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RBI Monetary Policy: 50bps rate hike—A lost opportunity?

The RBI's Monetary Policy Committee (MPC) unanimously and expectedly decided to hike the policy repo rate by 50bps to 4.9%, citing worsening and broadening inflationary pressures. With this, the recently introduced Standing Deposit Facility (SDF) and the extant Marginal Standing Facility as the floor and ceiling of the Liquidity Adjustment Facility (LAF) corridor stand adjusted at 4.65% and 5.15% respectively. Importantly, the MPC has *finally* articulately done away with the accommodative stance after delivering an effective total hike of 130bps in FY23 thus far (Including an additional hike of 40bps via the SDF introduction in April). Uncertainty to the domestic inflation outlook has risen manifold over the last few months, as reflected from a steep 220bps upward revision in RBI's FY23 inflation forecast to 6.7% in just three months. In fact, the RBI now expects headline inflation to remain well above the upper bound of 6% until Q3FY23. Growth forecast for FY23, however, has been surprisingly retained at 7.2% (Vs. our estimate of 6.5%), possibly disregarding any significant impact of rising prices on consumption demand at the current juncture. Among key regulatory announcements, the RBI enhanced individual housing loan limits by urban (UCBs) and rural cooperative banks (RCBs) and permitted RCBs to lend to residential housing projects, thereby easing credit facilities for the housing sector.

The RBI's move today was widely expected and therefore failed to shock the market—something that was needed for an optimal impact. On the other hand, the absence of any further aggressive measures including another hike in the Cash Reserve Ratio (CRR) provided comfort to the market, resulting in modest drop in yields across the curve. A steep jump in the inflation forecast sans any change in the growth outlook points towards stagflationary risks in India—something that's already apparent in many developed economies. We maintain our view that rate hikes need to be front-loaded to firmly anchor inflationary expectations and curtail broadening of price pressures without severely hurting growth. We expect another 75-100bps hike in the rest of this fiscal with a terminal rate of 6.5% on the repo in the current cycle. This is likely to be accompanied with continued withdrawal of surplus liquidity from the system via VRRRs (Variable Rate Reverse Repos) and CRR hikes, but only to the extent suitable for ensuring an orderly completion of the Government's borrowing programme.

- **RBI hikes repo rate by 50bps on expected lines…:** Following an off-cycle hike of 40bps last month, the RBI's MPC unanimously decided to hike the policy repo rate by another 50bps in the June policy review. This was on the back of worsening and broading inflationary pressures that's expected to persist in the forseeable future, thereby necessitating calibrated rate hikes and gradual withdrawal of liqudity, even as growth outlook has remained stable. With this, the SDF and MSF rates stand adjusted at 4.65% and 5.15% respectively. Importantly, the MPC eradicated the phrase "remain accomodative" from the "stance", in turn clearly elucidating their intent of withdrawing pandemic-induced accomodations, while supporting growth and ensuring a non-disruptive completion of the Government's borrowing plan.

Policy repo rate expectedly hiked by 50bps to 4.9%.

This translates into an effective total hike of 130bps in FY23 thus far including an additional hike of 40bps via the SDF introduction in April.

- **…Triggered by intensifying inflation pessimism…:** The RBI acknowledged that inflationary pressures have become broad-based and remain largely driven by adverse supply shocks. Alongside, they also remain wary of the intensifying upside risks getting materialised earlier than anticipated both in terms of timing and magnitude. Amidst continued surge in global crude oil and commodity prices due to ongoing geopolitical crisis and their pass-through to domestic prices, persistent global supply adversities and continuing shocks to food inflation, the RBI raised its inflation forecast for FY23 by a steep 100bps to 6.7%. This translates into a total upward revision of 220bps in just three months. In fact, headline retail inflation is expected to remain well above the RBI's upper bound of 6% through the first three quarters of FY23 and is estimated to fall within the tolerance band only by Q4FY23.

RBI has raised inflation estimate for FY23 by a steep 100bps to 6.7%, following a 120bps jump in April.

- **…And rising growth optimism at the margin:** On the growth front, RBI acknowledged that, amidst a challenging global environment, domestic economic activity continues to gain traction with growth impulses getting increasingly broad-based as evident from the slew of high frequency indicators. As such, the RBI has kept its FY23 GDP growth estimate unchanged at 7.2%, with Q1, Q2, Q3 and Q4 GDP growth estimates pegged at 16.2%, 6.2%, 4.1% and 4.0% respectively. This is much higher than our estimate of 6.5% and possibly doesn't factor in any meaningful impact of rising prices on consumption demand at the current juncture.

FY23 GDP growth forecast has been retained at 7.2%, much higher than our estimate of 6.5%,

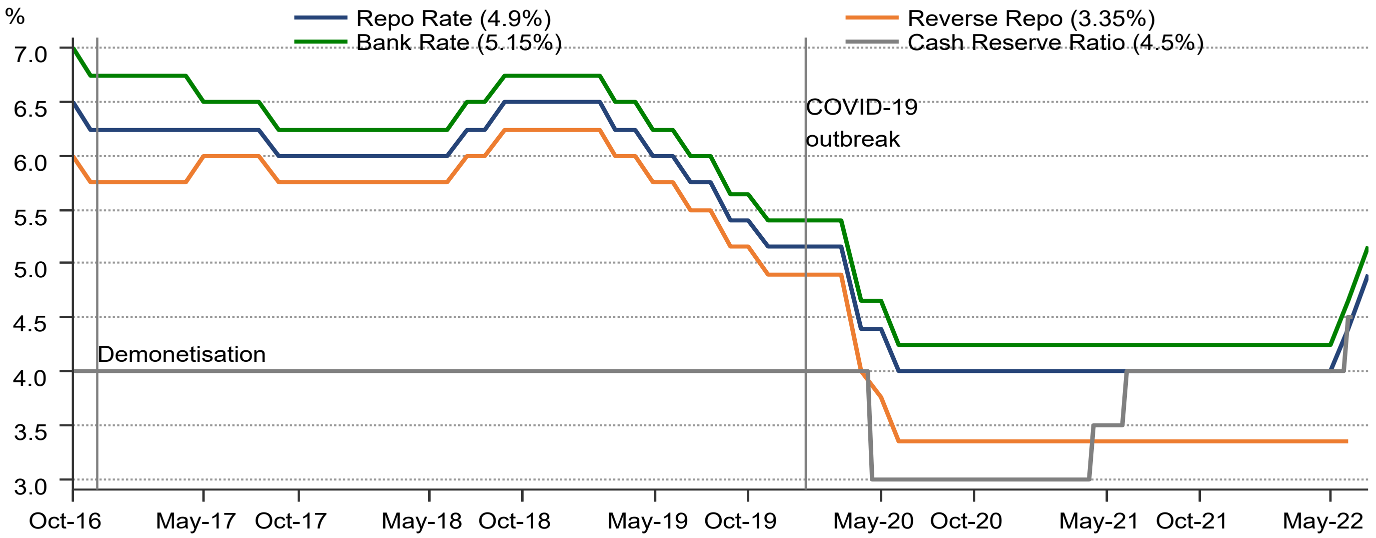
- **Liquidity withdrawal underway:** The RBI highlighted that there has been significant drop in systematic liquidity to Rs5.5trn during May 4th to May 31st from the surplus liquidity of Rs7.4trn during April 8th to May 3rd. That said, there remains an overhang of excess liquidity in the system which has been keeping average overnight rates below the repo rate. The RBI also acknowledged that on the longer-end, borrowing rates have increased and so have banks' term deposit rates.
- **Regulatory measures:** Taking into consideration the importance of cooperative banks in promoting inclusive growth, the RBI announced three measures to boost their lending: (a) limits for individual housing loan by UCBs and RCBs revised upwards by at least 100%; (b) RCBs permitted to lend to Commercial Real Estate – Residential Housing (CRE-RH) Sector within the existing aggregate housing finance limit of 5% of their total assets; and (c) UCBs permitted to provide doorstep banking services to their customers. Further, limits have been enhanced from Rs 5000 to Rs 15000 per transaction for e-mandate based recurring payments by cards. To strengthen the resilience of OTC (Over the Counter) derivative markets, RBI has proposed implementation of variation margins for non-centrally cleared derivatives (NCCDs), following the global practice.
- **Front-loading of rate hikes crucial for anchoring inflationary expectations:** The RBI's move today was widely expected and therefore failed to shock the market—something that was needed for an optimal impact. On the other hand, the absence of any further aggressive measures including another hike in the Cash Reserve Ratio (CRR) provided comfort to the market, resulting in modest drop in yields across the curve. A steep jump in the inflation forecast sans any change in the growth outlook poses risks of stagflation in India—something that's already apparent in many developed economies. We maintain our view that rate hikes need to be front-loaded to firmly anchor inflationary expectations and curtail broadening of price pressures without severely hurting growth. We expect another 75-100bps hike in the rest of this fiscal with a terminal rate of 6.5% on the repo in the current cycle. This is likely to be accompanied with continued withdrawal of surplus liquidity from the system via VRRRs (Variable Rate Reverse Repos) and CRR hikes, but only to the extent suitable for ensuring an orderly completion of the Government's borrowing programme.

Table 1: Current policy rates

Key rates	Scheduled April Policy	Unscheduled May Policy	Scheduled June Policy
Repo Rate	4.0%	4.4%	4.9%
Standing Deposit Facility (SDF)*	3.75%	4.15%	4.65%
Marginal Standing Facility (MSF) Rate	4.25%	4.65%	5.15%
Bank Rate	4.25%	4.65%	5.15%
Cash Reserve Ratio (CRR)	4.0%	4.5%	4.5%

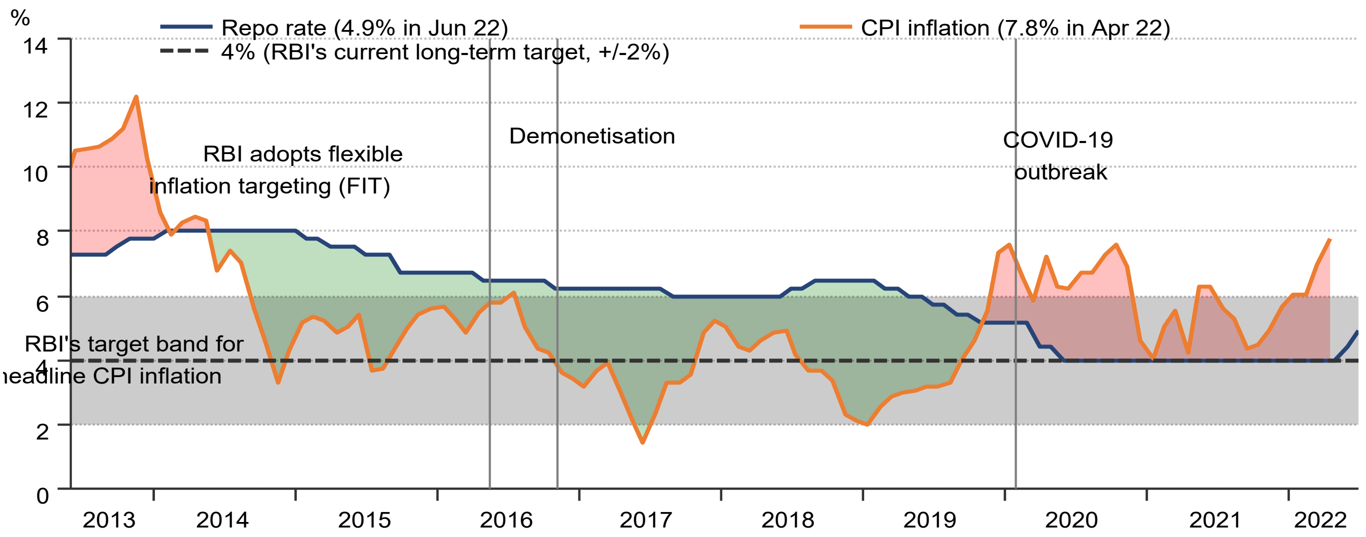
Source: RBI, NSE EPR. * Introduced in April 2022 policy as the new floor of the LAF corridor.

Figure 1: Movement in policy rates



Source: Refinitiv Datastream, NSE EPR.

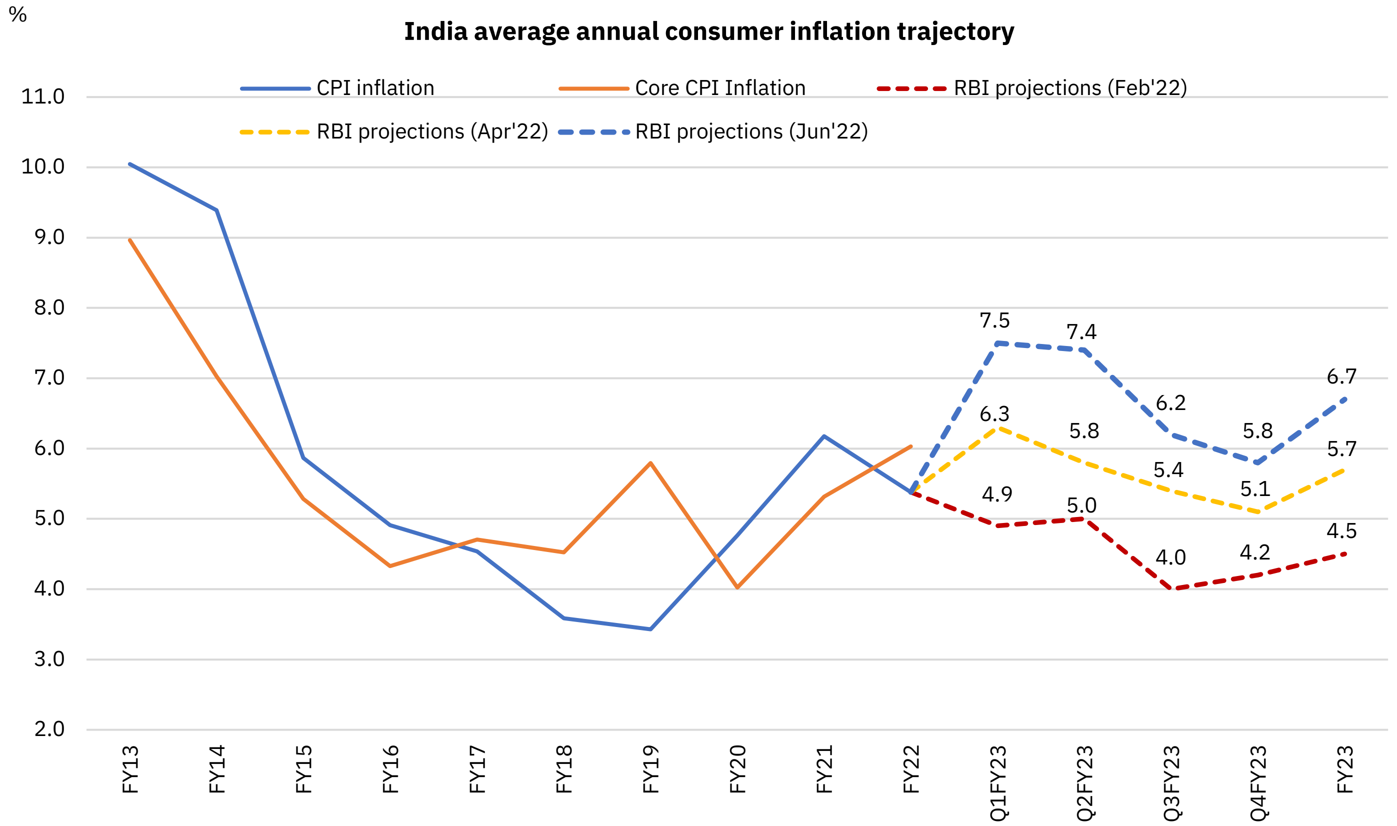
Figure 2: Movement in real interest rates



Source: Refinitiv Datastream, NSE EPR.

Figure 3: India's consumer inflation trajectory and RBI's forecasts

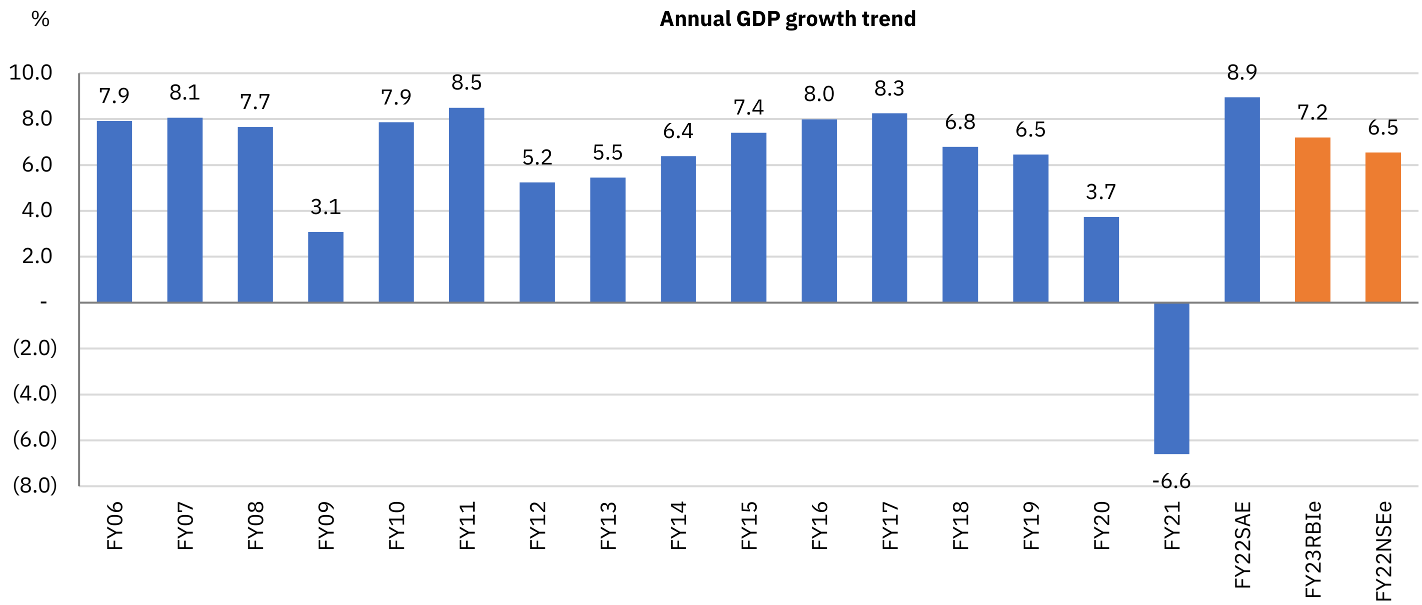
Amidst continued surge in global crude oil and commodity prices and their pass-through to domestic prices, persistent global supply adversities and continuing shocks to food inflation, the RBI raised its inflation forecast for FY23 by a steep 100bps to 6.7%. This translates into a total upward revision of 220bps in just three months.



Source: CMIE Economic Outlook, RBI EPR. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

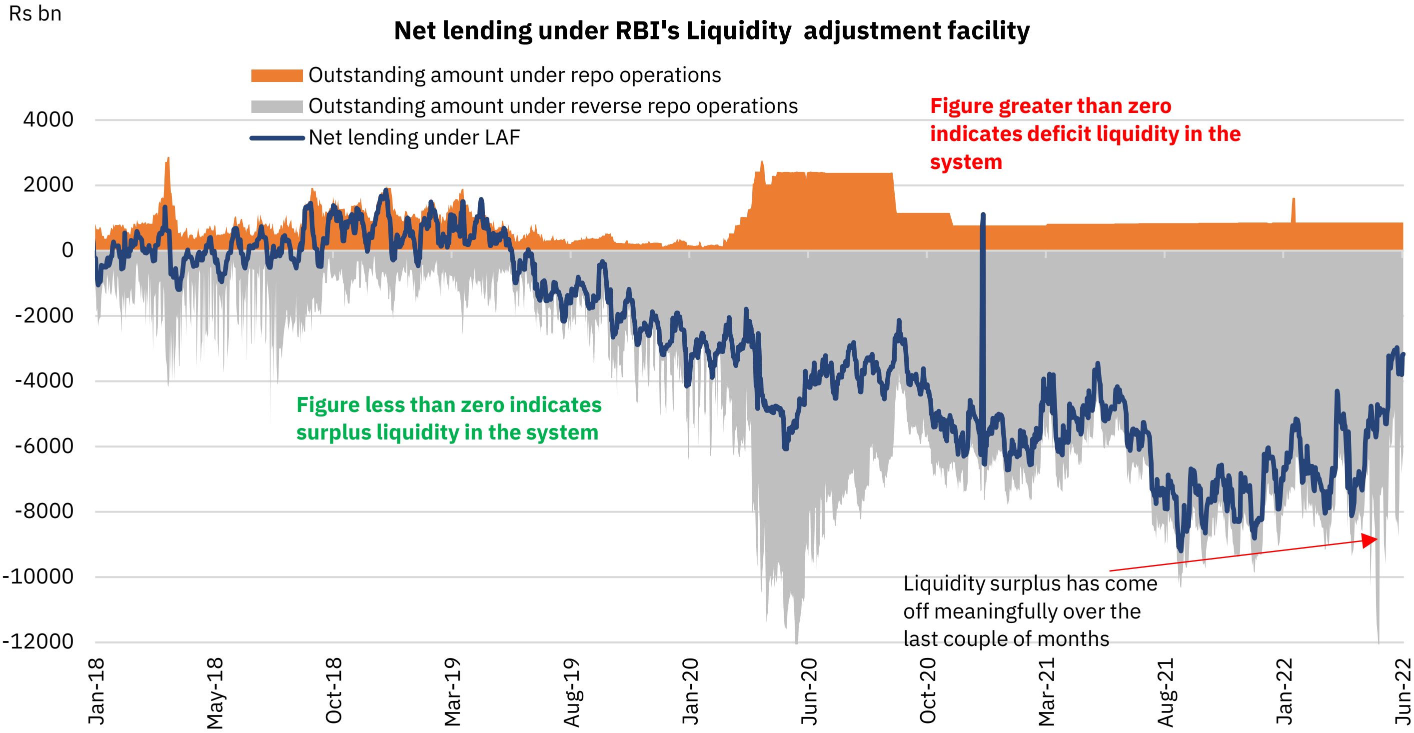
Figure 4: GDP growth trend and estimate for FY23

The RBI has retained FY23 GDP growth forecast at 7.2%, with Q1, Q2, Q3 and Q4 GDP growth estimated pegged at 16.2%, 6.2%, 4.1% and 4.0% respectively. This is much higher than our estimate of 6.5% and possibly doesn't factor in any meaningful impact of rising prices on consumption demand at the current juncture.



Source: CMIE Economic Outlook, RBI, NSE EPR. RBIe = RBI estimate, SAE = Second Advance Estimate, NSEe = NSE estimate.

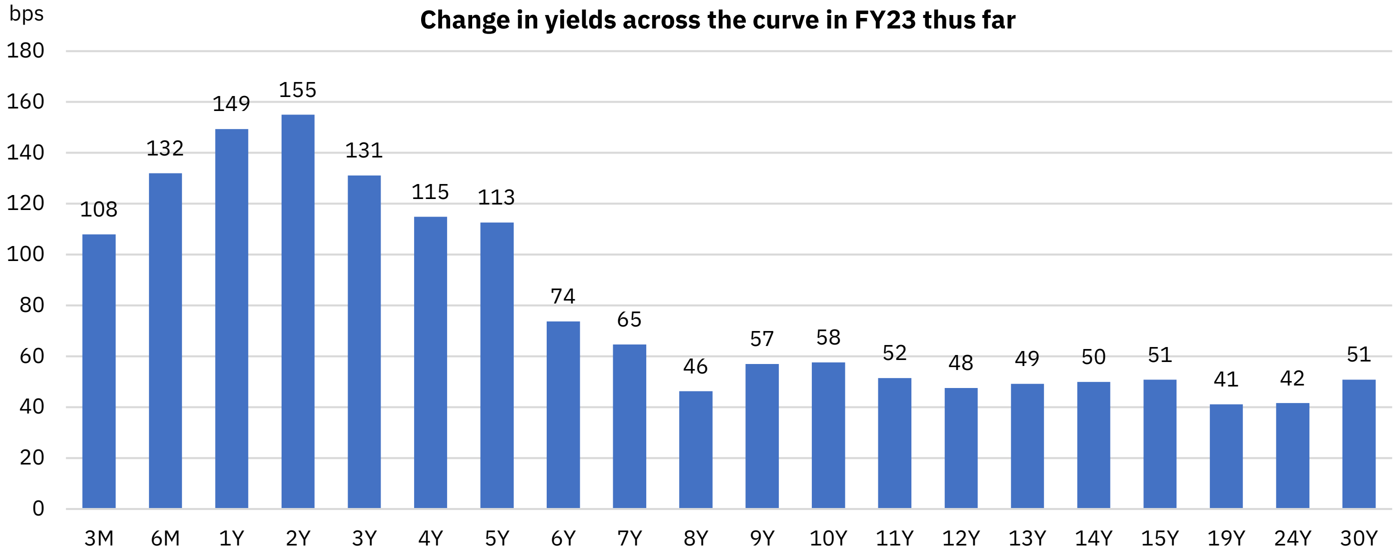
Figure 5: Net lending under RBI's Liquidity Adjustment Facility



Source: CMIE Economic Outlook, Refinitiv Datastream, NSE EPR.

Figure 6: Movement in yield curve so far

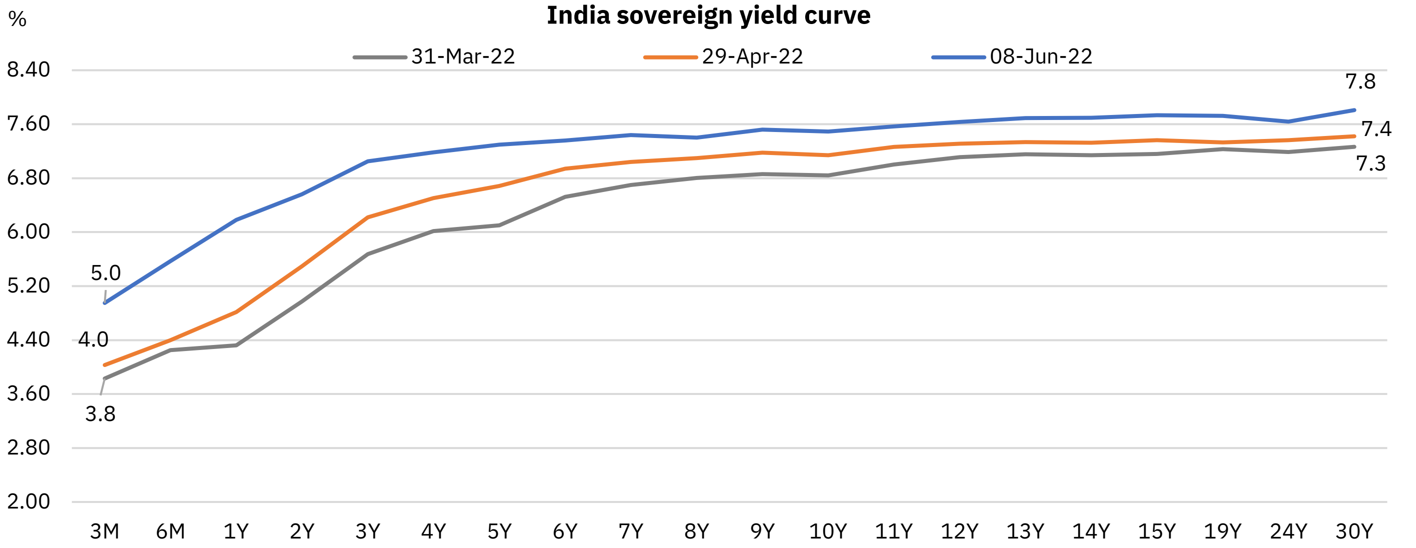
While yields have shot up significantly at the shorter end of the curve, the longer end is gradually inching higher.



Source: Refinitiv Datastream, NSE EPR.

Figure 7: India sovereign yield curve

Indian fixed income markets have followed global suit, with yields rising across the curve in FY23 thus far.



Source: Refinitiv Datastream, NSE EPR.

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