Press Release

RBI continues on the road of rate hikes

Pace of hikes may slow down in the remaining part of the fiscal

05-August-2022

RBI has persisted with its rate hike momentum by announcing a second consecutive 50 bps rate hike, raising the benchmark repo rate to 5.40%. This is largely in line with our expectations of front loading of rate hike in the current fiscal, in response to intense global inflation headwinds and rapid normalization of ultra-accommodative monetary policies in the developed economies. With the latest hike, which is the third in the current hike cycle, the aggregate interest rate increase so far has been 140 bps since May-22.

Since the initiation of policy action on rate hikes, RBI has revised its stance to "remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". We believe that such a stance will continue through a major part of the current year till the headline inflation withdraws to levels of sub 6.0% in a sustainable manner. The central bank has also acknowledged that "EMEs (like India) are facing a rapid tightening of external financial conditions, capital outflows, currency depreciation and reserve losses simultaneously" and such headwinds also merit strong policy action.

Since the April-22 policy meeting, RBI has clearly shifted its focus on inflation management by doubling down on its efforts to address increasing price pressures with the aim of pulling down CPI inflation within its target range (2%-6%) while also fostering macroeconomic stability.

As regards the growth outlook, RBI has highlighted that the overall growth signals are currently positive which is also borne out by our AMEP (Acuité Macroeconomic Performance) index. What perhaps gives the central bank added confidence on the resilience of the economy, is the increased credit growth which has climbed to 14.0% as of July'22 as compared to 5.4% a year back. Accordingly, it has retained its existing real GDP forecast at 7.2% for FY23 which is slightly lower than our forecast which remains pegged at 7.5% at the current juncture. Nevertheless, we believe mild downside surprises to growth (if any) is unlikely to sway the MPC from its inflation objective as of now.

While the headline CPI inflation trajectory has shown some signs of moderation over the last two months (May-Jun'22), it remains well over 6.0%, the outer band of the MPC target. Understandably, RBI continues to have concerns on the second order effect of persistently high inflation, the significant impact of high global crude oil prices and importantly, the additional factor of "imported inflation" due to the sharp depreciation of the rupee. This is reflected in retention of the previous inflation forecast of 6.7% for FY23 despite the likelihood of a reasonably good monsoon and visible moderation in commodity prices induced by the emerging risks of a global slowdown.

However, we believe that the inflation trajectory is set to move downwards over the next few months unless there are "surprises' on the kharif output or any fresh geo-political risks. While we continue to peg the average CPI inflation print for FY23 at 6.5%, we see an increasing downward bias there given the commodity price trends (except crude) and the steps being taken by the government to control prices of household items such as cereals and edible oil.

Surplus liquidity in the banking system, as reflected in average daily absorptions under the LAF (both SDF and variable rate reverse repo auctions), has dropped to an average of Rs 3.8 lakh Cr during June-July 2022 from Rs 6.7 lakh Cr during April-May. Further, high tax and capital outflows led to a sharp spurt in all money rates towards the end of July and to alleviate the liquidity stress, the RBI conducted a variable rate repo auction of Rs 50,000 Cr of 3 days maturity on July 26, 2022. This indicates that RBI will not allow any tightness in the liquidity scenario that may make short term rates volatile; as mentioned in the MPC statement "RBI will remain vigilant on the liquidity front and conduct two-way fine-tuning operations as and when warranted – both variable rate repo (VRR) and variable rate reverse repo (VRRR) operations of different tenors, depending on the evolving liquidity and financial conditions." Notably, RBI has not alluded to any further hike in CRR after the 50 bps hike in May-22.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "RBI continues to remain focused on addressing inflation risks and has already raised the benchmark rate by 140 bps over the last 3 months, in line with the expectation of front loading of rate hike in the current fiscal. While there is a scope of another 50-60 bps of rate hike in the current year, the pace of the residual hike will depend on the inflation print over the next few months. RBI's rate hike action is not only based on the continuing inflation concerns but also on the sharp rate hikes by the developed economies which has induced high capital outflows and increased pressures on the rupee.

The rate hike implies further and higher rate increases in consumer loans as well as deposit rates. We expect bank deposit and lending rates to rise by 50-100 bps over the next 1-2 quarters given the increase in the benchmark rates as also the higher growth in bank credit."

Annexure

Chart 1: Headline inflation trajectory gradually on its way down

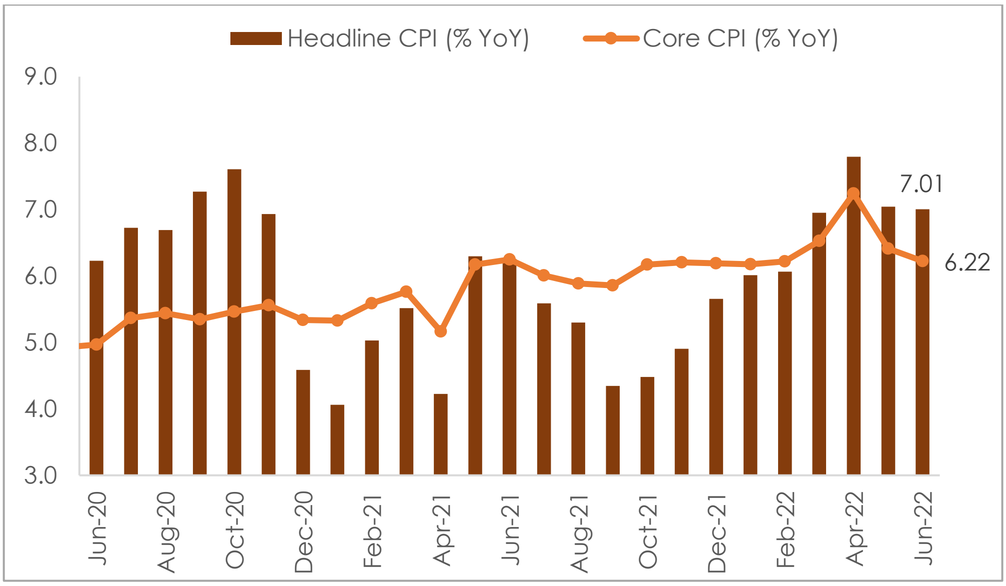
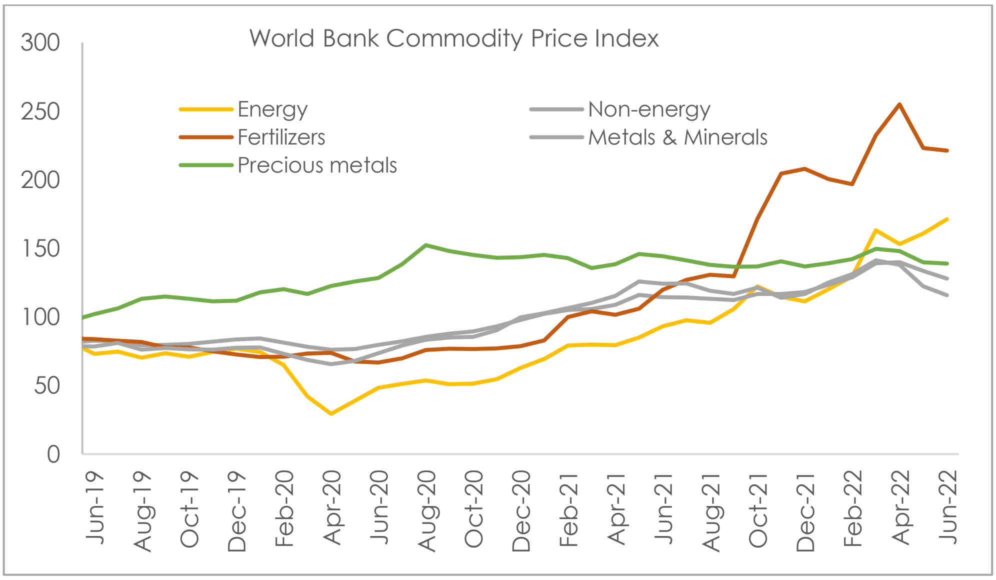


Chart 2: Global commodity prices record some moderation



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