RBI Hikes Repo Rate by 50 bps, Stays on Policy Tightening Path

September 30, 2022 | Economics

The Monetary Policy Committee (MPC) of the RBI delivered a fourth consecutive rate hike as it raised the policy repo rate by 50 basis points (bps) taking it to 5.90% in the September policy meet. So far in the current rate hike cycle, the cumulative rate hike of 190 bps by RBI has taken the repo rate to the highest level since May 2019. Five of the six MPC members voted to raise the repo rate by 50 bps, while one member voted for a 35-bps rate hike. In addition to the hike in repo rate, the central bank also raised the bank rate to 6.15%. The Liquidity Adjustment Facility (LAF) corridor was maintained at 50 bps with the Standing Deposit Facility (SDF) and Marginal Standing Facility (MSF) adjusted to 5.65% and 6.15%, respectively. The central bank has retained the policy stance at 'focus on withdrawal of accommodation' reiterating its commitment to inflation control while supporting growth.

Key Policy Rates									
	Feb'20	Mar'20	Apr'20	May'20	Apr-22	May'22	Jun'22	Aug-22	Sep-22
Repo	5.15	4.40	4.40	4.00	4.00	4.40	4.90	5.40	5.90
Reverse Repo	4.90	4.00	3.75	3.35	3.35	3.35	3.35	3.35	3.35
MSF	5.40	4.65	4.65	4.25	4.25	4.65	5.15	5.65	6.15
SDF					3.75	4.15	4.65	5.15	5.65

Outlook on Economic Growth & Inflation

With lower-than-expected GDP growth of 13.5% in Q1 FY23, the RBI has lowered its GDP growth forecast for FY23 to 7% bringing it in line with our forecast of 6.8-7%. The central bank highlighted challenges from geopolitical tensions, tightening global financial conditions and weakening external demand to be the key downside risks to exports and domestic growth outlook. Despite the global headwinds, the emerging data is supportive of the domestic economy's relatively better foundation. High-frequency growth indicators such as GST collections, E-way bills, bank credit, auto sales, and PMIs have been upbeat. On the demand front, urban demand has been on the recovery path, while, rural demand story had been subdued. However, RBI expects the catching up of Kharif sowing and expectations of favourable conditions for the upcoming Rabi season to be the positives for the rural demand which is showing signs of gradual recovery. There are also signs of revival in investment, with upbeat domestic production and import of capital goods and strong credit demand. The increase in the seasonally adjusted capacity utilisation of the manufacturing sector to 74.3% in Q1 FY23, the highest level in three years is expected to bode well for fresh investments in the economy.

RBI's GDP Growth Outlook (%)					
	Q2 FY23	Q3 FY23	Q4 FY23	FY23	Q1 FY24
Aug-22 Outlook	6.2	4.1	4.0	7.2	6.7
Sept-22 Outlook	6.3	4.6	4.6	7.0	7.2

The RBI expects the CPI inflation to remain above its upper tolerance band of 6% until the third quarter of FY23 and ease thereafter. The RBI has retained its inflation projection at 6.7% for FY23, with a marginal increase in inflation forecast for Q3 FY23. RBI's inflation projection is marginally higher than our inflation projection of 6.5% for FY23. The central bank expects price pressures to remain contained on account of easing supply conditions, softening global commodity prices and timely government interventions. However, it highlighted the upside risks to the food inflation trajectory due to unseasonal rainfall translating into higher vegetable prices and lower Kharif sowing pushing up cereal prices. An increase in food inflation is an area of concern as it can negatively affect inflationary expectations. Dollar strengthening and its adverse impact on imported inflation is another area of concern. Overall given the uncertain economic environment, there is a need to be cautious on the inflation front.

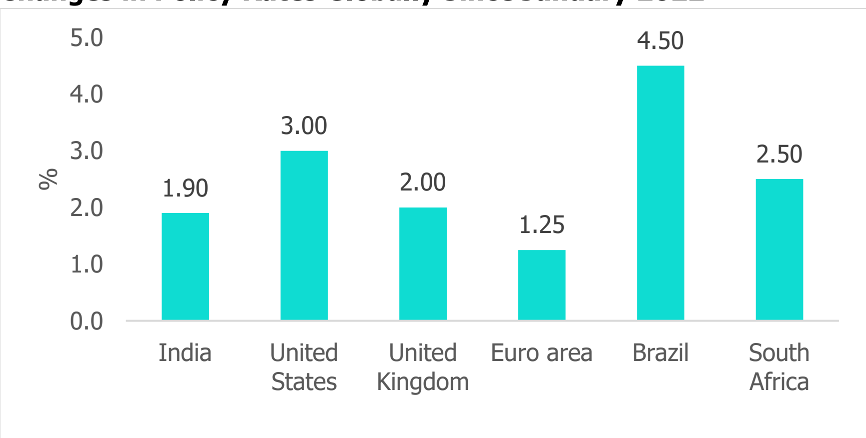
RBI's Inflation Outlook (%)					
	Q2 FY23	**Q3 FY23**	**Q4 FY23**	**FY23**	**Q1 FY24**
Aug-22 Outlook	7.1	6.4	5.8	6.7	5.0
Sept-22 Outlook	7.1	6.5	5.8	6.7	5.0

Economic Story since the August Policy Meet

The September policy meet takes place against a backdrop of emerging challenges in terms of growth-inflation trade-off, external sector vulnerabilities and liquidity management. The first quarter GDP growth print came lower-than-expected at 13.5% dragged by widening net exports. While the economy grew by a modest 3.8% over the pre-pandemic period, the output of contact-intensive sectors in trade, hotels, transport, communication and broadcasting were yet to recover to the pre-pandemic level. The CPI inflation inched up to 7% in August snapping the three-month easing trend primarily owing to higher food inflation. Inflation in food items like rice, wheat, pulses, vegetables, milk and products accelerated during the month. Core inflation remained elevated and sticky near the 6% mark with demand for discretionary items and services witnessing some strengthening. On the external front, the merchandise trade deficit ballooned to a record high of USD 68.6 billion in the first quarter of the current fiscal pushing the Current Account Deficit (CAD) to 2.8% of the GDP from 1.5% in the previous quarter. Despite some easing in the global commodity prices, the widening trend in trade deficit is likely to continue as exports weaken while imports remain upbeat.

Globally, Central banks have been tightening monetary policy since January this year in response to the high inflation levels. The latest rate hike by the US Federal Reserve marks a cumulative 3 percentage point rise in the interest rates since the beginning of 2022. Aggressive Fed tightening has led to the strengthening of the Dollar index by 18.6% on a year-to-date basis (calendar year). As a result, the currencies of major and emerging economies have been facing weakening pressure. The Rupee has depreciated by nearly 9.5% against the US Dollar since January this year forcing the RBI to step up forex market intervention to prevent excessive volatility in the currency movement. RBI forex intervention and valuation changes have resulted in a sharp drawdown in India's foreign exchange reserves by USD 88 billion during the same period. Moreover, FPI inflows have been volatile. After 9-straight months of fund outflows since October 2021 and marginal inflows in July this year, we saw strong inflows of USD 7.1 billion in August followed by moderation to USD 0.8 billion again in September.

Changes in Policy Rates Globally Since January 2022



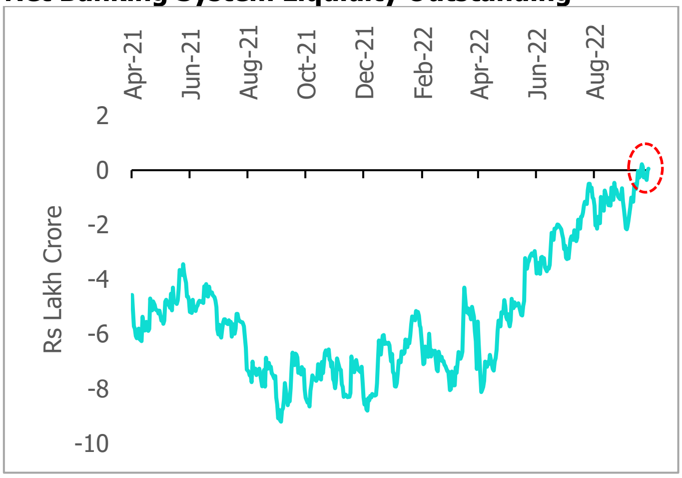
Source: Bank for International Settlements

Liquidity to be the Key Watch out in Coming Months

The banking system liquidity moved into a deficit for the first time in nearly 40 months in the second half of September, mainly due to advance tax payments and forex outflows. Liquidity condition is likely to remain pressured with higher BoP deficit, credit demand outpacing deposit growth, RBI's forex intervention and festive season currency demand. Increased government spending would ease some tightening pressure in the coming months. With the tightening liquidity conditions, the RBI would intervene as required to support the credit demand in the economy.

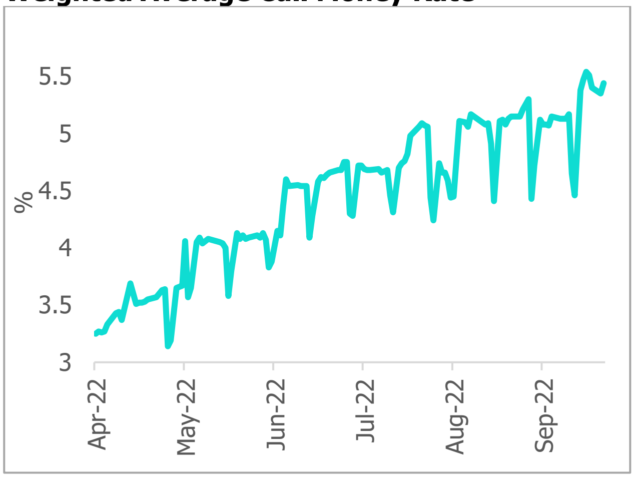
The liquidity tightening has pushed up the short-term interest rates. The weighted average call money rate has risen from 3.25% at the start of FY23 to 5.55% (closer to the repo rate) by end-September. The short end of the yield curve has been rising relatively more, resulting in a flattening of the yield curve. The spread between the 10-1 year G-Sec yield has fallen from 2.29 percentage points (pp) at the start of FY23 to 0.45 pp by end-September.

Net Banking System Liquidity Outstanding *



Source: CEIC; *(+)Deficit/(-)Surplus

Weighted Average Call Money Rate



Source: CEIC

CareEdge View

The RBI will have to walk a tightrope as it balances between inflation management while sustaining the growth impulses in the economy. Going ahead, RBI has indicated that its policy decision would be data-dependent. Given the persistent concerns on the inflation front, we feel the RBI could further hike the repo rate by 25-50 bps in the current fiscal year. Its objective would be to move towards a positive real rate of interest by the end of the fiscal.

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