Monetary policy | First cut

A tilt towards tightening

April 8, 2022

RBI keeps repo rate unchanged, but signals tighter policy ahead

The Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC) kept the repo rate unchanged and stance accommodative in today's meeting. However, it signalled at a gradual tightening in coming months, and restored the policy rate corridor under the liquidity adjustment facility (LAF) to the pre-pandemic position. The RBI seems to be preparing markets for repo rate hikes and tighter monetary policy conditions in coming months as external risks and inflationary pressures mount.

The RBI signalled its shifting focus from reviving growth to mitigating inflation risks. Upside risks to inflation show no signs of abating, with crude oil prices persisting above $100 per barrel, and food and metal prices at historic highs. Along with increasing cost pressures, we expect pressure on consumer prices to increase this fiscal. The RBI will also need to mitigate spill-overs from tightening global financial conditions, driven by the US Federal Reserve's (Fed) rate hikes and geopolitical tensions. Due to these factors, we expect the RBI to raise repo rate by 50-75 basis points (bps) in fiscal 2023, beginning with the June monetary policy review.

Highlights of the April MPC meeting

- The MPC voted unanimously to keep the repo rate unchanged at 4%
- While the reverse repo rate was maintained at 3.35%, it will be replaced by a new standing deposit facility (SDF) rate as the floor of the policy corridor under the LAF. The marginal standing facility (MSF) rate will remain at the upper end of the policy corridor. The SDF rate will permit liquidity absorption by the RBI without collateral and will be effective in sucking liquidity compared with the reverse repo rate
- The LAF policy corridor was restored to the pre-pandemic width of 50 bps. Accordingly, with the repo rate at 4%, the SDF and MSF rates stand at 3.75% and 4.25%, respectively
- While the MPC voted unanimously to retain its accommodative stance, it will now focus on "withdrawal of accommodation to ensure inflation remains within target going forward, while supporting growth"
- The MPC raised its forecast for consumer price index-linked (CPI) inflation to 5.7% for fiscal 2023 from 4.5% projected in February
- Projection for gross domestic product (GDP) growth was lowered to 7.2% from 7.8% for this fiscal
- The RBI intends to gradually withdraw the liquidity overhang of ~Rs 8.5 lakh crore persisting because of extraordinary liquidity easing measures undertaken post-pandemic
- The limit for statutory liquidity ratio (SLR) securities under held-to-maturity (HTM) was increased to 23% from 22% of net demand and time liabilities (NDTL)

What drove the RBI's decision?

- **The shock of war:** Since the February MPC meeting, the global geopolitical environment has deteriorated considerably because of the Russia-Ukraine war. Although India does not have significant trade linkages with these two economies, it is reeling under the impact of surging international commodity prices, global supply disruptions, and volatile financial conditions. For India, this has raised the upside risk on inflation and downside risks to growth

- **Rising inflation risks**: The MPC acknowledged that inflationary pressures have increased since the Russia-Ukraine war started. The two countries are major producers of a range of energy, food, and metal commodities, so the disruption in trade linked to these has caused a broad-based increase in cost pressures. After one year of double-digit wholesale price index-linked (WPI) inflation, the MPC believes input cost pressures could persist longer than earlier expected. The pass-through of cost pressures to consumer prices, while limited till now, needs to be monitored

  Significant upside is expected from elevated crude oil prices, which the MPC expects to average $100 per barrel this fiscal compared with $80 per barrel last year.

  The MPC was also worried about the impact of rising international food prices, particularly for wheat (a key export item from India), and edible oils (for which India is highly import-dependent). The agriculture sector, too, is facing rising cost pressures from rising international prices of fertilisers and animal feed. The MPC hopes normal monsoon and ample domestic food grain production to prevent a major flare-up in food inflation.

  Taking these factors into account, the RBI expects CPI-linked inflation to average at 5.7% in fiscal 2023, with 6.3% in the first quarter (Q1), 5.8% in Q2, 5.4% in Q3 and 5.1% in Q4. With this, inflation is projected to be close to the upper end of the RBI's target of 2-6%.

  The RBI's latest surveys further indicated rising household inflation expectations relative to the previous survey round. Manufacturing firms expected a rise in input costs and selling prices in the first quarter of this fiscal.

- **Gradual economic recovery**: The MPC believes the economy is on the path of recovery, given the waning impact of the pandemic. Contact-based services have begun showing increased contribution to growth. The RBI's surveys on consumer and business confidence also show an improvement. However, private consumption and investment remains subdued till date.

  Risks to economic recovery are now shifting from Covid-19 to geopolitical tensions. The MPC believes geopolitical tensions have added downside risks to growth in the wake of higher international commodity prices, supply disruptions, and financial market volatility. That said, the MPC expects growth to benefit from robust agriculture production and improving recovery in contact-based services and a pickup in investments.

  Considering these factors, the MPC expects GDP growth at 7.2% in fiscal 2023, with 16.2% in Q1, 6.2% in Q2, 4.1% in Q3, and 4% in Q4.

- **Volatile global financial conditions:** The governor noted that global financial conditions are turning volatile because of tightening monetary policies by other central banks, surging crude oil prices, and geopolitical tensions. The central bank believes high foreign exchange reserves and low external sector vulnerability will help the Indian economy tide over the impact of adverse external shocks. However, by sustaining measures to reduce excess liquidity in the domestic system, the RBI is trying to mitigate the adverse consequences of external shocks on the Indian economy.

Our view

The RBI is readjusting its policy to an environment, where inflation is becoming more persistent and external shocks are high.

The Russia-Ukraine war has amplified the cost pressures being faced by Indian producers. In the previous fiscal, CPI-linked inflation was mainly contained because of low food inflation (helped by the favourable base effect) and limited pass-through of cost pressures to core inflation (amid weak demand). We believe both factors are set to change this fiscal. Food inflation faces upside risks from surging international food prices and input costs related to agriculture. Core inflation is also expected to rise above 6% as producers increase pass-through of input costs amid improving demand conditions.

The excise duty cuts on petrol and diesel are no longer sufficient to ease fuel CPI-linked inflation, with Brent crude oil prices sustaining above $100 per barrel till date.

The RBI will also need to mitigate the reverberations from volatile global financial conditions, considering tightening monetary policies by major central banks and heightened geopolitical tensions. S&P Global expects six more rate hikes by the US Fed in calendar year 2022, including a 50 bps hike.

While low vulnerability and adequate foreign exchange reserves have cushioned the impact of external shocks on India so far, it is certainly not immune if these shocks rise further. India's vulnerability also hinges on crude oil prices since it impacts major macros, including GDP growth, inflation, the current account deficit, and rupee, and in some cases, the fiscal deficit.

Given these factors and the changing tone of RBI's policy stance, we expect a 50-75 bps hike in the repo rate in fiscal 2023, beginning with the June monetary policy review. The pace of tightening will depend on surprises emanating from inflation and external risks.

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SDF

- The RBI introduced the SDF arrangement at 3.75% in today's MPC, which allows the RBI to absorb liquidity from banks without binding collateral in return to the banks. Currently, through reverse repo, the RBI can absorb excess money within the banking system, where a bank in return of interest is offered a collateral of government securities. Moreover, access to the SDF and MSF will be at the discretion of banks, unlike repo/reverse repo, OMO and CRR, which are available at the discretion of the RBI. The SDF would help the RBI in time, when large liquidity absorption needs to be carried out without offering government securities as collateral
- The SDF will act as the floor of the LAF corridor with the MSF at the upper end of the corridor. Thus, at both ends of the LAF corridor, there will be standing facilities — one to absorb and the other to inject liquidity
- In the total overnight segment, CBLO/TREPS accounts for the majority share (78%), followed by market repo (21%) and Call (1%). However, under the LAF, the monthly average fixed reverse repo volumes have been observed at ~Rs 99,000 crore. With this announcement, the RBI gets greater flexibility of absorbing liquidity compared with fixed reverse repo

Extension of guidelines for rationalisation of risk weights for home loans

- Individual housing loans were assigned risk weighted basis ticket size and the loan-to-value (LTV) ratio before October 2020. However, based on the RBI circular dated October 16, 2020, risk weights were re-assigned only based on LTV. The initial guidelines indicated that this will be applicable to all new housing loans sanctioned till March 31, 2022. As of April 8, 2022, circular extension of revised guideline is announced by one year up to March 31, 2023

LTV ratio (%)	Risk weights (%)
<=80	35
>80 and <=90	50

- With the introduction of revised guidelines, housing loans above Rs 75 lakhs were the most benefitted as the risk weights for these loans has reduced to 35% from 50%, which, in turn, increase credit, led by lower capital adequacy requirement (due to new lower risk weights). Our assessment of the real estate scenario in the top 10 cities of India indicates that the share of under-construction units priced above Rs 1 crore is 22-25%. On the other hand, at the pan-India level, the share of housing loans priced above Rs 75 lakh constituted 20-25% of total disbursements in value terms over the past six quarters
- The country's overall housing credit outstanding loans are expected at ~Rs 24.5 lakh crore as of fiscal 2022, which increased at a CAGR of ~13% over fiscals 2016-21. CRISIL Research further expects the retail housing segment to grow at 12-14% in fiscal 2023, supported by healthy housing demand and broad-based recovery

Banking sector outlook

- Banking credit growth of 8-9% in fiscal 2022 was driven by the retail and agriculture segments, which posted double-digit growth. This was also supported by the service and industry segments, which revived in the second half of the fiscal, led by the timely intervention through government schemes such as Emergency Credit Line Guarantee Scheme (ECLGS). This drove credit flows to micro small and medium enterprises. CRISIL Research expects this growth trajectory to sustain momentum and banking credit to increase 10-12% for fiscal 2023 owing to improvement in the retail lending and wholesale verticals.

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