RBI Monetary Policy Review

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Economy Update

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Pragmatic policy; expect rates to increase by another 25-50bps in FY23

- **The monetary policy committee (MPC) unanimously voted for a 50bps hike in the repo rate. This was marginally higher than our expectation of a 35bps hike. The repo rate now stands at 4.90%, the standing deposit facility (SDF) rate at 4.65% and the marginal standing facility (MSF) rate at 5.15%. We expect additional rate hikes of 25-50bps in FY23.**
- **The MPC also unanimously voted to focus on withdrawal of accommodation. The RBI will move towards normal monetary policy in a calibrated manner. The Governor clarified in the press conference that normal monetary policy meant that the call rates should be close to the repo rate rather than the SDF rate.**
- **RBI noted that upside risks to inflation have manifested earlier than expected. Consequently, Inflation is expected to be above 6% for the first three quarters of FY23. RBI has revised up its inflation projection for FY23 to 6.7% from 5.7% earlier with 1Q at 7.5%, 2Q at 7.4%, 3Q at 6.2% and 4Q at 5.8%. This assumes crude at US$105/bbl. This is closer to the upper bound of our inflation forecast while our base case is at 6.2% (assuming cooling off in commodity prices in 2HFY23 on global policy tightening and consequent slowdown).**
- **The Governor pointed out that 75% of the increase in the inflation projection is attributed to food articles. At the same time, he also noted that fuel tax cuts have reduced the three month ahead inflation expectations of urban households by 190bp and 1 year ahead inflation expectations by 90bp.**
- **RBI retained its GDP forecast for FY23 at 7.2% with 1Q at 16.2%, 2Q at 6.2%; 3Q at 4.1% and 4Q at 4%. Notably, capacity utilisation has improved to 74.5% in 4QFY22 from 72.4% in 3QFY22.**
- **The Governor reiterated his commitment to orderly completion of the government borrowing programme. We expect the 10 - year to trade ~7.5% levels. Any significant spike may be met with intervention from RBI.**

Outlook for policy –calibrated move towards normal monetary policy; expect 25-50bps of rate hikes: The protracted war in Europe and the accompanying sanctions have kept global commodity prices elevated across the board. This is exerting sustained upward pressure on consumer price inflation, well beyond the targets in many economies. Globally, stagflation concerns are growing and are amplifying the volatility in global financial markets. This is feeding back into the real economy and further clouding the outlook. The MPC noted that, in such a challenging global environment, domestic economic activity is gaining traction, while inflation pressures have intensified further. The upside risks to inflation as highlighted in the April and May 2022 policies have materialised earlier than anticipated – both in terms of timing and magnitude. Inflationary pressures have become broad-based and remain largely driven by adverse supply shocks. There are growing signs of a higher pass-through of input costs to selling prices. The MPC noted that inflation is likely to remain above the upper tolerance band of 6% through the first three quarters of FY23. In this context, supply side measures taken by the government in reducing excise duties on petrol and diesel, along with the other measures would help in mitigating the inflationary pressures to some extent. The MPC also recognised that sustained high inflation could unhinge inflation expectations and trigger second round effects. It, therefore, judged that further monetary policy measures are necessary to anchor the inflation expectations. Accordingly, the MPC decided to increase the policy repo rate by 50 basis points to 4.90%. The MPC also decided to remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. The Governor noted that **the repo rate still remains below its pre-pandemic level. Consequently, We expect additional repo rate hikes of 25-50bps over the next two policy meetings.**

Outlook for inflation –upside risks drive revision in CPI forecast to 6.7%: Upside risks to inflation do persist. These risks emanate from elevated commodity prices; revisions in electricity tariffs across many states; high domestic poultry and animal feed costs; continuing trade and supply chain bottlenecks; rising pass-through of input costs to selling prices in the manufacturing and services sectors; the recent spike in tomato prices which are adding to food inflation; and most important of all, the elevated international crude oil prices. With the assumption of a normal monsoon in 2022 and average crude oil price (Indian basket) of US$105/bbl, inflation is now projected at 6.7% in FY23 (up from 5.7% earlier), with 1Q at 7.5%; 2Q at 7.4%; 3Q at 6.2%; and 4Q at 5.8%, with risks evenly balanced. 75% of the increase in inflation projections can be attributed to the food group. Further, the baseline inflation projection of 6.7% for FY23 does not take into account the impact of monetary policy actions. **The RBI's 6.7% forecast is closer to the upper bound of our inflation forecast while our base case is at 6.2% (assuming cooling off in commodity prices in 2HFY23 on global tightening and consequent slowdown).**

Outlook for growth – domestic growth holding up; capacity utilisation continues to improve: The recovery in domestic economic activity is gathering strength. Rural consumption should benefit from the likely normal south-west monsoon and the expected improvement in agricultural prospects. A rebound in contact-intensive services is likely to bolster urban consumption, going forward. Investment activity is expected to be supported by improving capacity utilisation, the government's capex push, and strengthening bank credit. Growth of merchandise and services exports is set to sustain the recent buoyancy. Spillovers from prolonged geopolitical tensions, elevated commodity prices, continued supply bottlenecks and tightening global financial conditions nevertheless weigh on the outlook. Taking all these factors into consideration, the real GDP growth projection for FY23 is retained at 7.2%, with 1Q at 16.2%; 2Q at 6.2%; 3Q at 4.1%; and 4Q at 4.0% with risks broadly balanced. **Notably, capacity utilisation has improved to 74.5% in 4QFY22 from 72.4% in 3QFY22. Capacity ulitisation edging closer to 80% levels bodes well for the capex cycle.**

Outlook for liquidity – calibrated tightening: In line with the emphasis on gradual withdrawal of accommodation articulated in the April and May MPC resolutions, systemic liquidity has moderated in the recent period. Surplus liquidity, as reflected in average daily absorption under the liquidity adjustment facility (LAF) – that is, the absorption under SDF and variable rate reverse repo (VRRR) of 14 days and 28 days –at Rs5.5tn during May 4-May 31 was lower than Rs.7.4tn during April 8-May 3, 2022. Nevertheless, the overhang of excess liquidity has resulted in overnight money market rates, on an average, trading below the policy repo rate. **Following the repo rate hike of 40 bps on May 4, the WACR has further increased, averaging 4.07% during May 5-31. However, this was still below the SDF rate of 4.15%, The Governor noted in his statement that RBI will move towards normal monetary policy in a calibrated manner. He further clarified in the press conference that normal monetary policy meant that the call rates should be close to the repo rate rather than the SDF rate. Consequently, we believe liquidity tightening has some room to run. Nevertheless, we also think that increases in the cash reserve ratio (CRR) will be the last resort, with RBI preferring other organic means of liquidity absorption such as increase in currency in circulation , credit growth and FX sales (as and when warranted).**

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