

## Monetary policy | **First cut**

# Steady with tightening

August 5, 2022

### **A hat-trick of hikes after, RBI cautious of inflation and external risks**

The Reserve Bank of India's (RBI) Monetary Policy Committee (MPC) raised the policy rates by 50 basis points (bps) in today's meeting, bringing the repo rate to 5.40%, 25 bps above the pre-pandemic level of 5.15% in February 2020. This was the second consecutive hike of 50 bps, and the third hike of this fiscal. The tightening was triggered by high inflation, synchronised monetary policy tightening globally, and volatile global financial conditions.

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*The frontloading of the repo rate hike was needed as inflation, despite some softening, is still way above the upper tolerance limit. It also partly addresses the spillover risks from sharper rate hikes by the US Federal Reserve (Fed) and other major central banks. In this backdrop, we expect the RBI to raise the rate by another 25 bps in its September monetary policy meeting. The future pace of hikes will depend on incoming data.*

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### **Highlights of the August MPC meeting**

- The MPC voted unanimously to raise policy rates by 50 bps, taking the repo rate to 5.40%, the standing deposit facility (SDF) to 5.15%, and marginal standing facility (MSF) to 5.65%
  - The monetary policy stance was maintained at 'withdrawal of accommodation' with a 5-1 majority
  - The MPC retained forecast for Consumer Price Index-based (CPI) inflation to 6.7% for fiscal 2023, as in the previous policy meeting, with risks evenly balanced
  - Projection for gross domestic product (GDP) growth was retained at 7.2% for this fiscal, with risks broadly balanced
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### **Why the aggressive stance?**

- **Elevated inflation:** Being an inflation-targeting central bank, the RBI remains concerned of headline inflation staying above target for the past two quarters. Even as CPI inflation came off its peak of 7.8% in April to 7.0% in June, it was a full percentage point above the RBI's upper tolerance limit. The MPC expects CPI inflation to remain above 6% in the next two quarters as well. It projects a gradual moderation from 7.3% in the first quarter (Q1) to 7.1% in Q2, 6.4% in Q3 and 5.8% in Q4 of fiscal 2023, reaching 5.0% in Q1 next year. Inflation is, therefore, expected to print higher than the RBI's medium-term target of 4% even in Q1 of fiscal 2024. The MPC was concerned that a stubbornly high inflation can risk unanchoring inflation expectations and trigger second-round effects.

Despite the recent softening in international commodity prices, these remain volatile and higher than last year.

The MPC inflation forecast assumes Brent crude price to average \$105 per barrel this fiscal, compared with \$80 per barrel last year. While the RBI's survey of firms in manufacturing and service sectors indicates softening of cost pressure in the second half (H2) of this fiscal, they are increasing the passthrough of these costs to consumer prices. IIM Ahmedabad's Business Inflation Expectation Survey for June shows that despite persistence of high cost pressure, business inflation expectations are moderating. Core inflation, even after accounting for relief on petrol and diesel prices, remains elevated and broad-based. For some food prices, rising kharif sowing might offer relief, but critical crops such as rice, where sowing is lagging, will be monitored.

- **Aggressive monetary tightening globally:** The RBI is worried about the spillover effects of synchronised monetary policy tightening globally, especially as the Fed is hiking at a faster pace. Compared with 140 bps hike by the RBI, the Fed has hiked its policy rate by 225 bps in 2022 so far. The governor views global financial conditions as tense, despite intermittent relief. Sharp appreciation of the US dollar is putting pressure on the rupee even as domestic fundamentals remain resilient. A weakening rupee can further add to domestic inflationary pressures through higher cost of imports. The RBI's tight monetary policy will also help cap capital outflows amid volatile global financial conditions, and control the rupee's depreciation. Along with hiking policy rates, the RBI has been progressively reducing systemic liquidity, consistent with its stance of 'withdrawal of accommodation'.
- **Growth remains resilient:** The MPC derives comfort from domestic economic recovery improving and getting broad-based. It retained its GDP forecast at 7.2% for this fiscal, with 16.2% in Q1, 6.2% in Q2, 4.1% in Q3 and 4% in Q4 (the sequential slowing driven by the base effect), moving up 6.7% in Q1 next year.

High frequency indicators hint at improving urban demand, benefitting from catchup in contact-based services and improving consumer confidence. However, signs on rural demand improvement are mixed, and are contingent on monsoon. Investment outlook remains positive, driven by the government's capital expenditure (capex) push, improving capacity utilisation in manufacturing, and rising bank credit growth. However, downside risks remain from global geopolitical tensions, financial market volatility, and possibility of recession in major economies.

## Our view

Since the last MPC meeting, risks to inflation and domestic financial conditions have reduced to some extent, but remain significant. The inflation trajectory and global financial conditions still appear cloudy, which will keep the RBI's policy actions data dependent. We expect the RBI to raise the repo rate by another 25 bps hike in its September meeting, beyond which it will be guided by inflation and the Fed's actions in the second half.

While international prices for critical commodities such as crude oil, edible oils and wheat have eased, these remain higher than last year so far. High costs will maintain a broad-based pressure on retail prices. The intensity and distribution of monsoon will also need to be monitored, especially as food supplies are tight. A well-distributed monsoon can help ease inflation in the second half.

The RBI's policy tightening is also warranted to reduce pressure on the rupee from widening the current account deficit (CAD), while aggressive monetary policy tightening by major advanced economies could impart volatility to capital inflows. The Fed has indicated its sole focus on fighting inflation, which remains at decadal highs and way above its target. S&P Global expects the Fed rate to peak at 3.50-3.75% by 2023, the highest since 2007.

We retain our growth and inflation outlook for fiscal 2023 at 7.3% and 6.8%, respectively, and expect the 10-year government security (G-sec) yield at 7.5% by March 2023.

## Impact on the banking and financial services sector

With an increase of 140 bps in the repo rate so far this fiscal, and an additional front-loaded increase in next policy, the cost of deposit for banks is expected to increase 25-30 bps vis-à-vis an increase in loan yield of 80-90 bps. This difference is because of tightening liquidity, lag in reset of loans, mix of fixed and floating portfolio accounts, borrowing instruments, and competition faced by banks from non-banks and housing finance companies.

The RBI's actions and robust credit growth have crunched liquidity to Rs 1.05 trillion as on July 31 from Rs 1.81 trillion mid-July and Rs 2.26 trillion at the start of the month.

Bank credit increased 13% on-year, way ahead of deposit growth of 8.4% on-year as on July 15, because of faster growth in retail credit and recovery in wholesale segments as evident by increase in capacity utilisation in the manufacturing sector to 75.3% in the last quarter of fiscal 2022 vs the long-term average of 73.7%. With continued growth momentum in retail and agriculture segments, supported by recovery in services and industrial credit, CRISIL Research expects bank credit to grow 10-12% during fiscal 2023.

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