Acuite
RATINGS & RESEARCH

Press Release

RBI continues its protracted battle against inflation

50 bps rate hike for the third time in a row, growth forecast slightly reduced to 7.0%

30-Sep-2022

Against the backdrop of persistent inflationary pressures and aggressive monetary policy actions taken by the global central banks, the RBI, in line with our expectations, has raised repo rates by 50 bps to 5.90%. This marked the third consecutive 50 bps hike, taking the cumulative rate hike to 190 bps since May-22. Consequently, the standing deposit facility (SDF) rate also stands adjusted to 5.65%; and the marginal standing facility (MSF) rate to 6.15%. What is noteworthy is that RBI has decided to remain focused on "withdrawal of accommodation" instead of revising the stance on "neutral", indicating a stronger likelihood of a further hike in rates in the subsequent MPC meets given the significantly uncertain external environment.

With an aim to restrain the broadening price pressures, anchor inflation expectations and contain second round effects, the RBI has been doubling down its efforts to manage inflation by front-loading rate hikes. As per RBI's projection, inflation is likely to come above 7.0% (7.1% expected in Q2 FY22) for the third consecutive quarter before scaling back in H2 FY23 to 6.15% which is still higher than the upper MPC band. While a sense of comfort was derived from the commodity prices retracting to the pre-geopolitical conflict level, some supply-side upside risks on domestic food prices are still brewing and expected to weigh on the inflation trajectory. While the onset of winter seasonality would bring in some relief to the food prices in H2 FY23, the extension of the Pradhan Mantri Garib Kalyan Yojna (free food grain scheme) by the government for another quarter may act as an upside risk for food particularly cereal prices. Additionally, rise in services inflation amid strong demand for contact-intensive services along with the lagged pass-through of elevated input prices is expected to keep core inflation sticky at elevated level. Last but not the least, the INR depreciation of 7.4% YTD against the dollar has brought in the element of "imported" inflation. Taking into consideration these factors, the RBI has retained the inflation at 6.7% for FY23, which is in line with our forecast.

On the other hand, after a favourable base induced 13.5% Q1 GDP growth, overall economy continues to remain resilient with high frequency indicators displaying incremental strength, well into Q2 FY23. Overall, the RBI expects the industrial activity to pick up amid government's thrust in capital expenditure, improvement in capacity utilization (seasonally adjusted CU improved from 73.0% in Q4 FY22 to 74.3% in FY23), pick-up in non-food credit growth and the upcoming festivities that would buoy domestic demand. While the domestic growth momentum is expected to remain strong in H2 FY23, the GDP forecast for FY23 was revised marginally lower to 7.0% from 7.2% amidst lower than expected Q1 GDP growth by RBI.

Systemic liquidity has moderated to ~Rs. 2.3 tn during Aug-Sep'22 from Rs. 3.8 tn during Jun-Jul'22 led by advance tax payments and increasing government cash balances amid slow pick-up in government expenditure and buoyant tax collection. In the view of the moderation in surplus liquidity, the RBI has decided to now merge the 28-day

VRRR with the fortnightly 14-day main auction. Going forward, the RBI would likely be fine-tuning operations of various maturities for absorption as well as injection of liquidity from time to time, depending upon the evolving liquidity scenario. Looking ahead, we expect the surplus system liquidity to moderate further in H2 FY23 given RBI's continued FX intervention to cap rupee depreciation, pick-up in currency demand amidst the upcoming festivities along with significant improvement in the credit growth cycle with some offsetting impact emerging from pick-up in government spending that usually happens in the second half of the year. While we expect the RBI to go for additional fixed and variable rate repo auctions, the probability of RBI opting for OMO to augment liquidity is low given the monetary policy is in 'withdrawal of accommodation" mode and lower government borrowing as compared to the FY23 Union Budget. As per the latest government borrowing calendar, out of the gross borrowing of Rs. 14.31 tn projected for FY23, the Government has decided to borrow Rs.14.21 tn. Accordingly, the balance amount of Rs. 5.92 tn (41.7% of Rs. 14.21 tn) is planned to be borrowed in H2 FY23 through dated securities, including Rs. 160 bn through issuance of Sovereign Green Bonds (SGBs) as per the announcement made in the Union Budget FY23.

Since the divergence of India's inflation vis-a-vis its target is relatively moderate as compared to the other major economies, the response from the RBI is unlikely to mimic the high degree of hawkishness currently displayed by most DM and few EM central banks. Going forward, we expect the central bank to balance the growth-inflation dynamics in a nuanced manner. As such, we expect the RBI to dial down the pace of interest rates hike with a likelihood of 35 bps rate hike in the Dec-22 policy review and pause thereafter. However, this view is subject to the evolving inflation trajectory and any other external shocks and uncertainties.

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "Clearly, the key concern for RBI at the current juncture is the persistent and the sharp monetary tightening by the major central banks which the governor referred to as the "third shock" after the pandemic and the war in Ukraine. While the MPC's primary objective is to balance growth and inflation, stability in the external front and the currency is an important prerequisite towards that objective. The possibility of a further hike in Q3FY23 is also borne out of RBI's expectation that inflation will not come down in a hurry, given that they have projected an average CPI print of 6.5% in the next quarter, well above the upper MPC band.

To ensure that the monetary transmission is efficient in the current upcycle, RBI has continued to curtail the surplus liquidity in the system in Q2 and this has also been partly driven by the pickup in credit growth. While lesser liquidity been reflected in the short term interest rates, bank deposit rates have lacked the upward momentum so far. We believe that the currently large 6%+ differential between the increased credit and deposit growth is clearly unsustainable and hence, we expect a significant hike in deposit rates by banks up to 50-150 bps in H2FY23."

Chart 1: RBI raises the repo rate by 50 bps for the third consecutive time

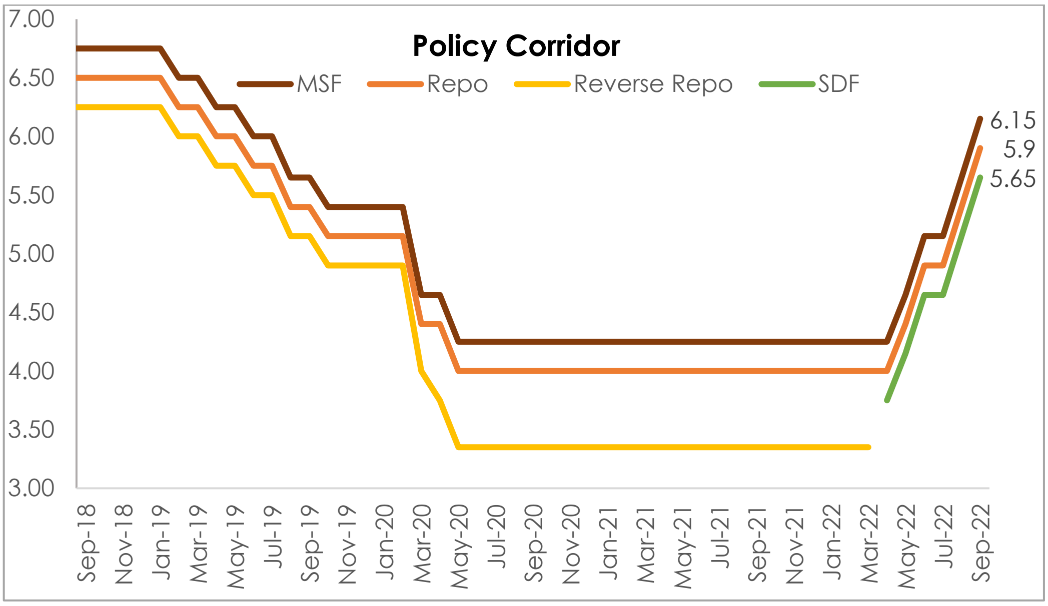
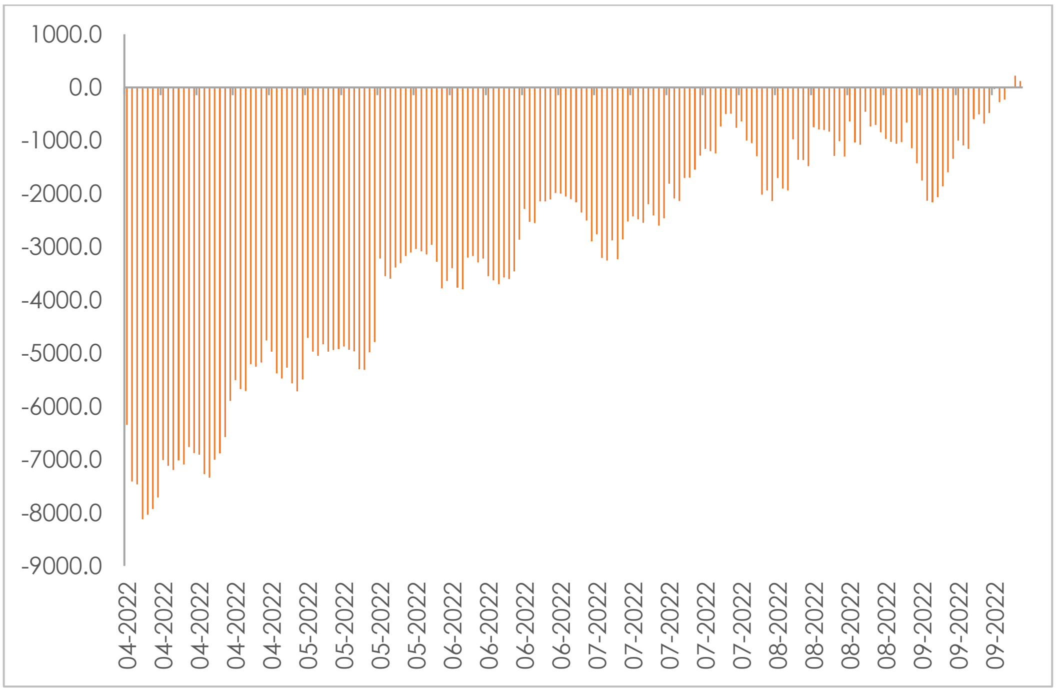


Chart 2: Banking system liquidity gradually moderates to ~Rs 2.3 tn in Aug-Sep'22



About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,200 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

Media Contact:

Sahban Kohari Ph: + 91-9890318722 sahban@eminenceonline.in

Analytical Contacts:

Suman Chowdhury Chief Analytical Officer Ph: + 91-9930831560 suman.chowdhury@acuite.in	Prosenjit Ghosh Chief Operating Officer – Subsidiaries Ph: +91-9920656299 prosenjit.ghosh@acuite.in