August 5, 2022

The RBI takes the policy repo rate above the pre-pandemic level with a second successive 50 bps rate hike

- The RBI's Monetary Policy Committee (MPC) continued to remain hawkish as it voted unanimously to increase the policy repo rate by 50 bps to 5.40% in today's meeting.
- Consequently, the Standing Deposit Facility Rate stands adjusted to 5.15% and the Marginal Standing Facility Rate and Bank Rate to 5.65%. The Cash Reserve Ratio was left unchanged at 4.5%.
- With a cumulative repo rate hike of 140 bps in FY23 so far, the policy repo rate is now above the pre-pandemic level, in line with our expectations of front-loading of rate hikes.
- Despite significant moderation in the system's surplus liquidity, the MPC maintained its stance of *"focus on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth"*.
- Given the elevated level of inflation and resilience in domestic economic activity, the MPC took the view that further calibrated monetary policy action was needed to contain inflationary pressures. Pressures on the currency have also likely played a role in the RBI's policy decision today.
- The RBI assessed that economic recovery has remained resilient despite the various external headwinds, providing it with the flexibility to act on inflation. It retained its FY23 real GDP growth projection at 7.2% YoY.
- The RBI noted some moderation in the CPI inflation but retained its FY23 inflation forecast at 6.7% YoY and projected it to ease to 5.0% YoY by Q1 FY24.
- On liquidity management, the RBI stated that it would remain vigilant and conduct two-way fine-tuning operations as and when warranted.
- We continue to believe that the terminal rate in the current policy tightening cycle will be around 6%, which given RBI's inflation projection of 5.0% in Q1 FY24, would attain a positive real interest rate.

Pramod Chowdhary
Chief Economist
pramod.chowdhary@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

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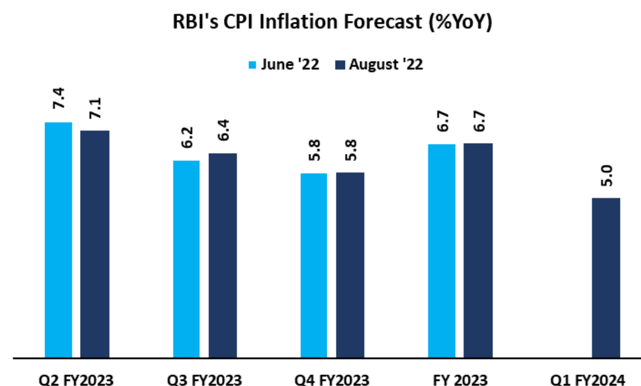
The RBI hikes the policy rate by 50 bps; to continue its focus on the withdrawal of accommodation

The RBI's Monetary Policy Committee (MPC) continued to remain hawkish as it voted unanimously to increase the policy repo rate by 50 bps to 5.40% in today's meeting. Consequently, the Standing Deposit Facility (SDF) Rate stands adjusted to 5.15% and the Marginal Standing Facility (MSF) Rate and Bank Rate to 5.65%. With a cumulative repo rate hike of 140 bps in FY23 so far, the policy rate is now above the pre-pandemic level (of 5.15%), the highest rate since August 2019. This is in line with our expectations of front-loading policy rate hikes to contain inflationary pressures. We continue to believe that the terminal rate in the current policy tightening cycle will be around 6%, which given RBI's inflation projection of 5.8% in Q4 FY23 and 5% in Q1 FY24, would attain a positive real interest rate.

Given the elevated level of inflation and resilience in domestic economic activity, the MPC took the view that further calibrated monetary policy action is needed to contain inflationary pressures. As inflation is projected to remain above the RBI's upper threshold in Q2 and Q3 FY23, the MPC stressed that sustained high inflation could destabilize inflation expectations and trigger the second-round effects and therefore judged that further calibrated withdrawal of monetary accommodation was warranted to keep inflation expectation anchored. Pressures on the currency have also likely played a role in the RBI's policy decision today. The RBI governor today broadly held on to the previous policy remarks of inflationary pressures being broad-based in an adverse global environment and additionally flagged the risk of imported inflation because of currency depreciation. Despite significant moderation in the system's surplus liquidity, the MPC kept its stance unchanged "to focus on withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth". However, the decision was not unanimous, with one member dissenting (Prof. Jayanth Varma) and expressing reservations on this part of the resolution. As some market participants were expecting a 35-bps rate hike and/or a less hawkish policy statement, bonds markets sold off post the policy meeting. The yield on 10-year G-Sec rose by ~15 bps to 7.30% today compared to yesterday's close of 7.16%.

The RBI governor noted the recent moderation in the headline inflation, though it remained elevated. In June, the headline inflation moderated to 7.0% YoY compared to an eight-year high of 7.8% YoY in April. In Q1 FY23, headline inflation averaged 7.3%, slightly lower than the RBI's estimate of 7.5%. The softening of the inflation print was primarily driven by the base effect and on account of efforts taken by the government, including import duty cuts on edible oil, moderate hikes in MSP for Kharif crops and fuel excise cuts.

RBI retained its headline CPI inflation projection for FY23 at 6.7%, with marginal changes in quarterly forecasts



Source: RBI. Note: June '22 and August '22 refer to projections given by the RBI in its June and August 2022 MPC updates, respectively.

The RBI governor noted that retail inflation has peaked and is expected to moderate going into Q4FY23 and Q1FY24. The easing of inflationary pressures will be supported by the softening of the global commodity prices because of some restoration of supply chains. As per the World Bank data, the global food price index has contracted by 12.8% in July'22 from its peak in May'22, while the base metal price index (ex. iron ore) has moderated by 29.2% from its highs of March'22. Domestically, the food prices are also expected to moderate as the southwest monsoon has begun to pick up recently after a slow start. On an all-India level, cumulative rainfall up to August 2 was ~7% above normal levels leading to improved Kharif sowing. Accordingly, the percentage change in the actual area sown has improved from almost 24% YoY deficit in the last week of June to just 2.2% YoY deficit as of July 29. The RBI, however, also noted that there are upside risks to inflation associated with unseasonal and excessive rainfall, which could boost vegetable prices, uneven rainfall distribution, the greater transmission of input cost pressures to selling prices across manufacturing and services sectors, and high living costs, which would push up wages and prices further. Keeping all these factors in consideration, the RBI retained its CPI inflation forecast at 6.7% YoY for FY23, with Q2 and Q3 FY23 projections at 7.1% YoY and 6.4% YoY compared to 7.4% YoY and 6.2% YoY earlier while the Q4 FY23 projection is retained at 5.8% YoY. Additionally, the RBI projected the Q1 FY24 inflation at 5.0% YoY.

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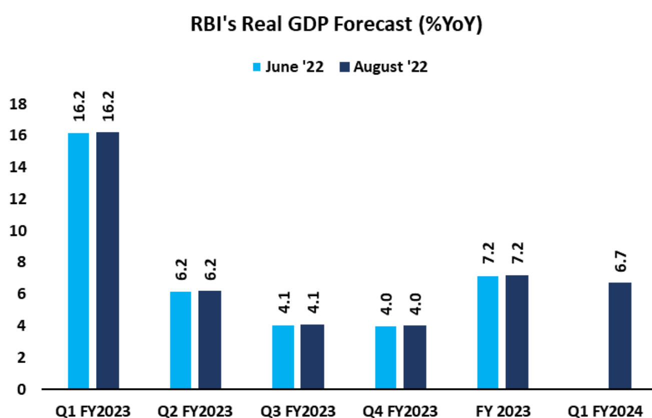
RBI retained its growth projection for FY23 at 7.2%



Source: RBI. Note: June '22 and August '22 refer to projections given by the RBI in its June and August 2022 MPC updates, respectively.

The MPC assessed that Indian economic recovery has remained resilient despite the various external headwinds. As per the RBI governor, a resilient economy has provided the RBI flexibility to act on inflation. High-frequency data show the continuation of the economic recovery, with Manufacturing PMI increasing from 53.9 in June to 56.4 in July and Services PMI, although moderating from its highs of 59.2 in June to 55.5 in July, has managed to stay in the expansionary zone for the twelfth consecutive month. Other indicators, including railway freight traffic, port freight traffic, and domestic air passenger, noted robust growth in June and July, reflecting a catch-up in the services sector. On the demand side, while the urban demand is strengthening, the rural demand is gradually catching up, as per RBI. The outlook for rural demand remains positive with a pick-up in southwest monsoon and a consequent pick-up in Kharif sowing. Further, the government continues to focus on CAPEX spending, which is expected to crowd in private investment through the multiplier effect. Several indicators are already indicating tentative signs of revival in investment, including recovery in cement production, new projects announced by the private sector, banks' credit, and capacity utilization (now above its long-term average as per the RBI's industrial outlook survey). On the other hand, the export growth has lost some momentum as the global growth shows signs of slowing down. Considering all these factors, the RBI retained its growth forecast for FY23 at 7.2% YoY (with no changes in quarterly projections) and projected the Q1 FY24 growth at 6.7% YoY, as the global headwinds arising out of recessionary concerns and tightening global financial conditions may counter the favourable impulses coming from the optimistic prospects for agriculture, potential pick up in investment activity, and the government's increased CAPEX spending in FY23.

RBI to conduct two-way fine-tuning operations depending on evolving liquidity conditions

The liquidity conditions have tightened since the last policy announcement in June due to multiple reasons, including GST outflows and large intervention of the RBI in the forex markets to defend the rupee. Accordingly, the liquidity surplus in the system dropped to below Rs 1 lakh crores in the week ending July 28 from above Rs 3.5 lakh crores at the beginning of June. Consequently, the RBI intervened to infuse short-term liquidity in the market by conducting a three-day variable rate repo auction for Rs 50,000 crore on July 26, 2022. With further maturity of 14-day VRRR (~Rs 1.83 lakh crores on July 29) and month-end spending by the government, the liquidity surplus increased to ~Rs 2 lakh crores as of August 4. Tighter liquidity conditions led to the weighted average overnight call money rate moving above the repo rate to 5.09% briefly before it moderated to 4.59% as of August 3 and increased further to 5.04% today. With the surplus liquidity conditions already normalizing, the RBI did not resort to any of the measures to curtail it further. Having said that, the RBI governor noted that RBI would remain vigilant on the liquidity front and conduct two-way fine-tuning operations as and when warranted. This will be managed using the variable rate repo operations and variable rate reverse repo operations of different tenors.

On the currency management front, the RBI noted that the recent depreciation of the Indian Rupee is largely on account of the strengthening of the US dollar. In order to support the domestic currency, the RBI has been intervening in the forex market, as reflected in the decline of its forex reserves (the RBI's forex reserves have declined by over $62 billion from ~$634 bn in December 2021 to ~$572 bn in the week ending July 22, 2022). It views the expected FY23 current deficit as manageable, despite widening sharply from last year. Going ahead, the RBI is committed to remaining watchful and focused on maintaining the stability of the Indian Rupee.

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

Master direction on Managing Risks and Code of Conduct in Outsourcing of Financial Services

- With a view to update and harmonize the extant guidelines, adopt and incorporate global best practices and also enable regulated entities (REs) to have all current instructions on outsourcing of financial services in one place for reference, the RBI proposes to issue a draft Reserve Bank of India (Managing Risks and Code of Conduct in Outsourcing of Financial Services) Directions, 2022, for public comments shortly. The scope of these Directions has been expanded to

include Regional Rural Banks (RRBs), Local Area Banks (LABs), All India Financial Institutions, Credit Information Companies, and non-scheduled Payments Banks.

Inclusion of Credit Information Companies (CICs) under the Reserve Bank - Integrated Ombudsman Scheme (RB-IOS) 2021 and extending the Internal Ombudsman (IO) mechanism

- In order to make the RB-IOS more broad-based, the RBI decided to include Credit Information Companies (CICs) under the RB-IOS framework. Further, to strengthen the internal grievance redress of the CICs and make it more efficient, it has also been decided to bring the CICs under the Internal Ombudsman (IO) framework.

Regulatory Measures - Standalone Primary Dealers (SPDs)

- The RBI decided to enable SPDs to offer all foreign exchange market-making facilities as currently permitted to Category-I Authorised Dealers, subject to prudential guidelines. This measure will provide customers with a wider set of market makers to manage their foreign currency risk and will also increase the breadth of the forex market.
- SPDs will be permitted to undertake transactions in the offshore Rupee Overnight Indexed Swap market with non-residents and other market makers. This measure will supplement a similar measure announced in February'22 for the banks. These measures are expected to remove the segmentation between onshore and offshore OIS markets and improve price discovery.

Committee on MIBOR benchmark

- In view of the recent international efforts to develop alternative benchmark rates, the RBI will set up a committee to undertake an in-depth examination of the issues, including the need for transition to an alternative benchmark for the Mumbai Interbank Outright Rate (MIBOR), and suggest the way forward.

Measures pertaining to payment and settlement systems

- The RBI decided to enable Bharat Bill Payment System (BBPS) to accept cross-border inward bill payments. This will enable Non-Resident Indians (NRIs) to undertake bill payments for utility, education and other such payments on behalf of their families in India.

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