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RBI's Surprise move

RBI clearly surprised markets by going for a rather abrupt 40bps hike in policy rate, signalling withdrawal of accommodation and also hiking the CRR rate by 50bps. Bond markets reacted negatively by trading as high as 7.47% during the announcement. Stock indices too fell by 2.3% today. Clearly, today's policy gear shifted to only inflation. We expect another 50-75bps policy rate hike during the year with another increase in the June policy. We expect RBI's CPI projection to go for another round of upward revision. Our CPI forecast is at 5.5-6%, with a clear upward bias towards 6%. Next all eyes will be on Fed, which is expected to go for a 50bps rate hike.

Rate decision: RBI in its off-cycle meeting today raised policy rate by 40bps to 4.40% (since Dec'18). Accordingly, the upper (MSF, bank rate) and lower (SDF) bound stands at 4.65% and 4.15% respectively. In another unexpected move, CRR has also been increased by 50bps to 4.5% (since 24 May 2021), which will amount to liquidity withdrawal of Rs 870bn from the system.

What was the reason behind RBI's sudden move?

- Since Apr'22 policies, the major factor which was incorporated to RBI's current reaction function has been the current-Mar'22 inflation print. Headline CPI shot up to 7% (against market consensus of 6.4%).
- If we closely look at the policy document, there is clear signalling that the inflation trajectory is indeed a concern. Statements such as 1) '*Confronted by elevated inflationary pressures that have shifted the future trajectory of inflation upwards*', 2) '*collateral risk that if inflation remains elevated at these levels for too long, it can de-anchor inflation expectations*' and 3) '*Sustained high inflation inevitably hurts savings, investment, competitiveness and output growth*', are indicative of the fact that the focus has changed to inflation at the current juncture.

Below is the list of food prices which exhibited inflationary pressure. It is clear that among vegetables, tomato is posing considerable price pressure. Majority fruit items are also noticing increase in prices, so is sunflower oil. Fuel basket have also gone up considerably in Apr'22 due to consecutive increase in pump prices. All this will be translated into the Apr'22 CPI print, which is expected to above 7%.

The curious aspect of this rate hike is that it comes a month after the policy announcement where there has been only one data point available on CPI inflation for March which was 7%. Quite clearly the RBI does believe that the inflation threat is serious and as the economy appears to have settled in a stable state notwithstanding the global disturbances on balance higher inflation is a bigger threat. High inflation has the potential to affect consumption and in turn investment.

Will higher interest rates bring down inflation? We believe that it will slow down the rate of change of inflation by quelling excess demand forces. Inflation will remain elevated as long as commodity prices are high. A big increase in repo rate of 40 bps in turn had a better effect on the market from the point of view of effectiveness of policy than a 'known' 25 bps hike which gets buffered in expectations.

Higher repo rate will increase lending rates of banks which are benchmarked with this rate and hence will be beneficial. However, rising rates will not be beneficial for treasury income due to the MTM losses that have to be booked. Hence from a banking standpoint there will be opposing reactions.

Higher lending rates would also increase cost of capital and at the margin can come in the way of future investment in industries where demand is stagnant.

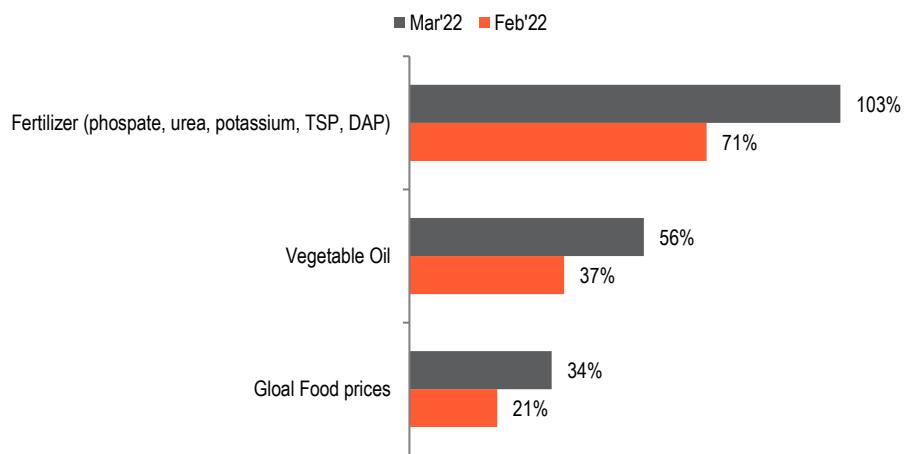
Table 1. Movement in prices of major food basket in Apr'22 over Mar'22

Retail prices of major commodities	Jan-22	Feb-22	Mar-22	Apr-22
Vegetables				
Cauliflower	-5.1%	-9.3%	-7.7%	20.4%
Ginger	0.8%	1.3%	11.0%	6.6%
Peas	-20.5%	2.3%	10.7%	30.6%
Tomato	-41.0%	-12.9%	-14.9%	19.1%
Fruits				
Banana	0.1%	8.6%	4.1%	7.8%
Guava	2.1%	15.0%	-8.3%	9.5%
Papaya	-3.7%	7.2%	0.6%	7.7%
Grapes	-8.4%	-14.5%	-7.0%	15.7%
Edible Oil				
Groundnut Oil	-4.1%	3.2%	1.7%	1.9%
Sunflower Oil	-3.9%	2.9%	9.3%	6.6%
Masur	-0.8%	0.3%	-1.3%	2.4%
Fuel Prices				
Petrol	-0.1%	0.0%	1.1%	8.3%
Diesel	0.0%	0.0%	1.2%	9.4%

Source: CEIC, Bank of Baroda Research note: Darker shade of red indicates steeper price increase

- **Other global prices** have also impacted RBI's current decision. The escalating geopolitical tension and growing supply shortage have impacted global food and fertiliser prices worldwide. This data which was released post RBI's Apr'22 policy meeting also raised considerable flag about the pass through of these prices to domestic inflation.

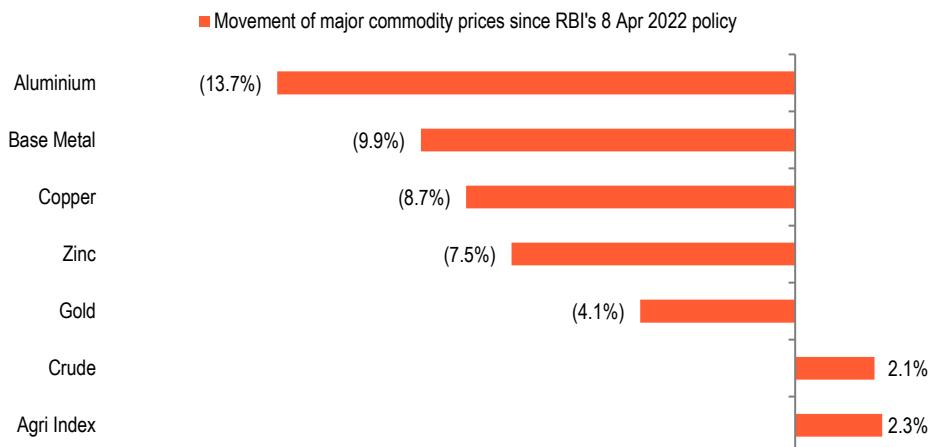
Fig 1. Movement of major global prices, on YoY basis:



Source: FAO, Bank of Baroda Research

- Energy prices still elevated: Despite recent correction in metals, gold, energy and agriculture commodity prices still remained elevated, which caused concern for RBI.

Fig 2. Movement of major commodity prices:



Source: FAO, Bank of Baroda Research

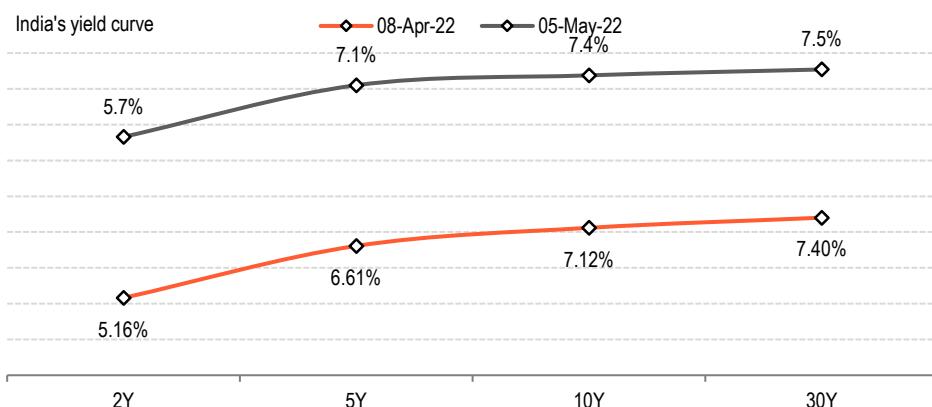
RBI slightly optimistic on growth: RBI in comparison to previous policy documents has remained slightly optimistic on growth through statements such as 1) Private consumption is regaining traction on the back of recuperating contact-intensive services and rising discretionary spending and 2) incipient revival taking place in the investment cycle. However, it agreed that the war could pose significant downside risks to growth.

Since last policy, manufacturing PMI data for India (54.7 in Apr'22 against 54 in Mar'22), exports (24.2% in Apr'22 against 19.7% in Mar'22, on YoY basis) and GST collection (Rs 1.68tn versus Rs 1.42tn in the previous month) showed activity gaining momentum.

What we interpret out of the policy:

- 1) We believe there is clearly *withdrawal of accommodation regarding the stance*.
- 2) *We expect another 50-75bps repo rate hike in FY23, in addition to the current 40bps rate hike.*
- 3) *Bond markets have already reacted adversely and during the policy announcement was trading at 7.47% (+35bps higher against its last close of 7.12%). We believe pressure on bond yields to continue and it will be in the range of 7.5-7.75% in FY23. However, firm demand at the auction and RBI's OMO purchase announcements if any, in the future will lend support.*

Fig 3. Across the board increase in yield:



Source: Bloomberg, Bank of Baroda Research

- 4) We believe our current growth forecast of 7.4-7.5% is likely to go down by further 25bps on account of the higher borrowing cost to curtail demand.
- 5) Our CPI forecast is expected to be in the range of 5.5-6%, however, risks remain on the upside and could go towards 6%.

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