruptive manner and curtail volatility, unlike during the 2013 taper-tantrum. We also noted that elevated global energy prices and broad commodity prices pose upside risks to domestic inflation, which may force the RBI to reconsider its gradual policy normalization approach. We are witnessing both of these implications in 2022, where the RBI is now on a path of accelerated policy normalization compared to its ultra-dovish stance in Feb '22. On the external front, the current account deficit is projected to widen in FY23 to ~2.9% of GDP, nearly doubling from an estimated 1.5% in FY22. India has also witnessed foreign capital outflows of ~$23 bn in 2022 until May (data till May 17), more than during the taper-tantrum and global financial crisis. Consequently, the Indian currency is under depreciation pressure, with the rupee hitting a record low in May.

**In the following sections, we analyze India's external vulnerability, especially from its external debt obligations perspective vis-à-vis FX buffers. We conclude that the RBI's FX reserves are still adequate to help ward-off external vulnerability risks despite falling from a record high of $642 bn in Oct '21 to $596 bn by early May (data as of May 6). As options of FX reserves accumulation will be limited in FY23 and even FY24, the RBI should employ FX reserves judiciously and complement these with prudent macro-policy adjustments.** We expect the RBI to use its sizeable FX reserves to curtail volatility, balancing its need to manage competitiveness (as peer currencies may still see depreciation pressures) and imported inflation pass-through.

### India's external debt is relatively moderate, with its favourable profile reducing vulnerability to shocks

India's external debt position has seen a gradual improvement over the past decade, reducing its external vulnerability compared to the taper tantrum episode of 2013, when India was pegged among the 'fragile five' economies. In absolute terms, external debt grew from $409 bn in FY13 to $615 bn by Dec' 21, in line with the economy's growing trade and external financing needs. However, as a percentage of GDP, the external debt has come down from 22.4% in FY13 to 20% by Dec' 21, as the current account deficit (CAD) position improved and non-debt foreign investment financed an increasing share of that. The non-government sector accounts for 78.6% of total external debt, driven by non-financial corporations and deposit-taking corporations, while the share of the general government is moderate at 21.4%, primarily reflecting external assistance/loans from multilateral agencies and other countries.

The currency composition shows that the dollar denominated debt continues to account for the dominant share (52% share as of December 2021) of external debt despite falling compared to 59.1% in FY13. Meanwhile, the share of external debt denominated in rupee has gone up sharply from 22.9% in FY13 to 32% by the end of Dec '21 on the back of increasing NR(E)RA (Non-Resident (External) Rupee Account) deposits and FPI debt investments. This reduces the potential demand on FX reserves in the event of major external account events. In terms of tenure, the major share (81.4% as of Dec '21) of India's external debt is long-term, with the share increasing from 76.4% in FY13. Parallelly, the share of short-term debt (on an original maturity basis) in total external debt went down from 23.6% in FY13 to 18.6% by Dec'21. Improvement in tenure-wise composition reduces annual repayment pressures as reflected in a fall in the debt service ratio to 4.9% by Dec '21 compared to 5.9% in FY13 and a high of 8.8% in FY16. Further, most of the short-term debt is trade credit which typically has a high roll-over ratio. Short-term debt on a residual maturity basis (i.e., long-term debt due over the next twelve months plus short-term debt by original maturity) accounts for ~44% of total external debt at the end of December 2021, deteriorating from 42.1% in FY13, as per government data.

### FX reserves adequacy: large buffers provide a strong cushion against external vulnerability

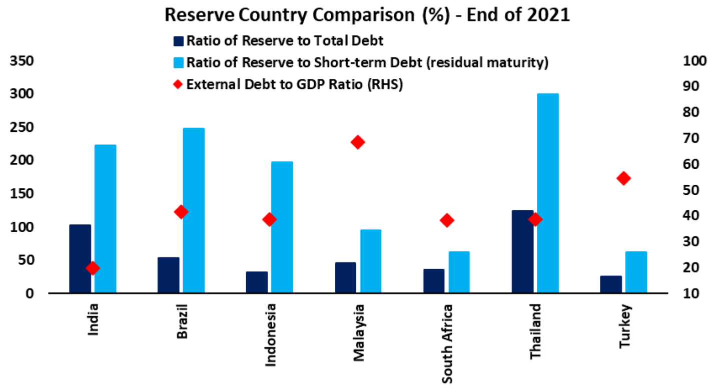
Due to the accretion of FX reserves over the past few years, external vulnerability indicators have shown marked improvement compared to FY13. FX reserves accumulation has resulted from a contained CAD and a rise in net foreign capital inflows. Ultra-accommodative monetary policies in major advanced economies have led to a rise in capital flows into EMs. As major central banks start to reverse these policies, foreign capital outflows from EMs, including India, have stepped up in 2022.

We analyze India's FX reserve adequacy on key metrics typically used and prescribed as per the IMF's analytical framework. These include reserve cover of imports, reserve cover of short-term debt (residual maturity) and IMF's reserve adequacy metric. We also do a peer comparison to see where India stands vis-à-vis major EMs in terms of its external vulnerability in the subsequent sections

**Reserves cover of imports:** As per an IMF study, three months of import cover is considered to be appropriate for countries with flexible exchange rates, given the estimated benefits provided by reserves in reducing both the probability and impact of shocks. RBI's FX reserves provide import cover of 12 months for merchandise imports and 10 months for goods & services import, nearly double that of the levels in FY13.

**Reserves cover of total external debt and short-term external debt**: As shown in the chart below, at the end of Dec '21, RBI's FX reserves stood ~100% of total external debt. India fares better than all countries mentioned in the chart except Thailand for this coverage ratio. For short-term debt (residual maturity), the coverage is ~200%, way above the 100% recommended as per the "Greenspan-Guidotti" measure of reserve adequacy and liquidity buffers against external shocks in EMs. Looking at peers (as shown in the chart), India's position is better than most countries except Brazil and Thailand in terms of FX cover for short-term external debt.

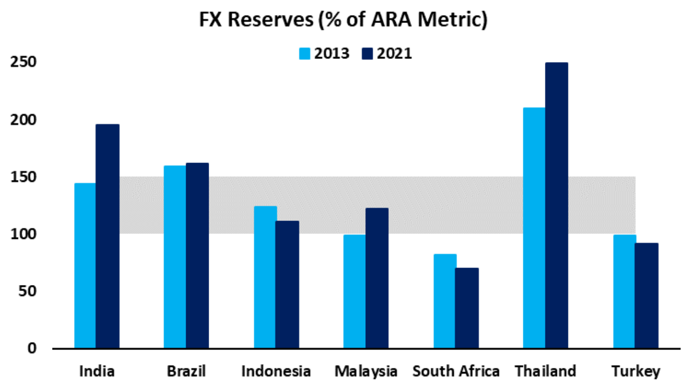
### India's FX reserves cover of external debt obligations stand favourably compared to most peers




***Source: IMF, DEA***

**IMF's reserve adequacy metric:** The IMF's analytical framework uses an assessing reserve adequacy (ARA) metric, which includes indicators encompassing multiple channels of market pressure and a broader set of risks that an EME can potentially face. The ARA metric is a composite value that takes into account the short-term external debt, broad money, export income coverage and other liabilities. According to the IMF, the ratio of reserves to ARA metric value between 100%-150% is considered an adequate level of reserves, as shown in the chart below. India's FX reserves % of ARA metric has improved compared to 2013 and stood above the thresholds suggested by the IMF. It also fares better than peer countries, just behind Thailand.

### India's FX Reserves as % of ARA Metric noted improvement since 2013




***Source: IMF, DEA***

From the above, India's large FX reserves provide strong buffers against external shocks. We note that in addition to official FX reserves, the net forward asset (receivable) of the RBI in the domestic foreign exchange market stood at $65.8 bn as of March 2022. Further, the central bank also renewed the $75 bn currency swap pact with Japan, providing additional buffers. Notwithstanding adequate FX buffers, the RBI should use its reserves judiciously as there is a high level of uncertainty about the pace and extent of major central banks' monetary policy tightening and geopolitical developments. Further, the central bank will also have to be mindful of the loss of competitiveness if peer countries' currencies depreciate more than the rupee.

### With CPI inflation rising to an eight-year high, the RBI embarks on a rate hiking cycle

We noted in our April India Economic Monitor report that the RBI's plan to withdraw liquidity in a gradual manner would face a huge challenge from the building up of inflationary pressures. In April, CPI inflation accelerated to an eight-year high of 7.8% YoY compared with 7.0% YoY in March, remaining above the RBI's tolerance level for the fourth consecutive month. Inflationary pressures are broad-based, with food, fuel, and core inflation seeing a spike in April. Food and beverages price inflation jumped to 8.1% YoY in April compared with 7.5% YoY in March, driven by cereals, milk, fruits, vegetables, spices and prepared meals. The sequential increase in food and beverages prices at 1.4% MoM was much higher than the pre-COVID five-year average of 0.6% MoM for April due to seasonal factors and spillover from the global developments. Fuel inflation escalated as the effect of retail price increase was felt in April. Core inflation also reached an eight-year high at 7% YoY (compared with 6.3% for March), driven by transport and communication, education, clothing and footwear, recreation and amusement, household goods and services, and health. Eight out of the eleven main sub-categories of the CPI basket noted in the table below continued to report inflation higher than their respective pre-COVID averages (FY16-FY20) in April. Deviation from the pre-COVID average was more pronounced in rural areas, with the latest print coming at an eight-year high of 8.4% YoY compared with 4.3% pre-COVID, while for the urban areas, it was an 18-month high of 7.1% YoY in April compared with 4.2% pre-COVID average.

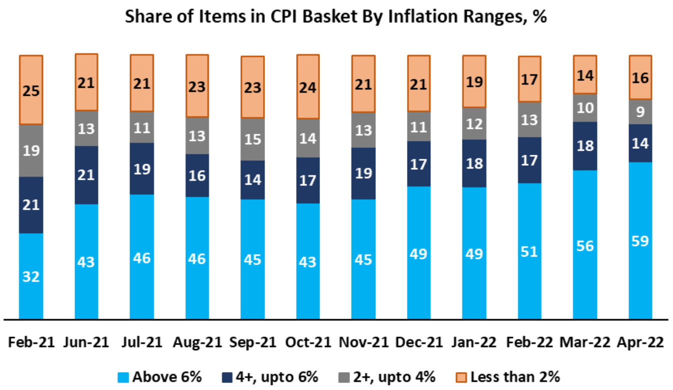
### Inflation spikes for most major sub-categories in April

| CPI Inflation, YoY% | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Sub-groups | Weights | Pre-COVID average* | Nov-21 | Dec-21 | Jan-22 | Feb-22 | Mar-22 | Apr-22 |
| CPI (headline) | 100.0 | 4.2 | 4.9 | 5.7 | 6.0 | 6.1 | 7.0 | 7.8 |
| CPI-Urban | | 4.2 | 5.5 | 5.9 | 5.9 | 5.8 | 6.1 | 7.1 |
| CPI- Rural | | 4.3 | 4.3 | 5.4 | 6.1 | 6.4 | 7.7 | 8.4 |
| Core-CPI | 54.1 | 4.8 | 6.2 | 6.1 | 6.0 | 6.0 | 6.3 | 7.0 |
| Food and beverages | 45.9 | 3.7 | 2.6 | 4.5 | 5.6 | 5.9 | 7.5 | 8.1 |
| Pan, tobacco and intoxicant | 2.4 | 6.7 | 4.1 | 3.2 | 2.5 | 2.4 | 3.0 | 2.7 |
| Clothing & footwear | 6.5 | 4.3 | 7.9 | 8.3 | 8.8 | 8.9 | 9.4 | 9.9 |
| Housing | 10.1 | 5.6 | 3.7 | 3.6 | 3.5 | 3.6 | 3.4 | 3.5 |
| Fuel & light | 6.8 | 4.4 | 13.4 | 11.0 | 9.3 | 8.7 | 7.5 | 10.8 |
| Household goods and servic | 3.8 | 4.5 | 6.4 | 6.8 | 7.1 | 7.2 | 7.7 | 8.0 |
| Health | 5.9 | 5.5 | 7.3 | 7.1 | 6.9 | 6.8 | 7.0 | 7.2 |
| Transport and communicati | 8.6 | 2.8 | 10.0 | 9.7 | 9.3 | 8.1 | 8.0 | 10.9 |
| Recreation and amusement | 1.7 | 4.6 | 7.6 | 7.4 | 7.0 | 6.9 | 7.0 | 7.3 |
| Education, stationery etc. | 4.5 | 5.6 | 3.1 | 3.3 | 3.3 | 3.6 | 3.6 | 4.1 |
| Personal care and effects | 3.9 | 4.8 | 3.2 | 3.7 | 3.5 | 5.5 | 8.7 | 8.6 |

***Source: CMIE, *Average for FY16-FY20***

A deeper analysis of 299 items of the CPI basket revealed that the share of items with inflation above 6% increased from 32% in February 2021 to 59% in April 2022. Meanwhile, the share of items with less than 2% inflation has dropped from 25% to 16% in the same reference period. In May, the central government announced a cut in excise duty on petrol and diesel by Rs 8/litre and Rs 6/litre, respectively, which will have a revenue implication of ~Rs 1 Lakh crore/year (approximately Rs 86,000 crores in FY23). It also announced a cut in customs duties on raw materials for plastic products and steel. These measures should help cool fuel, plastic, and steel prices, but wider high input costs suggest inflationary pressures are likely to continue. Wholesale price inflation rose to 15.1% YoY in April, compared with 14.5% in March, driven by fuel and power, food, and manufactured goods. In April, fuel and power inflation was 38.7%, while manufactured goods and food prices grew by 10.9% and 8.9%, respectively. These developments suggest inflationary pressures are likely to persist in FY23. Based on the change in our oil price assumption and momentum in inflationary pressures, we revise our FY23 CPI inflation projection to 6.3% YoY (with upside risks) from 6% YoY previously.

### The share of items with above 6% inflation rose to 59% in April 2022.




***Source: CMIE***

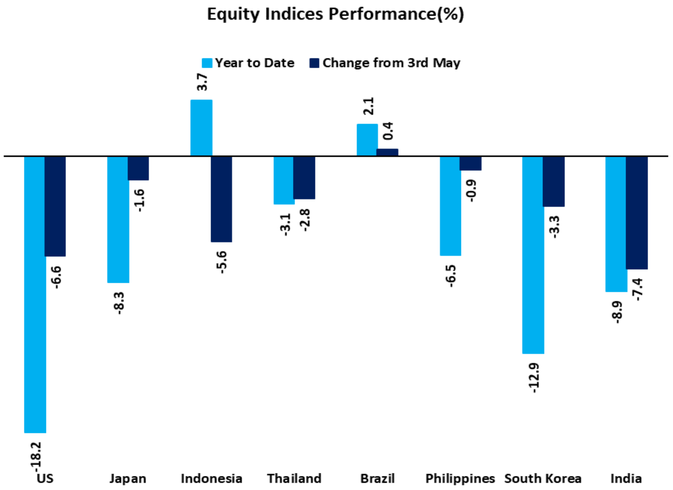
In its April policy meeting, the central bank revised the forward guidance, focusing on withdrawal from ultra-accommodation and prioritizing containing inflation over economic growth revival even as it kept the repo rate unchanged. In a surprise move, the RBI held an off-cycle meeting on May 4 to announce a repo rate hike of 40 basis points (bps) to 4.4%. To continue to withdraw surplus liquidity, the RBI raised the Cash Reserve Ratio (CRR) by 50 bps to 4.5%, effective May 21, 2022. The central bank assessed that the risks to the near-term inflation outlook are rapidly materializing. As per the minutes of the May 4 policy meeting, the RBI governor listed five reasons which made the committee take action in the off-cycle meeting, including 1) an increase in March CPI inflation beyond expectations to 7%, 2) historic high global commodity and food prices in March, with implications for the domestic food price situation, 3) almost all measures of core inflation registered a sharp pick-up in March, well above 6%, 4) the revision in administered electricity tariffs and essential medicines prices posed further risks to inflation over the short-term, and 5) the war in Europe – with its attendant consequences for supply chains, shortages, and prices – is now expected to last much longer than earlier anticipated. Consequently, the worsening outlook of inflation warranted timely action to forestall second-round effects and prevent unanchoring of inflation expectations. The committee felt the need to act through an off-cycle policy meeting without waiting for the June meeting to avoid loss of time and much stronger action in the June MPC. We expect the RBI to revise its FY23 inflation projection of 5.7% YoY upward in the June meeting. In line with our expectation of front loading of rate hikes and the urgency shown by the RBI to tame inflation, we expect the RBI to hike the repo rate by an additional 110 bps in FY23 (with 25-40 bps expected to be announced in the June meeting) after 40 bps already announced in May. We see the terminal repo rate at 6% by Q1-FY24 and expect the RBI to announce further increases in CRR in FY23 to continue to withdraw liquidly.

### Market update

The bond market came under renewed pressure after the RBI's off-cycle meeting. The 10-year G-Sec yield jumped from 7.12% on May 3 to 7.38% on May 4 when the RBI announced a surprise hike in repo rate and rose to a high of 7.47% on May 9. The surplus systemic liquidity has also reduced from 5.6 lakh crores at the end of April to 4.6 lakh crores as of May 19, and it will go down further by Rs 87,000 crores when the announced hike in CRR becomes effective on May 21. The 10 year G-Sec yield has eased in the last few days to ~7.32% by May 19 on reports that the government asked the RBI to cap yields. While the possibility of the RBI announcing some measures (Operation twist/OMOs, easing the held-to-maturity investment norms for banks, etc) to contain the rising yields cannot be ruled out, we believe that such actions are likely to be limited (given the RBI's focus on withdrawal of accommodation) and will at best provide temporary relief. Odds are stacked against the bond market with the government's large borrowing programme, increasing the risk of fiscal slippage in FY23, elevated crude oil prices, and worsening domestic inflation outlook pushing the RBI to front-load rate hikes. The government has already announced an additional fiscal spending of Rs 1.1 lakh crore for fertilizer, Rs 6,100 crore for LPG and Rs 80,000 crore for food subsidies compared to the budgeted amounts. The recently announced petrol and diesel exercise duties cut will impact FY23 revenues by ~Rs 86,000 crores in FY23. Moreover, the risk of missing the divestment target has gone up with the LIC IPO size reduced to ~Rs 21,000 crores from the previous ~Rs 65,000 crores, and BPCL privatization put on hold. The possibility of higher than budgeted tax revenues in FY23 provides some flexibility, but it may not be sufficient to cover extra subsidy outlays, raising the risk of missing the budget deficit target. Accordingly, we see pressures to continue on the bond market, with the recent moderation in 10-year G-Sec yield unlikely to sustain.

Indian equity markets started the FY23 with a sharp correction, as the benchmark indices - NIFTY and SENSEX fell in April by 2.1% and 2.6%, respectively, drawing negative cues from the global markets. After the RBI's off-cycle rate hike announcement, the markets came under added pressure, with NIFTY and SENSEX falling further by 7.6% and 7.5%, respectively, till May 19. While the capital flight by the foreign investors continues to intensify in response to the heightened uncertainty in the global financial markets, the Indian equity market continued to get support from domestic investors. As such, the FIIs sold Indian equities worth $2.7 bn in April and $3.5 bn in May (data till May 17), while the domestic institutional investors ploughed investments worth $2.9 bn in April in the equities markets. Meanwhile, the valuation in the equity market eased, with the PE ratio of NIFTY declining from 22.9 in March to 22 in April and further to 19.5 in May (data as of May 19). Markets are likely to remain under pressure given global risk aversion, synchronized monetary policy tightening by major central banks, and high domestic inflation and growth concerns weighing on corporate earnings outlook.

**India's equity markets correction intensified in May**




***Source: CMIE; Note: Equity indices data is till 19th May***

The Indian currency noted a mild appreciation of 0.1% after two consecutive months of depreciation to trade at 76.16 on average in April against 76.2 in the previous month, supported by the RBI's intervention. But FPI outflows to the tune of $3.2 bn (both equity and debt market), strengthening of the dollar against major currencies, and elevated global commodity prices continued to weigh on the domestic currency. As such, the Indian currency hit a record low in May and depreciated by 1.3% as it averaged 77.12 till May 19. In response to bouts of rupee depreciation, the RBI continues to intervene in the foreign exchange market to prevent any outsized movements. As such, the RBI's FX reserves have declined from $634 bn in Dec '21 to $596 bn as of May 6, 2022. Going ahead, the rupee is likely to remain under pressure given a strong dollar, widening of current account deficit, and foreign capital outflows, with the possibility of the rupee crossing the 78 threshold in the coming months. However, the RBI is expected to intervene to defend the rupee in the face of high volatility.

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