RBI POLICY

08 June 2022

Tackling inflation: a priority

RBI's hawkish policy is focussed largely on heightened inflationary concerns. It has raised policy rate by 50bps. CPI forecast has been revised upward by 100bps in FY23 to 6.7% (our est.: 6.5%). More importantly in the next three quarters, headline CPI is expected to be above RBI's upper tolerance band. However, the current policy gives clear signalling, hence market rates have also remained stable. We expect another 50-75bps rate hike in the current cycle.

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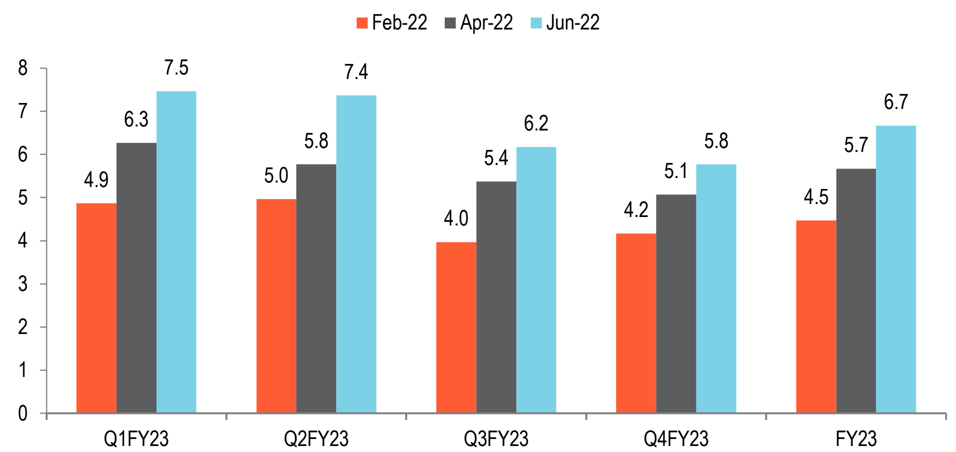
Policy decision: RBI in its current policy raised repo rate by 50bps to 4.9%. Accordingly, the upper and lower bound of policy rate stand at 4.65% and 5.15% respectively. The hawkish policy has focussed largely on elevated inflationary concerns.

Stance has also been changed focusing 'on withdrawal of accommodation'.

Inflation a growing evil: The current policy has revised inflation projection upward by 100bps to 6.7% in FY23 from 5.7% estimated earlier. The entire trajectory for FY23 has been revised upward. For Q1, headline CPI is expected to be 120bps higher at 7.5% from 6.3% earlier, for Q2, it is expected to be 160bps higher at 7.4%, for Q3, +80bps higher at 6.2% and for Q4, +70bps higher at 5.8%. The policy statement flagged significant upside risks to inflation. It highlighted 1) supply shocks emanating from adverse global factors, 2) heightened risks to food inflation from 'shortfall in the rabi production due to the heat wave'. 3) edible oil prices remaining under pressure, 4) second round pass through to pump prices on account of increase in international crude prices. Notably, in the current policy document average crude price assumption has been kept at US$ 105/bbl, which is also subject to considerable risks, considering the current run rate at ~US$ 120/bbl.

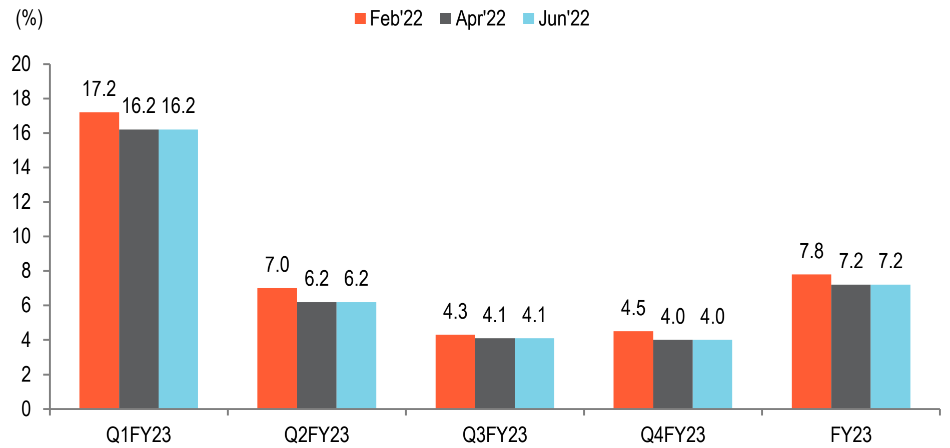
Fig 1 – RBI's headline CPI forecasts



Source: CEIC, Bank of Baroda Research

Growth to sustain: RBI has maintained its growth forecast for FY23 at 7.2%, as the MPC believes that recovery is gathering strength. High frequency indicators, such as-railway freight volumes, port cargo, air passenger traffic and GST collection have shown pick up in Apr-May'22 period. In addition, RBI believes that a normal monsoon will support rural consumption. Further, improvement in capacity utilization (74.5% in Q4FY22) and government's commitment in the FY23 budget to boost capex spending, will aid investment growth this year, also leading to healthy bank credit growth. Global demand is also expected to help our goods and services exports. However, prolonged war between Russia and Ukraine, supply chain bottlenecks and high pressure on input costs may impact margins of companies, thereby contributing to downward risks to growth. However, for now, RBI has maintained its annual and quarterly forecast for FY23.

Fig 2 – RBI's growth forecasts



Source: CEIC, Bank of Baroda Research

Liquidity measures: Standing deposit facility rate (SDF) introduced in the Apr'22 policy as the floor of LAF corridor, was set at 3.75% (+40bps). Following to May'22 policy decision this was hiked to 4.15% and after today's decision it stands at 4.65%, implying a cumulative increase of 130bps since the start of FY23. This has built upward pressure on all tenures of interest rates and reduced systemic liquidity in the system, indicating that RBI is on track for "gradual withdrawal of accommodation". However, RBI has noted there still remains an overhang of excess liquidity in the system which is keeping average overnight rates below the repo rate. On the longer-end, borrowing rates have increased and so have banks' term deposit rates, which will help banks in gathering resources to fund credit growth.

Where our forecast stand?: We have revised upward our headline CPI estimate to 6.5% from 6% earlier for FY23. Our growth projection has been retained at 7.2% for FY23. Our increase in CPI forecast hinges on a close look at the movement of international oil prices, which have increased by 15.5% since RBI'S last off-cycle May policy. Further, high frequency food price indicators (34 out of 65 items, which we track) for month of May has increased considerably. Among them, most notable ones are tomato, potato, apple, sugar etc. Thus, we expect another 50-75bps rate hike in the current cycle, to maintain price stability.

10Y yield to trade between 7.75-8% in FY23: Markets have already priced in a rate hike of higher quantum as RBI governor earlier has signalled that rate increase in a 'no brainer' in the televised interview. Thus during the current policy, 10Y yield was broadly stable between 7.47-7.5%. However, we expect India's 10Y yield to remain elevated in the range of 7.75-8%, as RBI moves towards calibrated withdrawal of liquidity.

Regulatory Developments

1) The limits for individual housing loans extended by Urban Cooperative Banks (UCBs) and Rural Cooperative Banks (RCBs-State Cooperative Banks and District Central Cooperative Banks) which were last fixed in 2011 and 2009 respectively, have been revised upwards by over 100%, on account of increase in house prices. This will enhance flow of credit to the housing sector.

2) It has been decided to allow State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs) to extend finance to Commercial Real Estate – Residential Housing (CRE-RH) within the existing aggregate housing finance limit of 5% of their total assets.

3) Urban Cooperative Banks (UCBs) have been permitted to extend doorstep banking services to their customers on par with scheduled commercial banks (SCBs).

4) The framework on processing of e-mandate based recurring payments, inter-alia, provides for an Additional Factor of Authentication (AFA) during registration, sending a pre-debit notification, subsequent recurring transactions to be executed without AFA, and an easier avenue to withdraw such mandates. Based on requests received from stakeholders to increase the limit under the framework to facilitate payments of larger value like subscriptions, insurance premia, education fee, etc., RBI has proposed to enhance the limit from Rs 5,000 to Rs 15,000 per recurring payments.

5) RBI has proposed to allow linking of credit cards to UPI. To start with, Rupay credit cards will be enabled with this facility. UPI currently facilitates transactions by linking Savings / Current Accounts through Debit Cards of users.

6) The Payments Infrastructure Development Fund (PIDF) Scheme, was operationalised by RBI in Jan'21 to incentivise the deployment of payment acceptance infrastructure (PoS, mPoS, QR codes) in tier 3-6 centres and N.E states. Under this scheme, RBI has now decided to enhance the subsidy amount and simplifying the subsidy claim process.

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