RBI RAISES REPO RATE BY 50BPS, HOPES INFLATION AND CAD TO MODERATE IN H2FY23

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The Reserve Bank of India (RBI) in its Monetary Policy Committee (MPC) meeting held on Friday announced 50 basis points (bps) hike in the repo rate to cool down retail inflation and narrow the current account deficit (CAD) which the central bank hopes to moderate in the second half of the current financial year.

The fifth hike in a row announced today took the repo rate to 5.9 percent now from 5.4 percent earlier. The continuous increase in the interest rate indicates that RBI's fight against retail inflation continues. The repo rate is the interest rate at which the central bank lends short-term funds to banks. One bps is the one-hundredth of a percentage point.

"Based on an assessment of the macroeconomic situation and its outlook, the MPC decided by a majority of five members out of six to increase the policy repo rate by 50 bps. Consequently, the standing deposit facility (SDF) rate stands adjusted to 5.65 percent, and the marginal standing facility (MSF) rate and the Bank Rate to 6.15 percent. The MPC also decided by a majority to remain focused on the withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth," said Shaktikanta Das, Governor, RBI.

The rationale behind the present repo rate hike is the global economic outlook which continues to remain bleak. Financial conditions are tightening and recession fears are mounting. Inflation continues to persist at alarmingly high levels across jurisdictions. The enduring effects of the pandemic and the geopolitical conflict are manifesting in demand-supply mismatches of goods and services. Central banks are charging new territory with aggressive rate hikes, even if it entails sacrificing growth in the near term, the RBI said.

The US dollar has strengthened rapidly to a two-decade high. Several advanced and emerging market currencies are currently facing sharp depreciation pressures. Emerging market economies, in particular, are confronted with challenges of slowing global growth, elevated food and energy prices, spillovers from advanced economy policy normalization, debt distress, and sharp currency depreciations are other factors that prompted RBI to effect repo rate hikes.

Taking these factors into account, the RBI retained India's retail inflation at 6.7 percent in 2022-23 with risks evenly balanced. CPI inflation is projected to further reduce to 5 percent in the April-June 2023 quarter. The RBI forecast September retail inflation to remain slightly above 7 percent but soften thereafter. Also, India's current account deficit stands at US$23.9 billion in August which is expected to narrow with an increase in oil exports after the government reduced the Windfall tax recently.

"Though headline CPI projections have been retained at the same 6.7 percent level, and there has hardly been any change in trajectory, yet policy tone reflects some impinging inflationary risks. First, the unanticipated food price shock, and lower showing of rice and pulses might pose threat to the forecast. Additionally, demand-pull inflation might also emanate from the economy running at full capacity and so far showing some degree of resilience. Thus, we expect headline CPI to be elevated in the range of 6.5-6.7 percent in FY 23," said Madan Sabnavis, Chief Economist, Bank of Baroda.

After two major shocks of the Covid-19 pandemic and the conflict, the world economy is witnessing a third major shock – a storm - arising from aggressive monetary policy actions and even more aggressive communication from the central banks in advanced economies. The recent sharp rate hikes and forward guidance about further big rate hikes have caused a tightening of financial conditions, extreme volatility, and risk aversion. All segments of the financial market including equity, bond, and currency markets are in turmoil across countries. There is nervousness in financial markets with potential consequences for the real economy and financial stability.

"While maintaining the CPI inflation projection at 6.7 percent for FY23, the central bank highlighted the risks to inflation due to unseasonal rainfall, elevated imported inflation, and geopolitical concerns. On the growth front, while the domestic demand is showing improvement, the central bank has very aptly highlighted the headwinds from geopolitical tensions. The RBI also lowered India's GDP growth forecast to 7 percent," said Rajani Sinha, Chief Economist, CareEdge.

Dharmakirti Joshi, Chief Economist, Crisil Ltd, said, "The repo rate hike can be seen as a response to two issues – first, persistent risks to inflation, which has remained above the upper tolerance band for eight months now, and second, spillover risks from the aggressive monetary policy stance of major central banks, especially the US Fed. An uncertain inflation trajectory, with upside risks arising from food inflation, and higher passthrough of input costs (even as international commodity prices have come down), meant the MPC retained its inflation forecast for the current fiscal. The MPC's future actions will depend on the trajectory of domestic inflation, developments in the external sector, and surprises in actions of other major central banks."

Going forward, liquidity will be crucial to watch out for. While the reduction in the banking system liquidity surplus will ensure more effective transmission of RBI's policy rate hikes, the central bank will ensure that there is enough liquidity to take care of the credit requirement. Looking at the aforementioned circumstances, another 25-30 bps repo rate hike in the current fiscal cannot be ruled out.

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