## RBI Monetary Policy: Rate hikes to continue

**The RBI's Monetary Policy Committee (MPC) unanimously decided to hike the policy repo rate by another 50bps to 5.4%, and on a 5 to 1 majority to remain focused on withdrawal of accommodation. Prof. Varma had a divergent view on the stance, but one would have to wait for the MPC minutes for details. This has translated into a cumulative hike of 140bps in the policy repo rate since May 2022 and an effective hike of 180bps with the introduction of Standing Deposit Facility as the new floor in April 2022. The MPC acknowledged the need for continued calibrated monetary policy action to bring down inflation within tolerance bands and anchor inflation expectations, particularly in the light of resilient domestic growth, disregarding market expectations of earlier-than-anticipated end to the current rate hiking cycle. GDP growth and inflation forecasts for FY23 were retained at 7.2% and 6.7%, higher than our estimate of 6.5% and 6.9% respectively. While the RBI recognized moderation in inflationary pressures, it remained wary of significant uncertainty emanating from geopolitical shock spill overs.**

**The MPC's move today contrasted with rising market expectations of a relatively muted hike in the light of softening commodity prices. Coupled with a hawkish commentary, this pushed yields higher by 10-30bps across the curve. With inflation expected to remain well above 6% until December 2022, rate hikes are likely to remain front-loaded for now, at least until the next policy review. We expect another 50-75bps in the rest of the fiscal, with the new terminal repo rate pegged at 6.15%, lower than our earlier estimate of 6.5% given improving inflation outlook. Liquidity conditions have tightened meaningfully since mid-July thanks to RBI's interventions in the forex market and tax outflows. The trend is likely to continue, thereby putting further pressure on short end of the curve.**

- **RBI hikes repo rate by 50bps…:** Following 90bps cumulative rate hike in May-June, the RBI's MPC unanimously decided to hike the policy repo rate yet again by another 50bps in the August policy review. With this, the Repo, SDF and MSF rates stand adjusted at 5.4%, 5.15% and 5.65% respectively. This has translated into a cumulative hike of 140bps in the repo rate since May 2022 and an effective hike of 180bps since April 2022 following the introduction of SDL as the new floor of the Liquidty Adjustment Facility (LAF) corridor. The MPC clearly acknowledged the need for continued calibrated monetary policy action to bring down inflation within tolerance bands and anchor inflation expectations, citing comfort from resilient domestic growth. Importantly, the MPC voted on a 5 to 1 majority to remain focussed on withdrawal of accomodation. Prof. Varma expressed reservations on that part, the nature of which would only be divulged in the MPC minutes.

*On expected lines, policy rates hiked by another 50bps following cumulative 90 bps rate hikes in May-Jun.*

- **…prompted by continued uncertainity around inflation trajectory…:** The RBI noted that though inflation has softened recently, it continues to stay elevated and broad-based, thanks to heightened INR volatility in currency that is indeed inducing imported inflationary pressures. While recognizing moderation in inflationary pressures going ahead, the RBI remained wary of the significant uncertainty emanating from spill overs from geopolitical shocks that continues to cloud the inflation outlook. Considering this, the RBI has retained its inflation forecast for FY23 at 6.7% (vs. our estimate of 6.9%), assuming a normal monsoon and average crude oil price of US$105/bbl. While the RBI has trimmed its CPI inflation forecast for Q2FY23 from 7.4% to 7.1%, it has raised its inflation projections for Q3FY23 from 6.2% to 6.4%. The estimates for Q4FY23 has been kept unchanged at 5.8%, with forecast for Q1FY24 expected to fall sharply to 5%, reflecting the impact of a favorable base.

*The RBI has retained its inflation forecast for FY23 at 6.7%, with risks evenly balanced.*

- **…and resilient growth momentum:** On the growth front, RBI acknowledged that activity is treading along the lines of the June MPC resolution, with the domestic economy continuing to gain traction despite a challenging global environment. As such, the RBI has retained its FY23 GDP growth forecast 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 also been retained at 7.2%, higher than our estimate of 6.5%.*

- **Liquidity withdrawal underway:** The RBI highlighted that there has been significant moderation in systematic liquidity to Rs 3.8trn during Jun-Jul'22 from Rs 6.7trn during Apr-May, thanks to tax and capital outflows. This has resulted in a significant firming of Weighted Average Call Rate (WACR) as well as 91-day T-bills, CP (Commercial Papers) and CD (Certificate of Deposits) rates. Governor Das in his statement maintained that RBI would continue to remain vigilant on the liquidity front and conduct two-way fine-tuning operations comprising of VRRs (Variable Rate Repos) and VRRRs (Variable Rate Reverse Repos) as and when required.

- **Regulatory measures:** Taking into consideration the importance of standalone primary dealers (SPD) in development of financial markets, it is proposed to enable them to (i) offer all forex market making facilities subject to prudential guidelines and (ii) undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) with non-residents and other market makers. To ease payments by NRIs, it is proposed to enable Bharat Bill Payment System (BBPS) to accept cross-border inward payments. Other regulatory measures include: (i) setting up a Committee on MIBOR Benchmark, (ii) bringing out a draft master direction on Managing Risks and Code of Conduct in Outsourcing of Financial Services for comments from stakeholders and (iii) Credit information companies (CICs) have been included under the RBI-OS framework and mandated to have their own internal Ombudsman (IO) framework.

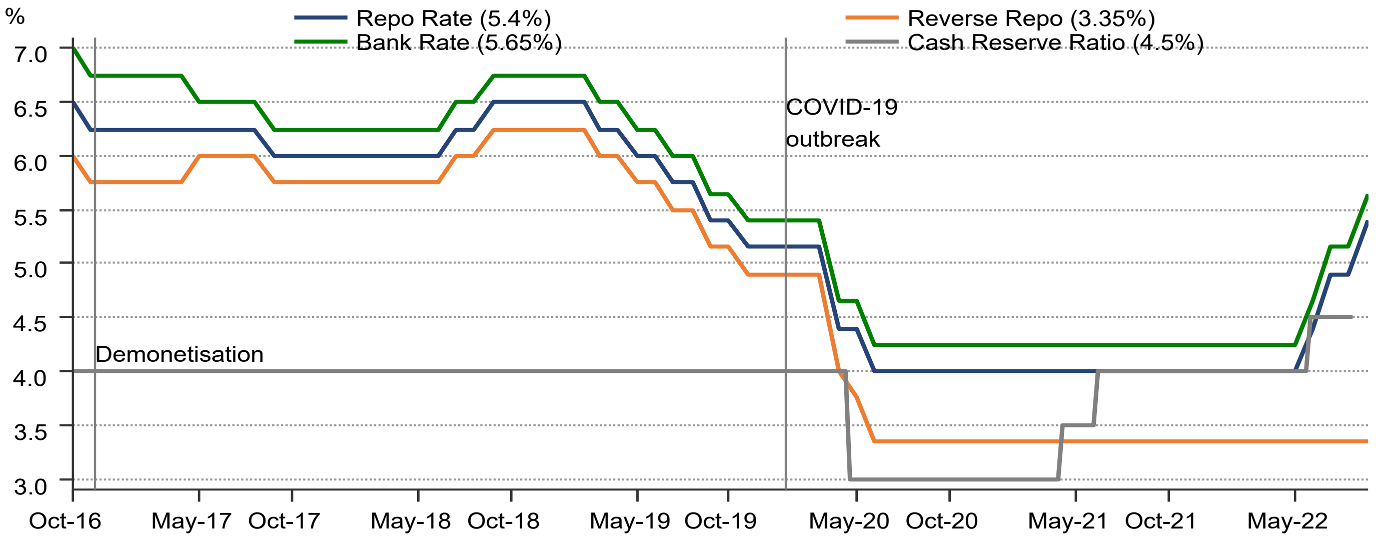
- **Rate hikes to remain front-loaded for now:** The RBI's move today contrasted with rising market expectations of a relatively muted hike in the wake of softening commodity prices. This, coupled with a rather hawkish commentary, pushed yields higher by 10-30bps across the curve. With inflation expected to remain well above 6% until December 2022, rate hikes are likely to remain front-loaded for now, at least until the next policy review. We expect another 50-75bps in the rest of the fiscal, with the new terminal repo rate pegged at 6.15%, lower than our earlier estimate of 6.5% given improving inflation outlook. Liquidity conditions have tightened meaningfully since mid-July thanks to RBI interventions in the forex market and tax outflows. The trend is likely to continue, thereby putting further pressure on short end of the curve.

**Table 1: Current policy rates**

| Key rates | Scheduled April Policy | Unscheduled May Policy | Scheduled Jun Policy | Scheduled Aug Policy |
|---|---|---|---|---|
| Repo Rate | 4.00% | 4.40% | 4.90% | 5.40% |
| Standing Deposit Facility (SDF)* | 3.75% | 4.15% | 4.65% | 5.15% |
| Marginal Standing Facility (MSF) | 4.25% | 4.65% | 5.15% | 5.65% |
| Bank Rate | 4.25% | 4.65% | 5.15% | 5.65% |
| Cash Reserve Ratio (CRR) | 4.00% | 4.50% | 4.50% | 4.50% |

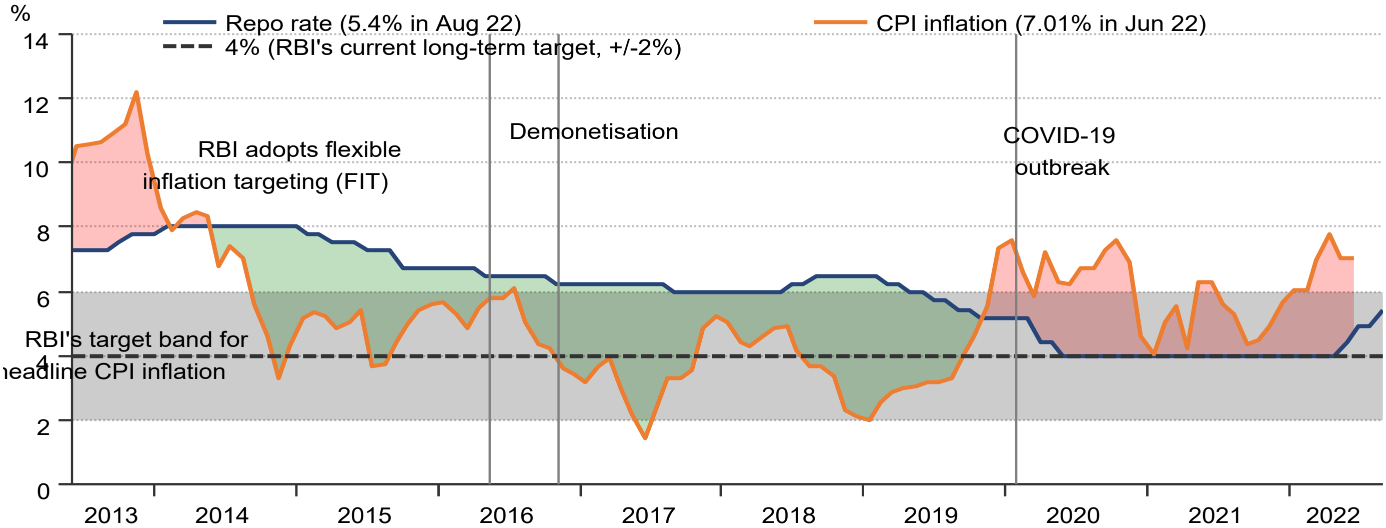
Source: RBI, NSE EPR. * Introduced in April 2022 policy as the new floor of the LAF corridor.

**Figure 1: Policy rates hiked by another 50bps taking cumulative rate hikes to 140bps so far in FY23**




Source: Refinitiv Datastream, NSE EPR.

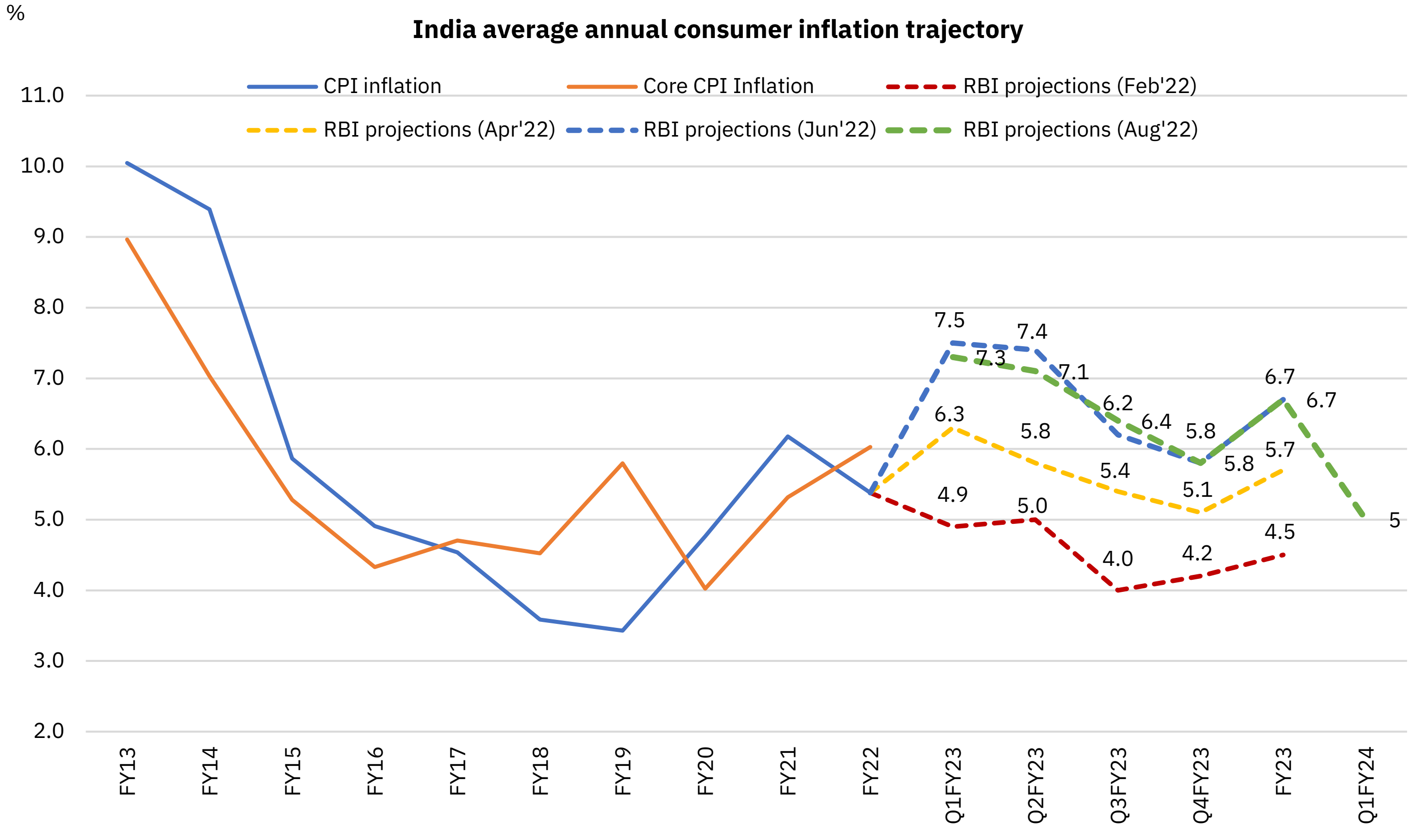
**Figure 2: Real interest rates have remained negative for more than two years now**




Source: Refinitiv Datastream, NSE EPR.

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

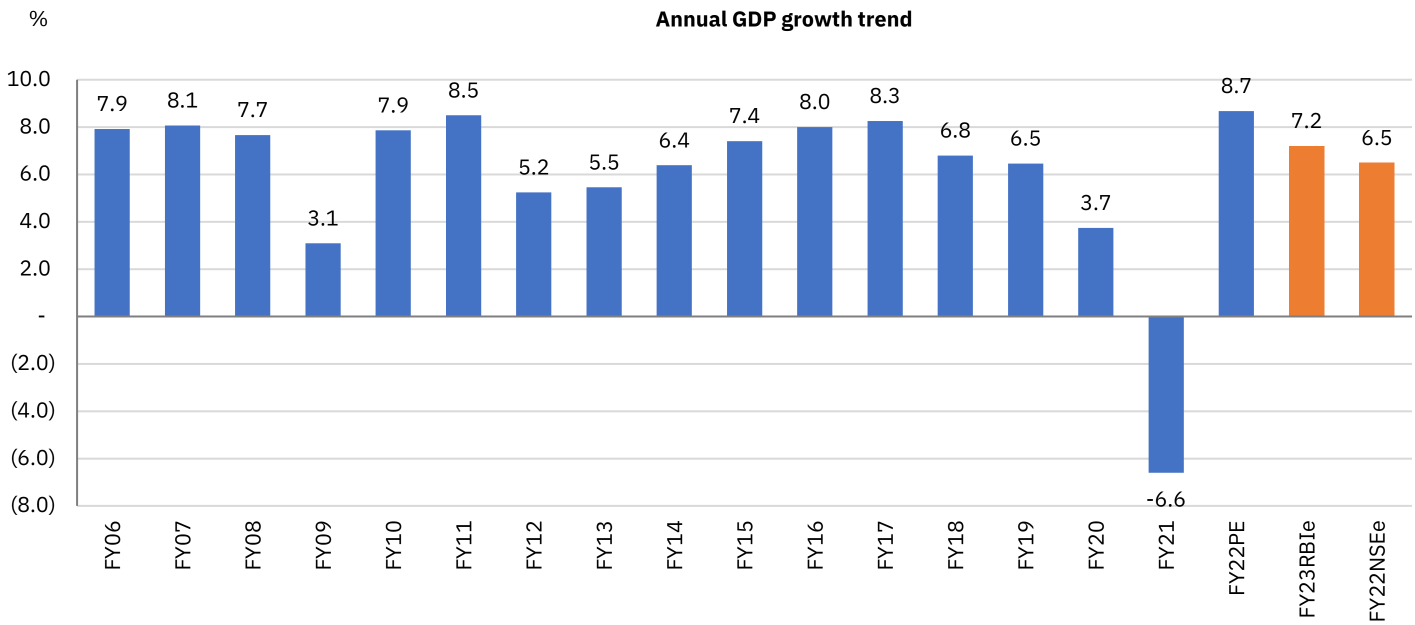
The RBI has retained its headline CPI inflation forecast at 6.7% for FY23, a tad lower than our estimate of 6.9% and highlighted that the risks remain evenly balanced.




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**

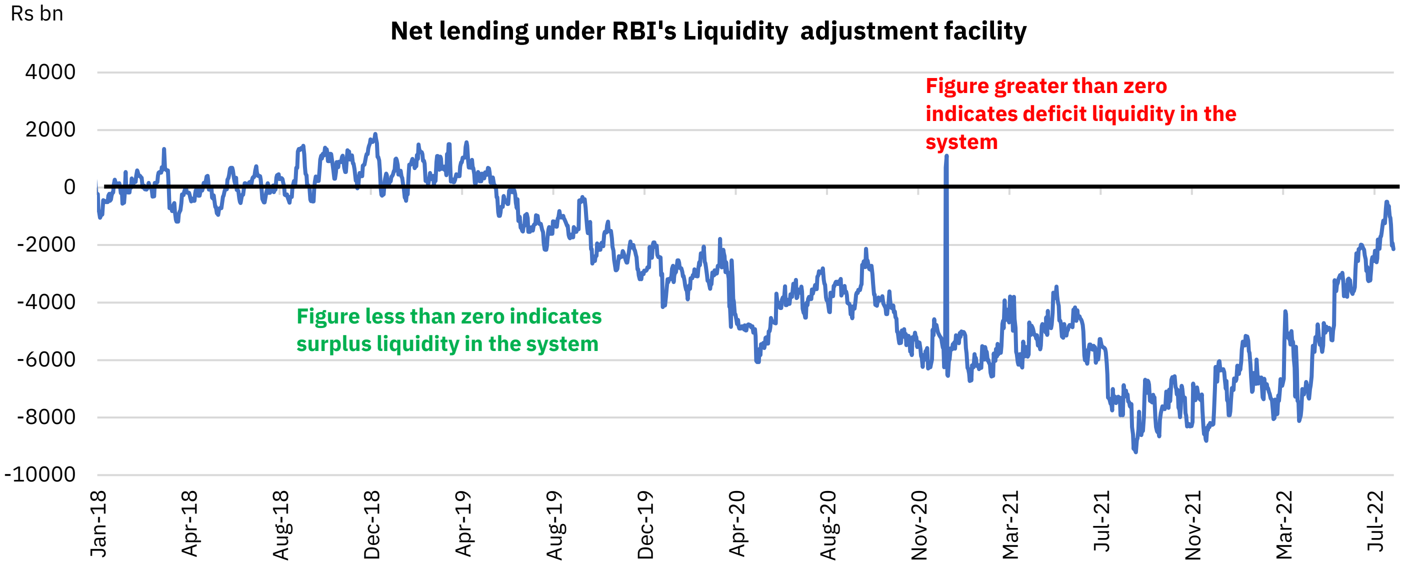
The RBI has retained FY23 GDP growth forecast at 7.2%, with Q1, Q2, Q3 and Q4 GDP growth estimated pegged at 16.2%, 6.2%, 4.1% and 4.0% respectively. This is much higher than our estimate of 6.5% and possibly doesn't factor in any meaningful impact of rising prices on consumption demand at the current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




Source: CMIE Economic Outlook, RBI, NSE EPR. RBIe = RBI estimate, FAE = First Advance Estimate, PE = Preliminary Estimate.

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

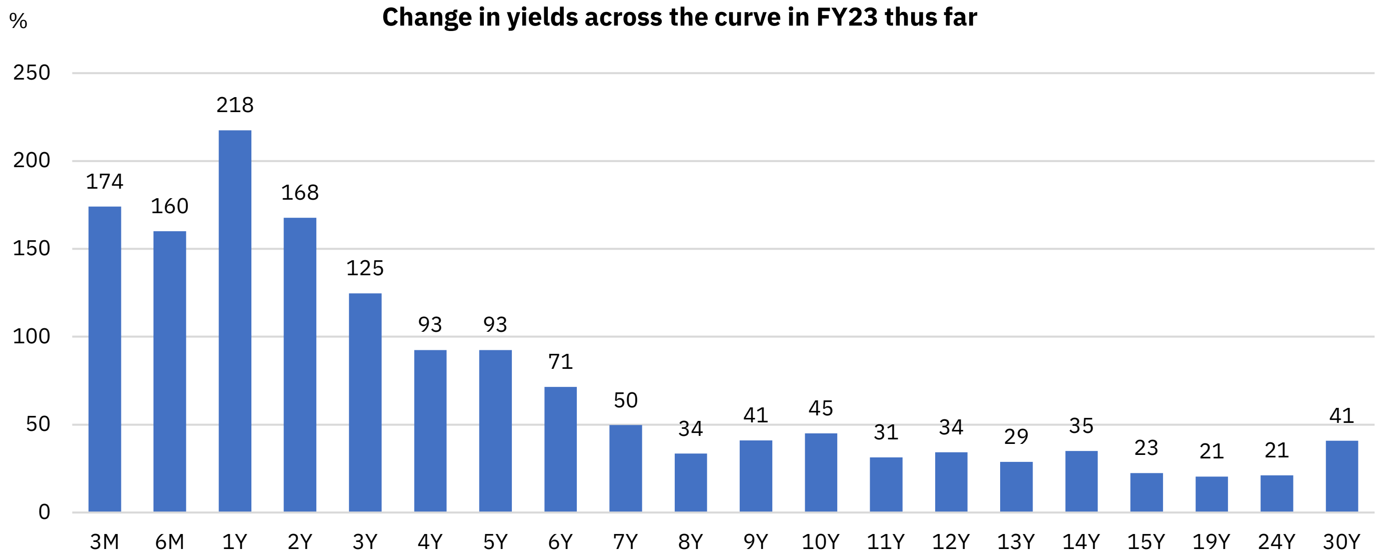
The net liquidity absorption by RBI under the LAF window fell to an average of Rs1.9trn in July from Rs2.9trn in June and Rs4.4trn in May, reflecting the impact of RBI's intervention in FX markets, CRR build-up, and tax outflows.




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

**Figure 6: YTD change in yield curve (as on Aug 5th, 2022)**

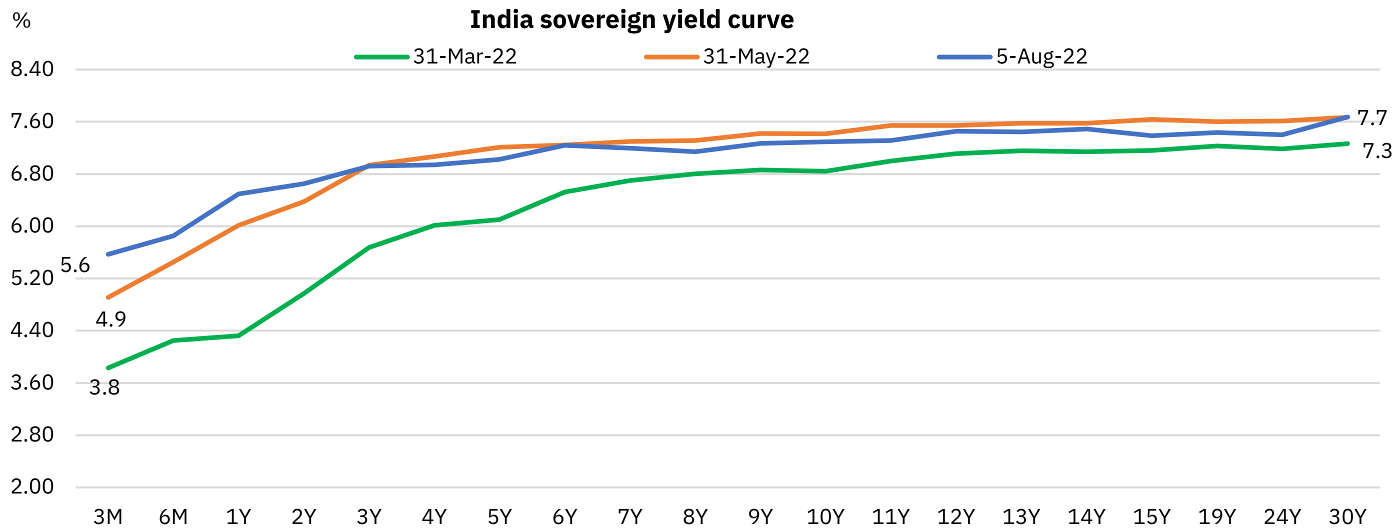
The RBI's move today contrasted with rising market expectations of a relatively muted hike in the wake of softening commodity prices. This, coupled with a rather hawkish commentary, pushed yields higher by 10-30bps across the curve. The impact has been far more prominent at the short end, with the 1-year G-sec yield rising by a steep 218bps since April 2022.




Source: Refinitiv Datastream, NSE EPR.

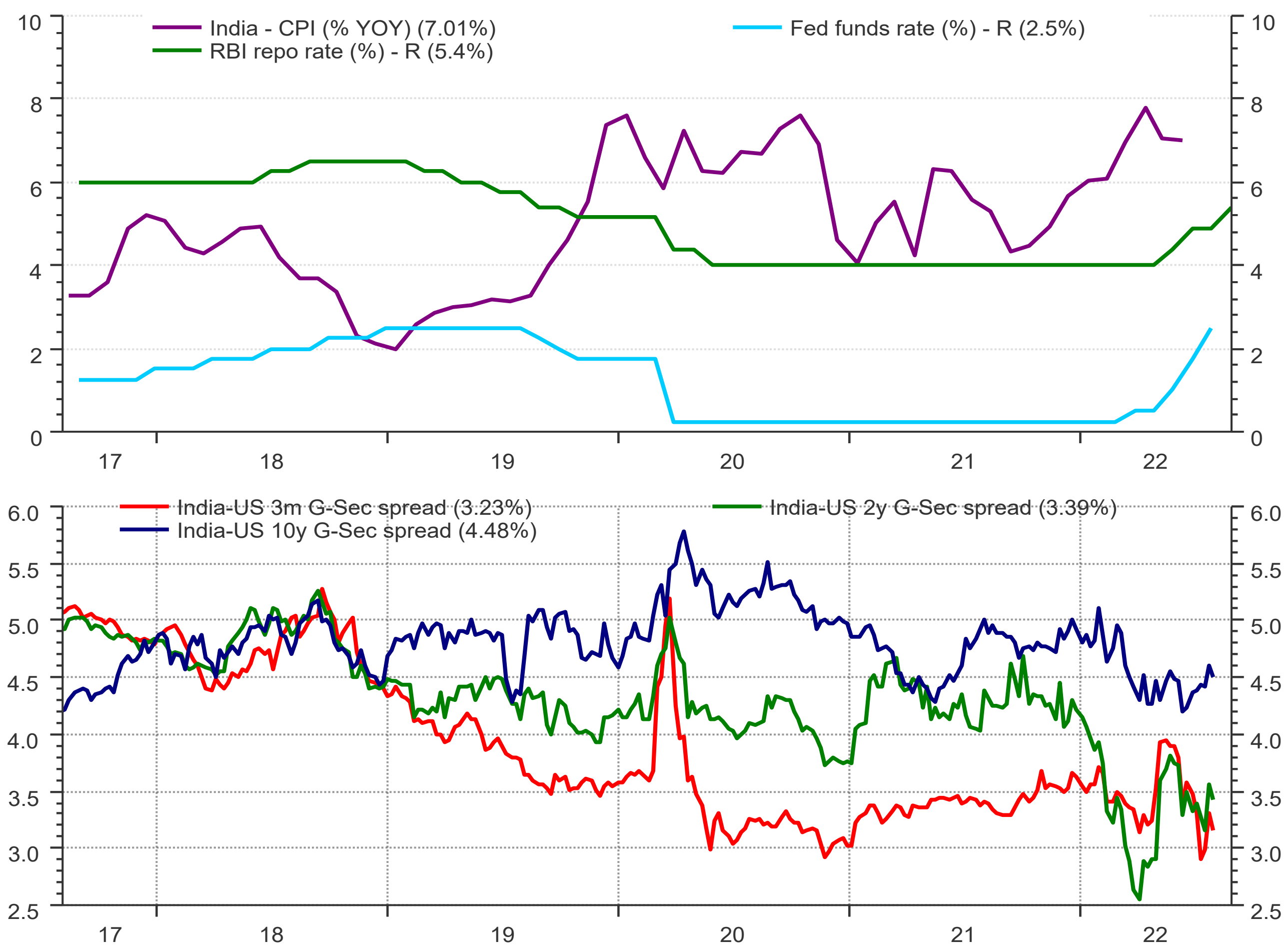
**Figure 7: India sovereign yield curve**

Indian fixed income markets have followed global suit, with yields rising across the curve in 2022 thus far. With 140 bps cumulative rate hike, yield curve has further flattened, with short-term rates rising by a much higher magnitude.




Source: Refinitiv Datastream, NSE EPR.

**Figure 8: India vs. US policy rates and yield differential**




Source: Refinitiv Datastream, NSE EPR.

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