Press Release

Biting the bullet: RBI prioritizes inflation over growth

Signals an impending change in monetary policy and rise in interest rates

8 April 2022

In the first monetary policy review for the new fiscal year, RBI has, rather a little unexpectedly, significantly altered the narrative prevailing over the last two years and brought in a hawkish tone to signal an exit from its ultra-accommodative policy, given the visibly increasing risks from the inflationary headwinds that has been aggravated by the ongoing Russia-Ukraine conflict.

While RBI maintained status quo on the repo rate at 4.0%, it rephrased its stance stating that "the MPC has decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth". In another interesting move, while the fixed reverse repo rate has been kept unchanged at 3.35%, the RBI has introduced the 'Standing Deposit Facility' (SDF) at 3.75%, which will now effectively serve as the floor for the LAF corridor. With the existing MSF rate at 4.25%, the RBI has restored the LAF corridor to 50 bps. The introduction of SDF is expected to increase the flexibility of the RBI to absorb liquidity, as its not constrained by the availability of collateral.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "The introduction of SDF at 3.75%, in essence tantamount to an increase in the reverse repo rate by 40 bps since the latter tool is likely to get defunct. In our opinion, the MPC statement indicate the impending rise in repo rate over the next 1-2 policy meetings and may trigger a moderate hike in banks' deposit rates that have already seen an upward revision of 10-15 bps from Feb-22."

Form macroeconomic standpoint, while RBI derives comfort on food inflation from record high rabi harvest along with prospects of a normal monsoon in FY23, it expects additional pressure on prices of pulses, edible oils and fertilizers due to the conflict in Ukraine. This is over and above the primary inflation risk accruing from the sharp surge in crude oil prices along with its steady passthrough to the retail consumers over the last 2-3 weeks. Expectedly, the RBI has now revised its FY23 inflation forecast upwards from 4.5% in Feb-22 policy meeting to 5.7%, on the assumption of crude oil averaging at USD 100 pb in FY23. We, however, attach a mild upward bias to RBI's inflation forecast given the low likelihood of any material cool down in crude oil and other commodity prices within a short period. Accordingly, we expect inflation to average at 5.9% in FY23. With inflation risks now getting skewed sharply upwards, RBI Governor acknowledged that inflation control was a higher priority for the MPC as compared to growth, in its post policy meeting conference.

Given significant layers of uncertainties injected due to the raging conflicts between Russia and Ukraine, the RBI also revised its growth forecast downwards to 7.2% for FY23 from 7.8% expected in the previous policy meeting. Nevertheless, RBI expects the ebbing of Covid risks, robust vaccination coverage, prospects of robust rabi output, pick-up in contact intensive services sector along with government's thrust on infrastructure segment to support growth momentum in FY23.

In order to facilitate the absorption of the increased government borrowings in the current fiscal, RBI has also decided to enhance the present limit under Held to Maturity (HTM) category from 22% to 23% of NDTL for an additional period of one year i.e. up to Mar-23. The HTM limits are subsequently, proposed to be restored from 23% to the pre-pandemic level of 19.5% in a phased manner starting from the quarter ending June 30, 2023. Further, given RBI's stated stance for orderly evolution of the yield curve and to support smooth completion of the government's huge borrowing programme, RBI did mention that it will deploy various instruments which are likely to include OMO and Operation Twist (OT).

In a policy normalization cycle, central bank's ability to support the bond market aggressively through OMO purchases remains limited. Nevertheless, given the higher supply scenario and the potential lower demand from FPIs due to the rise in interest rates in the developed economies, it may be imperative for RBI to cool down any potential heating up of the bond market which can push up 10 yr g-sec yields to 7.50% by Mar-23. Interestingly, any intervention in the forex market by RBI may create necessary space for undertaking OMOs in the domestic market.

Adds Suman Chowdhury "Given the tone of urgency in RBI's statement to signal the altered inflation-growth dynamics, we expect the change in stance from accommodative to neutral to happen as early in Jun-22, followed by a cumulative 50 bps hike in the repo rate in the rest of FY23 (likely to begin from Aug-22)."

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