Monetary policy | First cut

Pause and effects (to follow)

April 2023

RBI keeps rates unchanged, but leaves options open

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept its policy rates unchanged in April, compared with a 25 basis points (bps) hike in the previous policy. However, it maintained its stance of withdrawal of accommodation, and stated its readiness to fight any unexpected rise in inflation. RBI Governor Shaktikanta Das termed today's action as a "pause, not a pivot."

The central bank wants to carefully evaluate the consequences of the cumulative 250 bps repo rate hike since May 2022, the fastest pace of hikes in the past decade. The repo rate stands at 6.50%, the highest since February 2019. The real policy rate (repo-inflation), which is still below the pre-pandemic level, is expected to move up as inflation nudges down this fiscal.

Unless inflation rises above than RBI's forecast, we expect the central bank to pause and watch the impact of past rate hikes on growth and inflation. The RBI will need to closely monitor any spillovers from global market volatility, even as a slowdown in rate hikes by major central banks offers partial relief. As growth slowdown seeps in and inflation moderates, we expect the RBI to cut rates by the end of this fiscal.

Highlights from April monetary policy

- The MPC voted unanimously to keep policy rates unchanged — the repo rate at 6.50%, standing deposit facility at 6.25%, and marginal standing facility at 6.75%
- It voted with a 5-1 majority to keep the stance of 'withdrawal of accommodation' unchanged from the previous policy
- The MPC cut its projection for consumer price index (CPI)-based inflation to 5.2% from 5.3% for this fiscal
- It raised its projection for growth in real gross domestic production (GDP) by 10 bps to 6.5% for this fiscal

What factors prompted the RBI to pause?

Inflation expected to ease: The MPC expects CPI inflation to moderate this fiscal, after it breached the RBI's upper tolerance limit of 6% in January and February. The MPC projects CPI inflation to average 5.2% this fiscal (compared with 6.7% during April 2022-February 2023). On a quarterly basis, the MPC expects it to be rangebound within its target range, at 5.1% in the first quarter, 5.4% in the second, 5.4% in the third, and 5.2% in the fourth.

The MPC believes healthy foodgrain production, lower crude oil prices, and easing cost pressures for firms will tame inflation this fiscal. However, it remains cognizant of any upside risks to food inflation (from weather disruptions) and core inflation (from lagged pass-through of cost pressures to retail prices).

Slowing growth: While highlighting the resilience of Indian growth so far, the MPC expects GDP growth to

moderate to 6.5% this fiscal from an estimated 7.0[1]% last fiscal. It expects GDP growth to slow progressively from 7.8% in the first quarter to 6.2% in the second, 6.1% in the third and 5.9% in the fourth.

The MPC expects slowing global growth to be the main drag on India's growth, with tight global financial conditions and protracted geopolitical tensions remaining significant risks. It also thought it necessary to evaluate the impact of its past rate hikes on the economy.

Eye on global market volatility: The banking turmoil in advanced economies since March has made the RBI wary of rising risks of financial market volatility and its spillover effects on the Indian economy. Though this has increased downside risks to global growth, it is expected to reduce the pace of rate hikes by major central banks.

Improving resilience to external shocks: Global shocks remain elevated, but India's vulnerability to such shocks is reducing, thanks to falling current account deficit (CAD). Lower crude oil prices are expected to drive reduction in CAD this fiscal. The MPC expects crude oil prices to average $85 per barrel this fiscal, versus $95 per barrel last fiscal.

Our view

We believe the RBI will remain on pause as long as inflation does not rise materially above its forecast. After hiking repo rate by a cumulative 250 bps over the past year, the central bank will watch the effects of these hikes on the domestic economy. The monetary policy typically impacts the real economy with a lag of 3-4 quarters. Hence, the rate hikes so far are expected to slow growth and moderate inflation this fiscal. The RBI is likely to respond by cutting rates towards the end of this fiscal.

With the ongoing transmission of the RBI's rate hikes, nominal interest rates moved well above the pandemic levels across different market segments. In March, interest rates rose to 2018-19 levels across most instruments in money and debt markets, and even bank lending rates *(see table below).* Some instruments reached 2016 levels, such as call money rate and home loan rates. Reduction in domestic liquidity is further facilitating transmission of the RBI's rate hikes across market segments.

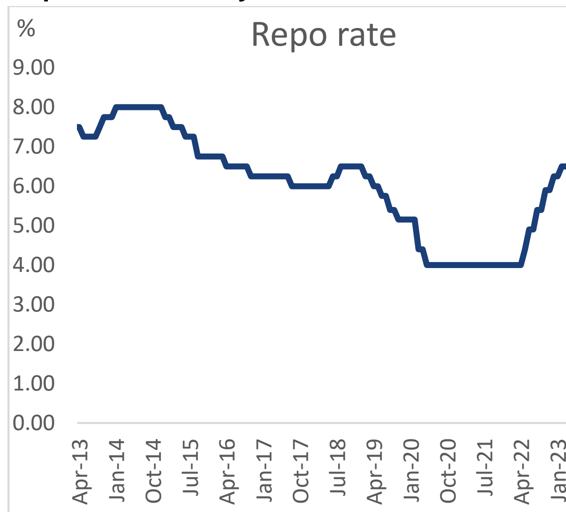
Demand slowdown is also expected to moderate core inflation (i.e. inflation excluding food and fuel), which responds more to demand factors. Some correction in international prices of crude and metals will offer relief on non-food inflation. However, food inflation continues to face risks from weather disruptions and a possible adverse impact of El Nino on monsoon. Rising food inflation, in case of a limited reduction in core inflation, could make headline inflation move above the RBI's target again.

Major global central banks also seem to be close to the end of the rate hike cycle. S&P Global expects a smaller rate hike in May (~20 bps), with the US Federal Reserve (Fed) rate peaking at 5.00-5.15%. Tightening financial conditions due to rate hikes and banking sector stress will slow growth in the US and Europe. Yet, rates are expected to remain higher for longer as inflation persists above the target. S&P Global expects the Fed rate to be cut only from mid-2024, and reach 4.00% by the end of 2024. This could keep external financing conditions challenging for emerging markets like India in 2023.

All this means that while the phase of aggressive rate hikes may be behind us, the aftereffects on financial conditions, along with any upside to inflation, would be the risks to monitor this fiscal.

[1] Second advance estimate by National Statistics Office

Repo rate currently at 2019 level



Market interest rates well above pandemic levels

	Instrument	Interest rate in March 2023	March rate comparable to	Peak rate in pre-pandemic decade (FY11-20)
Money market	Call money rate	6.5	Mar-16	9.97 (Sep-13)
	91D T-Bill	6.9	Oct-18	10.98 (Aug-13)
	6M CD	7.7	Nov-18	11.1 (Aug-13)
	6M CP	7.9	Feb-19	12.2 (Aug-13)
Debt market	1Y G-sec	7.2	Nov-18	10.5 (Aug-13)
	10Y G-sec	7.4	Apr-19	9.0 (Dec-13)
Bank lending rates	1Y MCLR	8.6	Jul-19	9.5 (Apr-16)*
	Auto loan rate	9.4	May-19	12.3 (Aug-11)
	Housing loan rate	9.4	Oct-16	13.3 (Jul-12)

Note: Rates in the table refer to average values for the given month
Source: RBI, CRISIL

View on the banking sector

CRISIL MI&A Research estimates banking credit to have grown 13-15% last fiscal and projects it to rise 12-14% this fiscal. A large part of this growth would be spurred by the retail segment, primarily owing to healthy demand for home and vehicle loans and supported by recovery in the service segment, with pent-up demand in non-banking financial companies and the trade segment. On the industry side, additional working capital requirement due to high inflation and a move from bond markets to bank loans, given the transmission of interest rate hikes last fiscal, will continue to drive credit growth.

The growth is also supported by the government's capital expenditure push, progress of the Production-linked Incentive (PLI) scheme, healthier corporate balance sheets, and a well-capitalised banking sector with low non-performing assets (NPAs). With better collection efficiency and lower slippages, gross non-performing assets (GNPA) improved from 7.5% in March 2021 to 5.00% in September 2022 (with private banks' GNPA at 3.3% and public sector banks' at 6.5%). CRISIL MI&A Research estimates GNPA to have reduced further to 4.1-4.3% as of March 2023.

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