8 June 2022

The RBI hikes the repo rate by 50bps: front-loaded rate hikes to continue to tame inflationary pressures.

- The RBI's Monetary Policy Committee (MPC) raised the policy repo rate by 50 basis points (bps) to 4.9% in today's meeting, bringing the cumulative rate increase in FY23 so far to 90bps.
- The policy stance was reworded by dropping ***"to remain accommodative"*** from the forward guidance while keeping to ***"focus on withdrawal of accommodation"*** to ensure that inflation remains within the target going forward while supporting growth.
- The governor noted that liquidity withdrawal would be calibrated and measured in the future, and the RBI will ensure that adequate liquidity remains available to meet the economy's credit requirements.
- The RBI governor also stated that the central bank would remain focused on the orderly completion of the government's borrowing program even though he did not announce any new measures in this regard. Nevertheless, the market seems to have taken some comfort from that statement itself, as seen by a slight moderation in the 10-year G-Sec yield today.
- The RBI assessed that economic activity is gaining traction. It retained its FY23 economic growth projection at 7.2% YoY, with risks broadly balanced.
- The RBI noted that inflationary pressures have intensified and become broad-based as the upside risks have materialized earlier than anticipated.
- Inflationary pressures remain largely driven by adverse supply shocks emanating from the Russia-Ukraine and related developments.
- Considering these factors, the RBI raised its FY23 inflation projection sharply from 5.7% YoY to 6.7% YoY, with quarterly projections showing inflation remaining above the 6% threshold in the first three-quarters of FY23 before easing to 5.8% YoY by Q4-FY23.
- In line with our expectation of front loading of rate hikes, we expect the RBI to continue with rate hikes in the upcoming meetings. With the significant upward revision in inflation projection by the RBI, the risk of the terminal rate being above 6% has gone up.

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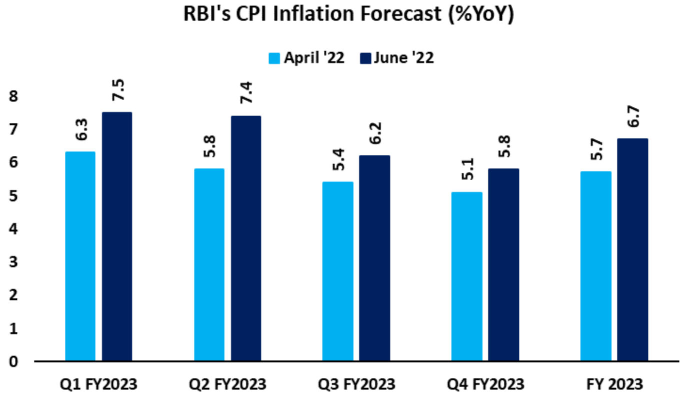
The RBI hikes the policy rate by 50bps; to focus on the withdrawal of accommodation

The Monetary Policy Committee (MPC) voted unanimously to increase the policy repo rate by 50bps to 4.90%. Consequently, the Standing Deposit Facility Rate stands adjusted to 4.65% and the Marginal Standing Facility Rate and Bank Rate to 5.15%. This comes on top of a 40bps rate hike announced in the RBI's off-cycle meeting in early May. Given the intensification of inflationary pressures, the RBI stated a need for calibrated monetary policy action to keep inflation expectations anchored and restrain the broadening of price pressures. The RBI governor also noted that the MPC decided unanimously to "focus on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth". This is a shift from the last meeting when it had decided "to remain accommodative while focusing on withdrawal of accommodation". The governor noted that the policy rate is still below the pre-pandemic level, and the liquidity is above the pre-pandemic level, implying accommodative conditions. In line with our expectation of front loading of rate hikes, we expect the RBI to continue with rate hikes in the upcoming meetings. With the significant upward revision in inflation projection by the RBI, the risk of the terminal rate being above 6% has gone up. A sharp upward revision in the inflation projection and change in the stance suggests RBI's hawkish leaning.

The inflation projection revised sharply up by 100bps to 6.7% for FY23

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. 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. 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. These developments suggest inflationary pressures are likely to persist in FY23, underlying our inflation projection of 6.3% (with upside risks). Global crude oil prices have risen to ~$120/bbl in recent weeks, with demand recovered with the easing of lockdown in China, and the supply outlook worsened as the EU nations moved ahead to cut reliance on Russia's energy supplies. This, coupled with the risk of rising food prices, continued pass-through of input costs, and acceleration in services inflation, poses upside risks to our inflation projection.

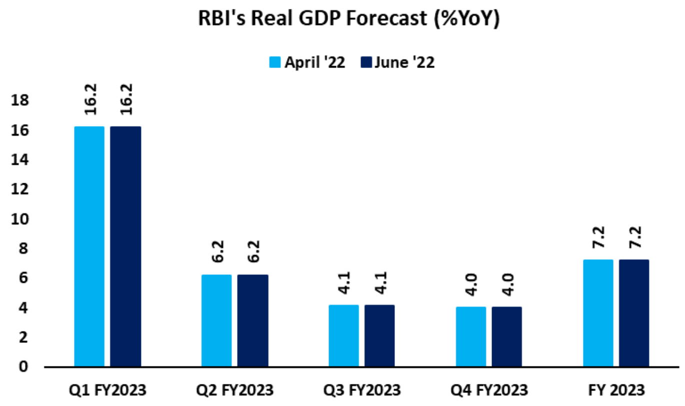
RBI projects inflation to remain above 6% in the first three-quarters of FY23



Source: RBI

Today, the RBI raised its FY23 inflation projection sharply from 5.7% to 6.7% (crude oil price assumed at $105/bbl, up from $100/bbl earlier). Its quarterly projections show that RBI expects the inflation to average 7.45% in the first half of FY23, remaining above the 6% threshold in the first three-quarters of FY23 before easing to 5.8% by Q4-FY23. It attributed ~75% of the increase in inflation projections to the food group and did not take into account the impact of monetary policy actions announced today. The MPC noted that inflationary pressures have intensified and have become broad-based as the upside risks have materialized earlier than anticipated. Inflationary pressures remain largely driven by adverse supply shocks emanating from the Russia-Ukraine and related developments. There are also growing signs of a higher pass-through of input costs to selling prices with the recovery in demand conditions. It also noted several positive developments that may help moderate inflationary pressures, including petrol and diesel excise duties cut, supply-side measures taken by the government, expectations of a normal southwest monsoon, the palm oil export ban lifted by Indonesia, and easing of the global industrial metal prices. RBI's quick survey of urban households undertaken after the excise duty cuts on petrol and diesel on May 21, 2022, also showed a significant moderation in their inflation expectations – a decline of 190bps in three months ahead expectations and 90bps in one year ahead expectations. Still, there is considerable uncertainty surrounding the inflation trajectory due to global growth risks and geopolitical tensions. Upside risks to inflation persist emanating from several channels, including elevated commodity prices, revisions in electricity tariffs, high domestic poultry and animal feed costs, continuing supply chain bottlenecks, rising pass-through of input costs to selling prices in the manufacturing and services sectors, and the elevated international crude oil prices. Considering these factors, the MPC recognized that sustained high inflation could unhinge inflation expectations and trigger second-round effects. It, therefore, judged that further monetary policy measures are necessary to anchor the inflation expectations.

No change in RBI's economic growth projection of 7.2% YoY for FY23; risks seen as broadly balanced



Source: RBI

Regarding the economic outlook, the MPC assessed that the Indian economy has remained resilient, despite several factors, including the Ukraine-Russia war, supply-chain issues, elevated global commodity prices, and synchronized monetary tightening by major central banks. The economic recovery has gained momentum with high-frequency data, including manufacturing and services PMIs for May, showing a pick-up in activity. Exports' robust performance continued in May. The forecast of a normal southwest monsoon should boost agricultural output and, in turn, support rural consumption. Meanwhile, pick-up in contact-intensive services coupled with the contained COVID situation should aid urban demand. The RBI expects the investment activity to strengthen, driven by rising capacity utilization, the government's CAPEX push and improved corporate balance sheets. However, the central bank noted that ongoing spillovers from external developments, including prolonged geopolitical tensions, elevated commodity prices, continued supply bottlenecks, and tightening global financial conditions, continue to weigh on the growth outlook. Considering these factors, the RBI retained its FY23 real GDP growth projection at 7.2%, with risks broadly balanced, which is slightly above our projection of 7%.

Liquidity withdrawal to be calibrated and measured in future

On the liquidity management front, the RBI reiterated its approach of gradual removal of excess liquidity, spread over a multi-year time frame. With the RBI introducing the Standing Deposit Facility in its April meeting and the 50bps CRR hike in May, the liquidity surplus has moderated recently. The systemic liquidity has declined from Rs 7.5 lakh crore in the first week of April to ~Rs 3.5 lakh crores and stood at ~2% of the NDTL as of June 7. As a result, the RBI did not resort to further CRR hike in today's meeting. The governor noted that liquidity withdrawal would be calibrated and measured in the future, and the RBI will ensure that adequate liquidity remains available to meet the economy's credit requirements. The RBI governor also stated that the central bank would remain focused on the orderly completion of the government's borrowing program but did not provide explicit guidance. Nevertheless, the market found some comfort in the reassurance itself as the yields moderated across the tenors at the time of the writing. The 10-year yield fell by ~3 bps from yesterday's close of 7.52% to 7.49% today.

The RBI also announced developmental and regulatory policy measures listed below related to financial markets and payment and settlement systems.

Individual Housing Loans by Cooperative Banks – Enhancement in Limits

- The RBI decided to increase the existing limits on individual housing loans by cooperative banks. Accordingly, the limits for Tier I /Tier II Urban Cooperative Banks (UCBs) shall stand revised from Rs. 30 lakh/ Rs. 70 lakh to Rs. 60 lakh/ Rs. 140 lakh, respectively. As regards Rural Cooperative Banks (RCBs), the limits shall increase from Rs. 20 lakh to Rs. 50 lakh for RCBs with an assessed net worth less than Rs. 100 crores; and from Rs. 30 lakh to Rs. 75 lakh for other RCBs.

Permitting Rural Co-operative Banks (RCBs) to Lend to Commercial Real Estate - Residential Housing Sector

- The RBI has decided to allow State Cooperative Banks (StCBs) and District Central Cooperative Banks (DCCBs) to extend finance to Commercial Real Estate – Residential Housing (CRE-RH) within the existing aggregate housing finance limit of 5 % of their total assets.

Permitting Urban Cooperative Banks (UCBs) to Offer Doorstep Banking

- To provide the convenience of banking services to the customers at their doorstep, the RBI has decided to permit UCBs to extend doorstep banking services to their customers on par with the scheduled commercial banks.

Margin Requirements for Non-centrally Cleared Derivatives (NCCDs)

- In line with G20 reforms, the RBI is putting in place margin requirements for non-centrally cleared OTC derivatives. In the first phase, the Directions on the Exchange of Variation Margin (VM) for NCCDs were issued on June 1, 2022. In the second phase, it is now proposed to mandate the requirements for the exchange of Initial Margin (IM) for such derivatives. To garner feedback from stakeholders on these requirements, Draft Directions on Exchange of Initial Margin for NCCDs will be issued shortly.

Measures pertaining to payment and settlement systems

- The RBI has enhanced the limit on recurring e-payments from Rs 5,000 to Rs. 15,000 to further facilitate payments of larger value like subscriptions, insurance premia, education fees, etc.
- In order to deepen the reach and usage of the UPI platforms, the RBI has proposed the linking of credit cards to UPI. To begin with, the Rupay credit cards will be enabled with this facility.
- The Payments Infrastructure Development Fund (PIDF) Scheme was operationalized by the RBI in January 2021 to incentivize the deployment of payment acceptance infrastructure such as physical Point of Sale (PoS), mPoS (mobile PoS), Quick Response (QR) codes, in Tier 3 to 6 centres and the North-eastern States. With an intent to further accelerate the deployment of payment acceptance infrastructure in these geographies, the RBI has proposed modifications to the PIDF scheme by increasing the subsidy amount, simplifying the subsidy claim process, etc.

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