RBI vs Inflation: Battle Hots Up

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In a bid to contain inflationary pressures, the Monetary Policy Committee has increased the repo rate by 50 bps, taking it to 4.9%, and changed its policy stance to 'focus on withdrawal of accommodation'. The increase in repo rate was higher than our expectations of 35-40 bps. As per a poll conducted by CareEdge, only 21% of the participants expected a 50-bps hike in this meeting.

With these decisions, taken unanimously by all the six members of the MPC, the RBI has chosen to front-load the rate hikes to tackle the concerns about inflation getting broad-based and deeply entrenched in the system.

In addition, the RBI also increased the bank rate to 5.15% from 4.65%. The Liquidity Adjustment Facility corridor was maintained at 50 bps, with the Standing Deposit Facility and Marginal Standing Facility adjusted to 4.65% and 5.15%, respectively. A major takeaway from the MPC meeting on June 8 was the notable upward revision in the FY23 inflation projection to 6.7%, 100 bps higher than the earlier one, signalling the persistent nature of inflationary pressures in the economy.

Table 1: Key Policy Rates (%)

	Feb-20	Mar-20	Apr-20	May-20	Apr-22	May-22	Jun-22
Repo	5.15	4.40	4.40	4.00	4.00	4.40	4.90
Reverse Repo	4.90	4.00	3.75	3.35	3.35	3.35	3.35
MSF	5.40	4.65	4.65	4.25	4.25	4.65	5.15
SDF					3.75	4.15	4.65
Bank Rate	5.40	4.65	4.65	4.25	4.25	4.65	5.15

RBI's Outlook on Economic Growth & Inflation

Broadly in line with CareEdge's growth expectation, the RBI has retained its GDP growth projection at 7.2% for FY23, with risks broadly balanced. The central bank expects agricultural output and rural consumption to benefit from the expectation of a normal monsoon, while urban consumption would receive a boost from the revival of contact-intensive services. However, it noted downside risks to the growth outlook emerging from elevated commodity prices, rising input prices, global monetary policy tightening, weakening global growth and negative spillovers from the geopolitical tensions.

Table 2: RBI's GDP Growth Outlook (%)

	Q1 FY23	Q2 FY23	Q3 FY23	Q4 FY23	FY23
Jun-22 Outlook	16.2	6.2	4.1	4.0	7.2

The RBI has sharply raised its inflation projection for FY23 to 6.7%, 100 bps higher compared to the earlier estimate of 5.7%. It estimates inflation to be close to 7.5% during the first two quarters of FY23, and ease thereafter but remain elevated around RBI's upper tolerance level of 6%. RBI's projection is higher than CareEdge's projection of around 6.5% for FY23. We expect inflation to moderate from these high levels in the second half of the fiscal year, given the measures announced by the government and the RBI. The slowdown in global growth is also likely to help in moderating global commodity prices by the second half of the fiscal year.

Table 3: RBI's Inflation Outlook (%)					
	Q1 FY23	Q2 FY23	Q3 FY23	Q4 FY23	FY23
Revised Jun-22 Outlook	7.5	7.4	6.2	5.8	6.7
Apr-22 Outlook	6.3	5.8	5.4	5.1	5.7

Additional Measures

- Announcement of regulatory measures for co-operative banks to boost inclusive growth:
    - Limits for individual housing loans extended by Urban Cooperative Banks (UCBs) and Rural Cooperative Banks (RCBs) revised upwards by over 100% to enhance credit flow to the housing sector amid an increase in housing prices.
    - RCBs permitted to extend finance to 'commercial real estate – residential housing' within the existing aggregate housing finance limit of 5% of their total assets. This will facilitate the expansion of credit flow from the cooperative banks to the housing sector.
    - UCBs permitted to extend doorstep banking services to their customers.
- Decision on margin requirements for non-centrally cleared OTC derivatives to strengthen the resilience of the OTC derivatives market.
- Limit for e-mandate based recurring payments enhanced from Rs 5,000 to Rs 15,000 per transaction to facilitate recurring payments of larger value.
- Proposal to link RuPay credit cards to the UPI platform to expand the scope of digital payments.
- Proposal to review and make modifications to the Payments Infrastructure Development Fund (PIDF) Scheme by enhancing the subsidy amount, simplifying the subsidy claim process and other steps.

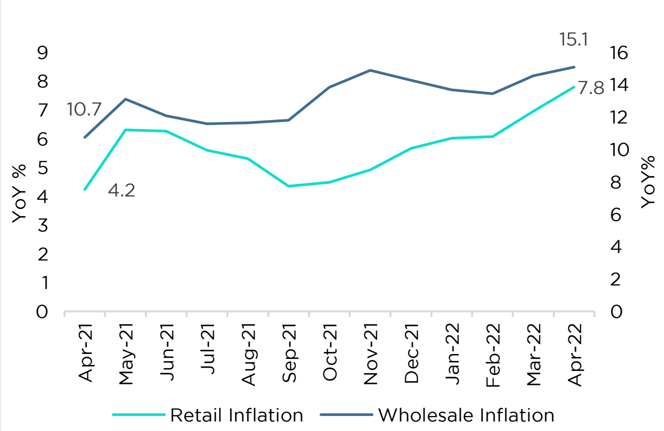
Growth-Inflation Trade-off

Domestic inflation has persistently remained high with retail inflation scaling an eight-year high in April 2022, wholesale inflation ruling in double-digits for thirteen months in a row and core price pressures hardening. Food and fuel have been major contributors to domestic inflation, with food contributing around 50% to overall inflation in the last few months. However, inflation is already getting broad-based, with rising prices for other items in CPI such as clothing, footwear, transport, communication, recreation and personal care.

On the growth front, a few indicators such as GST collections, PMIs and bank credit offtake have been showing progress. However, the GDP data for FY22 shows only a marginal improvement of 1.5% when compared with the pre-pandemic level of FY20. The manufacturing sector weakness is evident from the GDP data for Q4 FY22. IIP consumer durables and non-durables remain weak as per the latest data. The overall macro-economic scenario shows a mixed picture indicating that it is still fragile economic recovery and the Central Bank needs to be cautious.

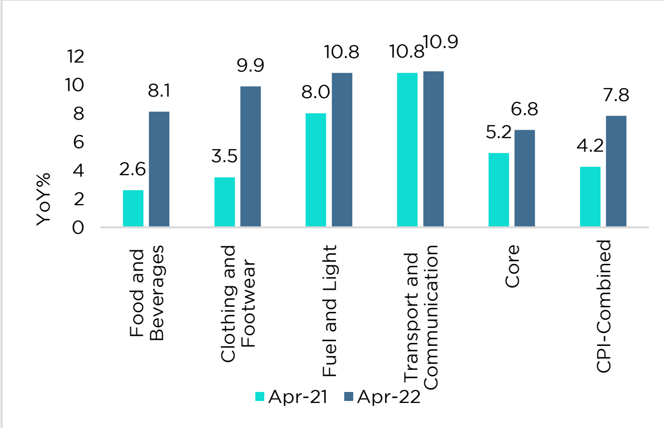
The challenge at hand for the RBI will be to manage accentuating price pressures while ensuring that the economic growth momentum is not adversely impacted. The global and domestic growth trajectory, the pace of policy tightening by the Federal Reserve, and evolving geopolitical scenario will be closely watched to determine RBI's rate hike trajectory.

Exhibit 1: Inflationary Pressures Upward Bound



Source: MOSPI

Exhibit 2: Inflation Broad-Based Across Categories

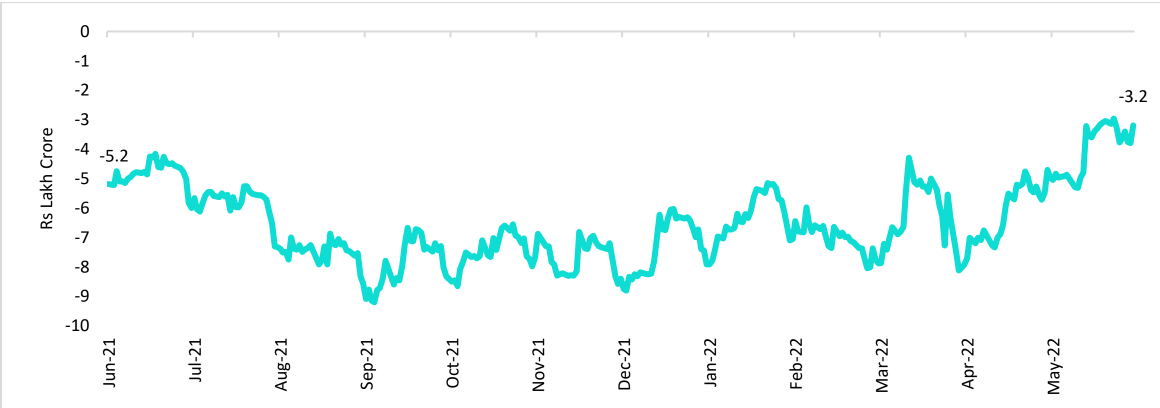


Source: MOSPI

Focus on Liquidity Withdrawal Continues

The CRR has been kept unchanged at 4.5%, following a 50-bps hike in the off-cycle meeting last month. This was in line with our expectations. There has already been a steady decline in liquidity to around Rs 3.5 lakh crore from around Rs 7 lakh crore at the beginning of the year. With India's balance of payments likely to move to a deficit in FY23 and the weakening pressure on the rupee, RBI may have to continue intervening in the forex market to reduce volatility. This is likely to keep the liquidity in the system contained, going forward.

Exhibit 3: Outstanding (Net) Liquidity Surplus Shows a Steady Decline Since April 2022



Source: CEIC Note: (+)Deficit/(-)Surplus

Way Forward

Since the off-cycle policy review last month, the RBI has raised the policy repo rate by 90 bps with a change in its stance to focus on withdrawal of accommodation. This is a testimony to RBI's commitment to step up its fight against inflation. With inflationary pressures likely to remain elevated in the near term, RBI is likely to front-load the rate hikes to anchor inflationary expectations and prevent inflation from feeding on itself. Going forward, we expect the RBI to hike the repo rate by around 100 bps in FY23 in order to move towards a positive real rate of interest. The RBI will have to walk a tightrope as it balances between anchoring inflationary expectations while keeping growth impulses intact.

Contact

Rajani Sinha	Chief Economist	rajani.sinha@careedge.in	+91 - 22 - 6754 3525
Akanksha Bhende	Associate Economist	akanksha.bhende@careedge.in	+91 - 22 - 6754 3424
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East),
Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

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