8 Apr 2022

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Inflation back in focus

RBI has kept the policy rates unchanged and is tilted towards what may be called a hawkish view as it has rephrased its accommodative stance while keeping it unchanged. Amidst the escalated concerns over geopolitical conflict and surge in global commodity prices; inflation forecast has been revised upwards and growth projections are revised downwards across all quarters for FY23. RBI"s forecasts are now 7.2% for GDP and 5.7% for inflation. We expect inflation at 5.5-6% and growth at 7.4%-7.5% in FY23. RBI has announced SDF with the objective to manage liquidity and will serve as the floor rate for LAF corridor at 3.75%. There will be a gradual and calibrated withdrawal of surplus liquidity measures over a multi-year period. We expect Repo Rate hike of at least 50 bps in FY23.

RBI in its 1st meeting for FY23 has unanimously voted to keep the policy rates unchanged in line with expectations. The impact of the same can been seen on lending and deposit rates:

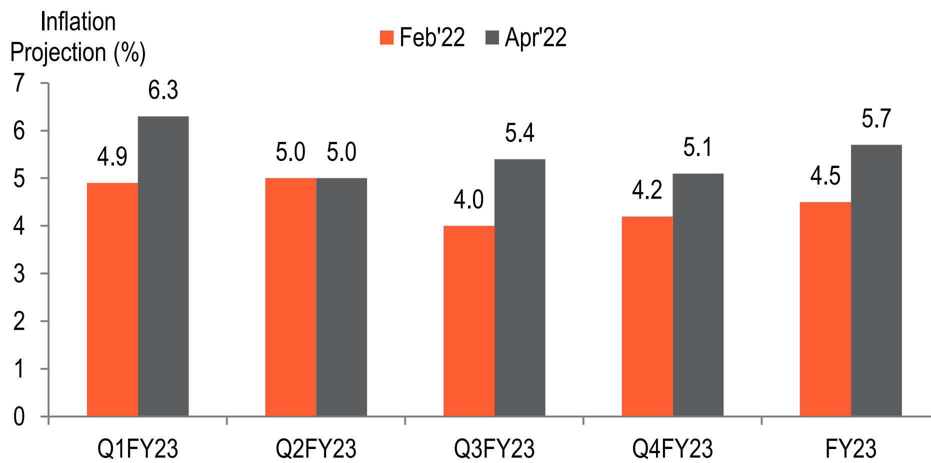
Lending rate: Since the onslaught of the Covid-19 pandemic, MPC has been proactive to support growth and keep inflation in check. Both the policy rates were last reduced in May'20 with repo at 4% and reverse repo at 3.35% and has since been kept at the historic lows. The loans linked to MCLR are likely to enjoy the ultra-low rates for an extended period, making the environment conducive for reviving and fostering demand. Though, there are expectations of upward pressure to emerge in the coming months with expectations of rate hike as early as Q1FY23.

Deposit rates: Recently with few banks announcing rise in FD rates, deposit accretion is likely to pick pace.

Hawkish moves: MPC while reiterating its accommodative stance has also rephrased with focus on withdrawal of accommodation as it ensures inflation remains in target with continuous support to growth.

Upside risk to inflation: MPC has revised the inflation projection upwards on the back of the evolving geopolitical tensions and its impact on overall global commodity prices. The Committee noted it remains watchful as it continues to monitor as elevated global price pressure in food items including edible oils, is expected to result in global supply shortages. These disruptions will add to input cost pressure too. Against the above backdrop along with assumption of normal monsoon and crude at US$100/BBL, MPC has revised its forecast to 5.7% in FY23 (4.5% previously), for Q1FY23 to 6.3% (4.9% earlier), Q2 at 5%, Q3FY23 and Q4FY23 at 5.4% and 5.1% respectively. We expect inflation 5.5%-6% in FY23.

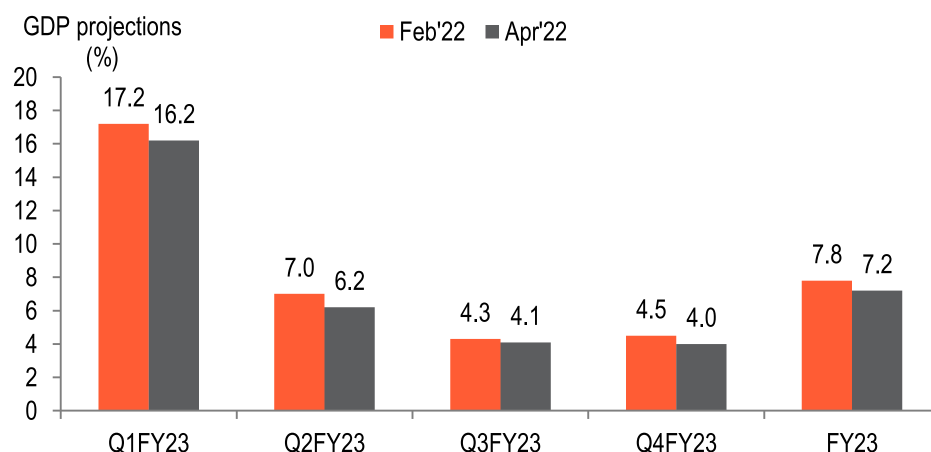
Fig: 1 Changes in Inflation projections through the last 2 policies



Inflation revised: MPC has changed its quarterly forecasts in the upward direction for FY23. Q1 and Q3 have witnessed the highest deviation in forecasts. For Q2 the forecasts remain unchanged.

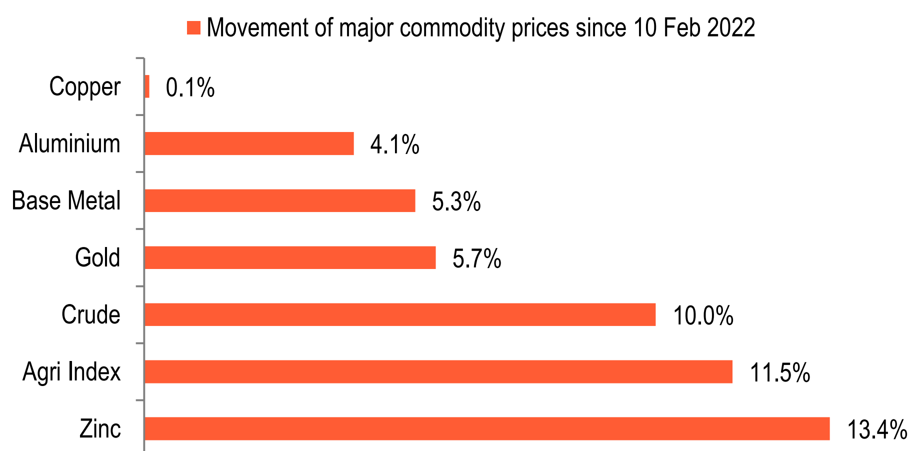
Growth revised: MPC noted domestic economy has been showing signs of recovery as has been reflected by high frequency indicators including domestic air traffic rebounding in Mar'22 along with buoyancy in merchandise exports. Expectations of higher Rabi output bodes well for rural demand. Private investment activity will be boosted further with Government schemes such as PLI. However, there has been tectonic shifts in macroeconomic environment since the last meeting (Feb'22). This is on the back of uncertainty in the ongoing geopolitical framework, along with tightening global financial conditions and surge in global crude and commodity prices are likely to impede growth outlook. Accordingly, RBI lowered its growth forecast downwards to 7.2% for FY23 (7.8% in Feb'22), Q1FY23 at 16.2% (from 17.2%), Q2FY23 at 6.2%, Q3 and Q4FY23 at 4.1% and 4% respectively. We expect growth at 7.4-7.5% in FY23.

Fig: 2 Changes in GDP projections through the last 2 policies



Global commodity prices have registered an uptick with prices of certain commodities inching up by double digit, including crude (+10%), agri index (+ 11.5%) and zinc (+13.4%).

Fig: 3 Since last policy, prices of major commodities remained elevated, despite recent correction



Liquidity management: RBI has indicated that given the current macro-economic conditions and tightening by other major global central banks, RBI's response will also be "pre-emptive and re-calibrated dynamically to the evolving outlook". Currently, RBI manages liquidity in the system through Variable Reverse Repo Rate (VRRR) and Variable Repo Rate (VRR) auctions. These tools will continued to be used. Policy also confirmed that in order to avoid market shocks, RBI had been absorbing ~80% of the liquidity at rates close to Repo Rate (4%) through VRRR. Thus, normalization of LAF corridor to 3.75-4.25% (50bps; at pre-Covid-19 levels) has been along the expected lines.

To further manage liquidity, RBI has introduced a new tool, SDF (Standing Deposit Facility) or standing absorption facility. This will act as the floor of the LAF corridor and will be set at 25bps below the Repo Rate (3.75% at present). The key difference between Reverse Repo facility and SDF is that in case of SDF, RBI has no binding collateral constraint. Upper-end of the LAF corridor will be the Marginal Standing Facility (MSF), which will be 25bps above the Repo Rate (4.25% at present). With the introduction of SDF, the usability of Fixed Rate Reverse Repo (FRRR) will decline as the rate remains unchanged at 3.35%.

In addition, RBI has also announced that there will be a "calibrated withdrawal" of the current surplus liquidity overhang of Rs 8.5 lakh crore in the system. This will done using a multi-year framework, with withdrawal starting from the current fiscal year FY23.

Our forecast on Growth and inflation: *For FY23, we have also downgraded our GDP forecasts from 7.5-7.75% earlier to 7.4-7.5% now. However, we are still more optimistic than the RBI, observing the resilience of high frequency macro indicators. Following the relaxation of Coivd-19 restriction in Feb and Mar'22, we have an improvement in the following indicators in Mar'22-railway freight, GST collections, toll collections, domestic air passenger traffic, and diesel consumption. RBI has also indicated that consumer and business sentiment surveys are showing optimism. Forecast of normal monsoon and rebound in capacity utilization (72.4% as of Dec'21 versus 68.3% as of Sep'21) are also positive for growth.*

For inflation we expect, headline CPI to settle between 5.5-6% in FY23 (against our previous forecast of 5-5.5%) and risks remain tilted to the upside. We are assuming crude to average around US$ 90-100/bbl this fiscal year.

Regulatory Developments

1) In Oct'20, RBI had rationalised the risk weights for individual housing loans by linking them only with loan to value (LTV) ratios for all new housing loans sanctioned up to March 31, 2022. *This facility has been extended to all housing loans sanctioned u pto March 31, 2023.*

2) In Oct'20, RBI had increased the limits under Held to Maturity (HTM) category from 19.5% to 22% of NDTL in respect of statutory liquidity ratio (SLR) eligible securities acquired on or after September 1, 2020. *This limit has been increased to 23% till March 31, 2023*. From Q1FY24 onwards, the limit will begin to be reduced from 23% to 19.5% in a phased manner.

3) A discussion paper on Climate Risk and Sustainable Finance will be placed by the RBI. This is due to the need for Regulatory Entities (REs) to develop and implement a sound process for understanding and assessing the potential impact of climate-related financial risks in their business strategy and operations. This would require an appropriate governance structure and a strategic framework to effectively manage and address these risks.

4) RBI has proposed to set up a committee to examine and review the state of customer service in the Regulatory Entities (REs) and adequacy of customer service regulations and suggest measure to improve the same.

5) RBI has proposed that all banks and all ATMs support card-less withdrawal facility. To encourage card-less cash withdrawal facility across all banks and all ATM networks/operators, it is proposed to enable customer authorisation through the use of Unified Payments Interface (UPI) while settlement of such transactions would happen through the ATM networks.

6) Bharat Bill Payment System (BBPS) – RBI has proposed rationalisation of Net-worth requirement for operating units (BBPOUs). The current requirement of net worth for a non-bank BBPOU to obtain authorisation is Rs 100 crore and it is viewed as a constraint to greater participation. Therefore, RBI has reduced the net worth requirement for non-bank BBPOUs to Rs 25 crore.

7) Cyber Resilience and Payment Security Controls of Payment System Operators (PSOs)-With greater adoption of digital payment modes, RBI had prescribed the necessary security controls for digital payment products and services offered by banks and credit card issuing NBFCs. Now, similar directions have been issued for Payment System Operators (PSOs).

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