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Press Release

RBI frontloads rate hike amid increased inflationary headwinds

Consumer loans set to get costlier by 100 bps over the next few months

08 June 2022

Against the backdrop of accentuated inflationary pressures, the RBI, in line with our expectations, frontloaded its policy normalization path by hiking the repo rate by 50 bps taking it to 4.9%. Consequently, the standing deposit facility (SDF) rate also stands adjusted to 4.65%; and the marginal standing facility (MSF) rate to 5.15%. Clearly, RBI is gradually moving away from its accommodative stance to a more neutral approach with MPC clearly stating that it would now "remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". In our opinion this forward guidance, would give the RBI more liberty to take further action on the policy rate that may be warranted based on the evolving inflation-growth dynamics.

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. However, we believe mild downside surprises to growth (if any) is unlikely to sway the MPC from its inflation objective as of now.

RBI has acknowledged the serious and persistent nature of the current inflation trajectory through its revised CPI forecasts which is projected to persist above the upper tolerance threshold of 6% in the first three quarters of FY23. With an expectation of normal monsoon and assumption of crude oil price averaging at USD 105 pb in FY23, it now expects inflation in FY23 to be sharply higher at 6.7% in FY23 from 5.5% in FY22. This forecast takes into account the latest government measures in the form of excise duty and import duty cuts which is expected to moderate the print by 20-40 bps. As per the latest RBI survey on inflation expectations undertaken after the excise duty cuts, household inflation expectations declined significantly by 190 bps in the three months scenario and 90 bps in one year scenario. Notwithstanding these positive developments, RBI expects steady upside risks to inflation to emanate from persistent rise in commodity prices, revisions in electricity tariffs across many states, high domestic poultry and animal feed costs, continuing supply chain bottlenecks along with rising pass-through of input costs to selling prices in the manufacturing and services sectors.

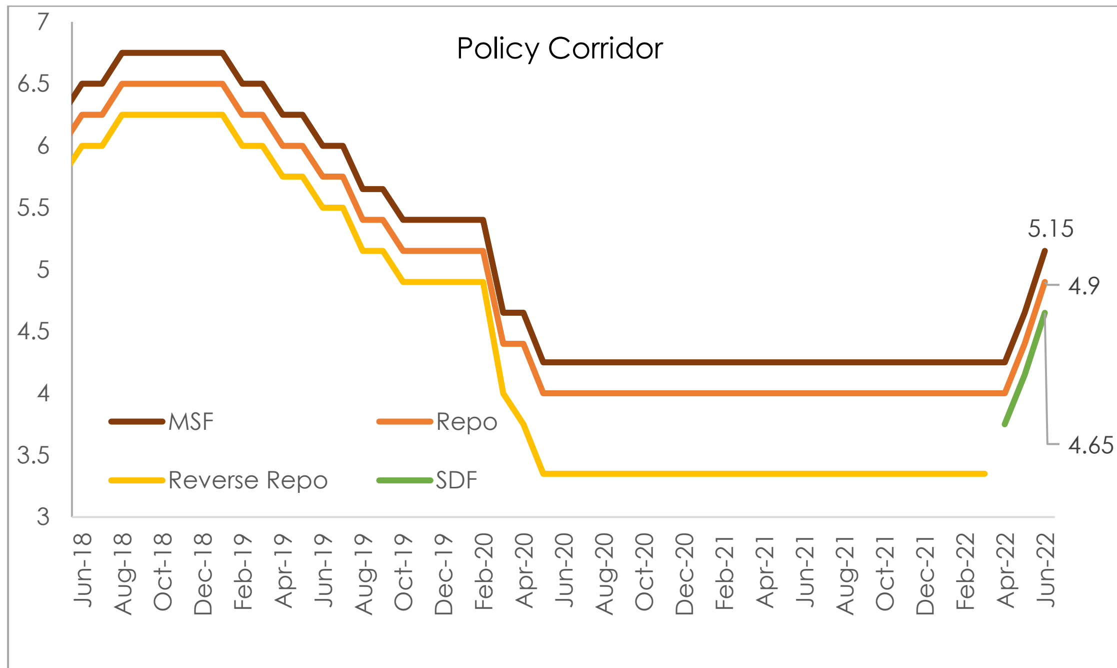
As per our inflation model, in the base case assumption, headline CPI inflation is likely to average at 6.5% in FY23. This forecast factors in the government measures including the domestic wheat export ban along with reversal of export ban on edible oils by Indonesia and prospects of a normal monsoon that will help in moderating the food price pressures in FY23. It also anticipates further duty cuts by both the central and the state governments to moderate the impact of increased commodity prices like crude oil. However, we do acknowledge risks to our estimate to stem from the unusually high degree of volatility in global commodity prices especially crude oil prices which are currently hovering close to USD 120+ pb.

As regards growth prospects, RBI has not made any revision to its earlier forecast of 7.2% which is slightly lower than our forecast of 7.5%. RBI expects support to growth from improving manufacturing capacity utilization levels, expanding vaccination coverage, healthy pick-up in contact intensive sectors, budgetary thrust on public capex, and the rollout of manufacturing incentives in the form of PLI Scheme. However, there are downside risks which emanate from sharp escalation in geopolitical uncertainty and the accompanying surge in global commodity prices, tightening of global financial conditions, persistence of supply side disruptions, and weakening of external demand.

On liquidity front, RBI is likely to continue with its surplus liquidity accommodation over a multi-year time frame and ensure availability of adequate liquidity to meet the productive requirements of the economy. As per the recently released RBI report on Currency and Finance, the central bank articulated that every percentage point increase in surplus liquidity above 1.5% of NDTL causes average inflation to rise by 60 bps in a year. While announcement of CRR hike by 50 bps in May-22 along with improvement in credit growth and capital outflows has led overall surplus system liquidity to ease from INR 5.4 trn in May-22 to INR 3.1 trn (2% of NDTL) currently and has brought liquidity in a comfortable range to manage inflationary concerns, further CRR hike cannot be ruled out as the core liquidity (system liquidity + government cash surplus with the RBI) still remains above INR 6+ trn. Going forward, there could be further rise in system liquidity as the government expenditure picks up.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "With the MPC clearly decisive in addressing inflation risks, we expect the RBI to raise repo rates by a cumulative 150-200 bps in FY23 taking the repo rate in the range of 5.5%-6.0% in FY23, well above the pre-pandemic level of 5.15%. Clearly, the need for further front loading of rate hikes has been highlighted by RBI through its forecasts for quarterly CPI inflation which is set to remain above 6.0% for consecutive 4 quarters. The front loading of rate action will also continue to be in sync with the aggressive monetary policy normalization in several countries, led by the US. Nevertheless, the extent of the subsequent hikes will depend on the inflation print over the next few months, the performance of the monsoon and its impact on the food prices as also on the effectiveness of the price control measures taken by the government. The rate hikes imply further and higher rate increases in consumer loans as well as deposit rates. By Dec-22, we expect retail home loan and bank deposit rates across all categories to rise by at least 100 bps from the current levels, translating to an increase of at least 15% for home loans EMIs. We expect the central bank to rely on various monetary tools to support yields and ensure an orderly completion of government's record high borrowing program in FY23."

Chart 1: The tide has turned on rates, cumulative 90 bps repo rise within a month



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