4 May 2022

The RBI hikes policy rate in an off-cycle policy meeting

- In a surprise move, the RBI governor announced a repo rate hike of 40 basis points (bps) to 4.4% in an unscheduled policy statement today.
- Consequently, the standing deposit facility (SDF) rate stands adjusted to 4.15%; and the marginal standing facility (MSF) rate and the bank rate to 4.65%.
- Counterintuitively, the RBI decided to keep the policy stance as *"accommodative while focusing on withdrawal of accommodation"* even as it started on a rate hike path.
- To continue to withdraw surplus liquidity, the RBI raised the Cash Reserve Ratio (CRR) by 50 bps to 4.5%, effective May 21, 2022.
- As per the RBI, the current liquidity in the banking system stood at over Rs 7 lakh crore in April. The increase in CRR is expected to withdraw liquidity of around Rs 87,000 crores.
- Today's statement was hawkish with a clear focus on containing upside risks to inflation.
- The central bank assessed that the risks to the near-term inflation outlook are rapidly materializing, and it expects inflation to rule at elevated levels, warranting steps to anchor inflation expectations and contain second-round effects.
- The governor also noted that even as economic activity gains traction, growth continues to face headwinds from global spill overs.
- The central bank believes that the Indian economy appears capable of weathering the deterioration in geopolitical conditions, though it is prudent to continuously monitor the balance of risks.
- The RBI's growth and inflation projections for FY23 remained at 7.2% YoY and 5.7% YoY, respectively, as no revision was announced today. These could see some revision in the June policy meeting.
- The Governor reiterated that the RBI would ensure adequate liquidity in the system to meet the productive requirements of the economy while focusing on a careful and calibrated withdrawal of pandemic-related extraordinary accommodation.
- We expect the RBI to hike the policy rate in the June meeting by 25-40bps in line with our expectation of front loading of rate hikes.

Pramod Chowdhary
Chief Economist
pramod.chowdhary@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@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.

The RBI embarks on a policy tightening cycle

In a surprise move, the RBI governor announced a repo rate hike of 40bps to 4.4% in an unscheduled policy statement today. The RBI's surprise move came just ahead of the US Fed meeting later today which is expected to announce a further rate hike (25 bps was announced in the last meeting). The Monetary Policy Committee (MPC) decided to hold an off-cycle meeting to reassess the evolving inflation-growth dynamics and the impact of the developments after the MPC's April meeting. Based on its assessment of the macroeconomic situation and the outlook, the MPC voted unanimously to increase the policy repo rate by 40 bps to 4.40%, with immediate effect. Consequently, the standing deposit facility (SDF) rate stands adjusted to 4.15%; and the marginal standing facility (MSF) rate and the bank rate to 4.65%. 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 current liquidity in the banking system stood at over Rs 7 lakh crores in April. The increase in CRR is expected to withdraw liquidity to the tune of Rs 87,000 crores. Counterintuitively, the MPC decided to keep its policy stance as "*accommodative while focusing on withdrawal of accommodation"* to ensure that inflation remains within the target going forward while supporting growth. The Governor reiterated that the RBI would ensure adequate liquidity in the system to meet the productive requirements of the economy while focusing on a careful and calibrated withdrawal of the pandemic-related extraordinary accommodation, keeping in mind inflation-growth dynamics. After the RBI's announcement today, the 10-year G-Sec yield rose to 7.38% from the previous close of 7.12%.

RBI focusing on containing upside risks to inflation

The Governor's statement was hawkish today with a clear focus on containing upside risks to inflation. In its April meeting, the RBI had revised the forward guidance indicating a focus on withdrawal from ultra-accommodation and a shift from prioritizing economic growth to focusing on containing inflationary pressures. Today, the RBI governor noted significant upside risks to the inflation trajectory set out in the April statement of the MPC, including elevated geopolitical tensions, high global commodity prices, and supply chain disruptions. He stated that *"there is the collateral risk that if inflation remains elevated at these levels for too long, it can de-anchor inflation expectations which, in turn, can become self-fulfilling and detrimental to growth and financial stability*". The MPC assessed that the risks to the near-term inflation outlook are rapidly materializing, and it expects inflation to rule at elevated levels. It judged that the inflation outlook warrants an appropriate and timely response through resolute and calibrated steps to ensure that the second-round effects of supply-side shocks on the economy are contained, and long-term inflation expectations are kept anchored.

We had 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 March, India's CPI inflation accelerated to a 17-month high of 6.95% YoY, led by food prices and core inflation, remaining above the RBI's upper threshold for a third straight month. Among the nine sub-groups noted in the table below, all except the housing and pan/tobacco categories reported inflation higher than their respective pre-COVID averages. There are also signs that the inflation pressures are becoming broad-based. Looking closely at 299 items within the CPI basket, the share of items with inflation above 6% has gone up to 56% by Mar '22 from 45% in Sep '21 and 32% in Feb '21. Considering a higher than previously anticipated momentum in prices, we project the FY23 inflation of ~6.0% YoY (with upside risks), higher than the RBI's projection of 5.7% YoY. Given high uncertainty, the RBI is likely to continue to assess incoming data for the next policy actions. We continue to see the risk that if inflation does not materially ease after the expected peak in Q1-FY23, the RBI will be forced to tighten monetary policy even more than presently anticipated.

Inflation for most major sub-groups running above pre-COVID averages

CPI Inflation, YoY%								
Sub-groups	Weights	Pre-COVID average*	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22
CPI (headline)	100.0	4.24	4.48	4.91	5.66	6.01	6.07	6.95
CPI-Urban		4.20	5.04	5.54	5.90	5.91	5.75	6.12
CPI- Rural		4.28	4.07	4.29	5.36	6.12	6.38	7.66
Core-CPI	54.1	4.75	6.24	6.21	6.12	6.01	6.02	6.33
Food and beverages	45.9	3.69	1.82	2.60	4.47	5.58	5.93	7.47
Pan, tobacco and intoxicants	2.4	6.68	4.27	4.05	3.16	2.45	2.39	2.98
Clothing & footwear	6.5	4.25	7.53	7.94	8.30	8.78	8.86	9.40
Housing	10.1	5.57	3.54	3.66	3.61	3.52	3.57	3.38
Fuel & light	6.8	4.37	14.35	13.35	10.95	9.32	8.73	7.52
Miscellaneous	28.3	4.44	6.83	6.75	6.65	6.55	6.58	7.02

Source: CMIE, Pre-COVID average is for FY16-FY20 period

On the economic outlook, the RBI did not provide any revision to its April meeting forecast. Accordingly, the RBI's growth and inflation projections for FY23 remain at 7.2% YoY and 5.7% YoY, respectively. These could see some revision in the June policy meeting. The MPC noted that domestic economic activity is progressing broadly on the lines anticipated in April. Contact-intensive services are benefitting from pent-up demand, and investment activity is showing signs of gaining traction. Export growth has remained buoyant, and private consumption is regaining traction. The outlook for the agriculture sector remains positive, supported by a normal monsoon projection.

However, the Governor highlighted that even as economic activity gains traction, growth continues to face headwinds from global spill overs, including protracted geopolitical tensions, elevated commodity prices, COVID-19 related lockdowns in some major economies (China), slowing external demand, and tightening global financial conditions on the back of monetary policy normalization by major central banks. The MPC assessed these risks to be evolving in line with the April 2022 statement. The central bank noted that the Indian economy appears capable of weathering the deterioration in geopolitical conditions, though it is prudent to continuously monitor the balance of risks. Large FX reserves provide the central bank with significant policy flexibility to respond to external shocks.

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