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Aditi Gupta
Jahanvi
Economist

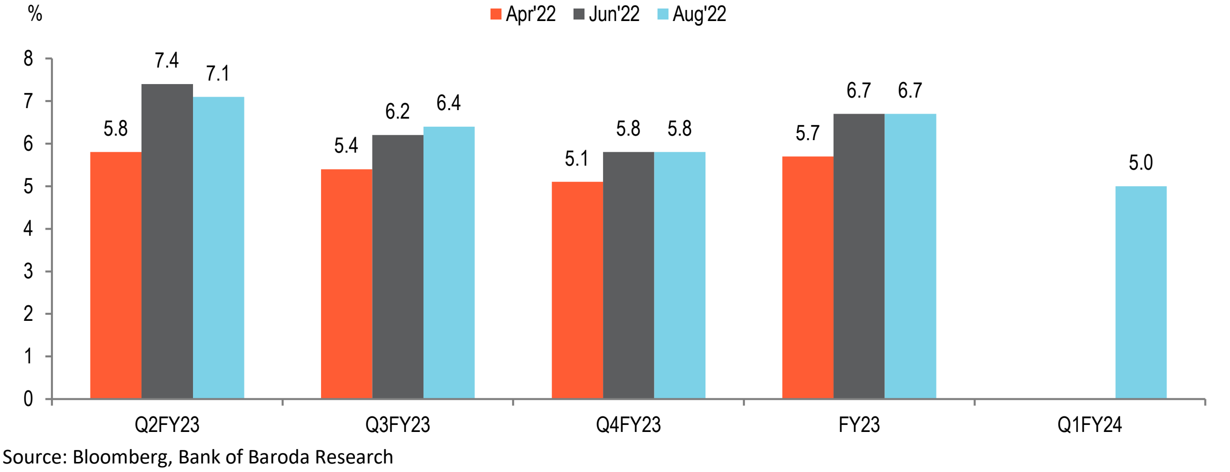
RBI front-loading rate hikes

RBI continued with hawkish policy as repo rate was hiked (3rd time in a row) by 50bps and is back to the pre-pandemic level. Elevated inflation and resilience in domestic market prompted MPC to hike rates. It also took the view that further calibrated monetary action is needed. GDP and CPI forecast for FY23 has been retained at 7.2% and 6.7% respectively. Inflationary pressures are broad based and remains uncomfortably high and above RBI's upper tolerance level. We expect another 50bps rate hike in the current cycle.

Policy decision: RBI in its current policy unanimously raised repo rate by 50bps to 5.4%. Accordingly, the upper and lower bound of policy rate stand at 5.15% and 5.65% respectively. Stance is retained and continues to focus 'on withdrawal of accommodation'. RBI will remain vigilant on liquidity

Inflation trajectory at a decisive point: RBI in the statement noted that the volatility in global market is leading to imported inflation. The spillover from geopolitical shocks have resulted in uncertainty to inflation trajectory. Global commodity, metal and food prices have eased off from recent peaks, however they still remain elevated. On domestic front, higher sowing of Kharif crops bodes well for food price outlook. The shortfall in paddy sowing is being monitored closely, even though rice stock remain above buffer norms. Secondly, RBI survey pointed to softening of cost pressure across sectors in H2. Yet, transmission of input cost pressure might create fresh price pressures. Based on these factors and assuming the crude oil price at US$ 105/bbl along with normal monsoon, inflation projection for FY23 has been retained at 6.7% in FY23. For Q2, headline CPI is expected to be 20bps higher at 6.4% from 6.2% earlier, for Q3 and Q4, the projections remain unchanged at 5.8% and 6.7% respectively as estimated earlier. The risks remain balanced. For Q1FY24, RBI expects CPI at 5%.

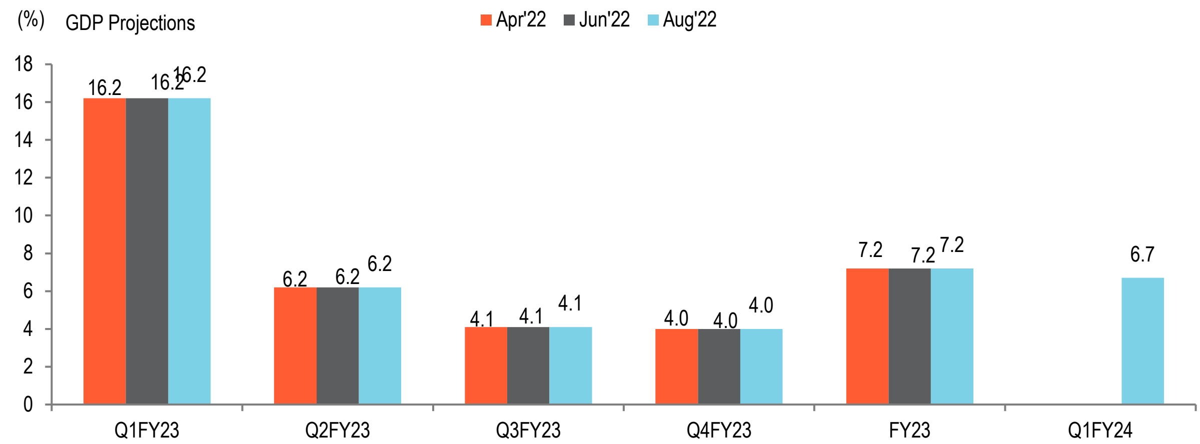
Figure 1: RBI's headline CPI forecasts



Source: Bloomberg, Bank of Baroda Research

Growth to sustain: RBI has retained its growth forecast for FY23 at 7.2%, amidst a broad-based improvement in economic activity. While urban demand is holding up well led by strong demand for contact-intensive services, rural demand is likely to benefit from a normal monsoon. Investment demand also remains strong led by improvement in capacity utilization rate, capex spending by government and a substantial pickup in credit offtake. However, global factors such as risks of recession, continued war in Eastern Europe, financial market volatility and tightening liquidity conditions remain key risks to the outlook. Overall, RBI noted that risks to the growth outlook remain broadly balanced. Notably, GDP growth in Q1FY24 has been pegged at 6.7%.

Figure 2: RBI's growth forecasts



Source: Bloomberg, Bank of Baroda Research

Liquidity measures: Following MPC's decision to hike repo rate by 50bps, the standing deposit facility rate (SDF) now stands at 5.15%. Cumulatively, in FY23 it has been raised by 180bps. The subsequent hikes in SDF rate has led to a gradual decline in systemic liquidity. However, deposit rates have also firmed up, which will improve the availability of funds with banks, amidst a pickup in credit. To maintain adequate liquidity in the system, RBI will conduct two-way fine tuning operations in the form of Variable Rate Repo (VRR) and Variable Rate Reverse Repo (VRRR) operations of different maturities.

Where our forecast stand?: We retain our headline CPI estimate at 6.5% in FY23, which is a tad lower compared with RBI's forecast. This is because softening global commodity prices will be positive for domestic inflation. With increasing risks of a global recession, commodity prices including oil are likely to remain depressed. Further, supply-side measures from the government are also likely to aid in easing inflationary pressures. We keep our growth projection at 7.2% for FY23, in line with RBI. However, given that RBI expects inflation to remain above its upper target of 6% in the next two quarters, we expect another 50bps rate hike in the current cycle.

10Y yield to hover at ~ 7.5% till RBI's next policy: While a rate hike had already been priced in by the markets, the magnitude was higher than both the consensus (35bps), and our estimate (25bps). The MPC's action signals a strong intent to tackle inflation and bring it back on track, suggesting further rate hikes. As a result, India's 10Y yield which closed at 7.16% yesterday, has risen by ~10bps and is trading at 7.26% currently. We expect India's 10Y yield to remain elevated at ~7.5% till RBI's next policy in Sep'22.

Regulatory Developments

1) With the objective to update current guidelines, adopt and incorporate global practices along with enabling Regulated Entities (REs) to have all instructions at one place, RBI has proposed to issue Master Direction on managing risk and code of conduct in outsourcing of Financial Services.

2) It has been decided to make RBI-Integrated Ombudsman (RBI-IOS) more board based and bring Credit Information Companies (CICs) under the ambit of RBI-IOS 2021. It will provide cost free alternate redressal mechanism to customers of REs for grievances against CICs. Also, in order to strengthen the internal grievance redressal of the CICs, it has been suggested to bring CICs under the Internal Ombudsman (IO) framework.

3) Standalone Primary Dealers (SPDs) have been enabled to offer all forex market-making facilities currently permitted to Category-I Authorised Dealers, subject to prudential guidelines.

4) SPDs have also been allowed to undertake transactions in the Foreign Currency Settled-Overnight Indexed Swap (FCS-OIS) markets with non-residents and other market-makers, bringing them at par with banks.

5) RBI also announced setting up a committee to analyze the need for transitioning to an alternate to MIBOR, in line with international standards.

6) On the BBPS (Bharat Bill Payment System) platform, currently over 20,000 billers and over 8 crore transactions are processed on a monthly basis. To make it more accessible, it has been proposed to enable BBPS to accept cross-border inward payments. This will facilitate NRIs to also undertake utility, education and other bill payments on behalf of their families in India.

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For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
aditi.gupta3@bankofbaroda.com
jahnavi@bankofbaroda.com