Monetary policy | First cut

Pre-emptive tightening

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RBI raises the repo rate and the cash reserve ratio

In a surprise move, the Reserve Bank of India's (RBI's) Monetary Policy Committee (MPC) raised policy rates by 40 basis points (bps) today, ahead of its scheduled meeting in June.

The repo rate now stands at 4.40%, the standing deposit facility (SDF) at 4.15%, and the marginal standing facility (MSF) at 4.65%.

This is the first hike since the Covid-19 pandemic began, and restores the repo rate to the April 2020 level. However, it remains below the pre-pandemic rate of 5.15% in February 2020.

The RBI also increased cash reserve ratio (CRR) requirement by 50 basis points (bps) to 4.50%. This will take out a large quantum of liquidity from the banking system, since CRR is the share of deposits banks are mandated to park with RBI. The sudden move follows a series of gradual measures to withdraw excess liquidity, starting from the use of variable rate reverse repo operations since August 2021 to restoring the policy corridor under the liquidity adjustment facility to the pre-pandemic width of 50 bps.

Mounting inflation and external risks brought forward the rate hike cycle

The sudden hike in policy rates seem to have been spurred by a sharp rise in inflation, and growing risks to financial stability from US Federal Reserve's monetary policy tightening.

- **Inflation risks are rising in a broad-based manner**: The consumer price index-linked (CPI) inflation saw a sharp rise to 7% in March, 100 bps above the upper limit of the RBI's target range of 2-6%. Since then, the drivers behind rising inflation show no signs of abating. The supply shock caused by Russia-Ukraine war has been exacerbated by China's pandemic-driven restrictions, and Indonesia's ban on edible oil exports. International prices remain elevated for food, energy and metal commodities, which will lead to higher food, fuel and core inflation this fiscal.

- In fiscal 2021, inflationary pressures came largely from food and, to some extent, core (which excludes fuel and food). Back then, fuel inflation was quite benign. Last fiscal, crude prices rose and became the new inflation driver. While core inflation rose as a consequence, the drop in food inflation offset this, so overall inflation was lower at 5.5% compared with 6.2% on-year. What makes this fiscal perturbing is, all three indicators are now firmly pointing in one direction – up.

  The MPC is rightly worried that such a broad-based rise in inflationary pressures could result in de-anchoring of inflationary expectations. In order to show its commitment to keeping inflation close to target, the MPC has opted for a sharper-than usual hike in repo rate.

- **Risks from tighter global financial conditions: The** RBI's surprise move on Wednesday came hours ahead of US Fed's announcement of its monetary policy. Market participants expect a minimum 50 bps hike in Fed rate, along with a trimming of its bond holdings. Given the persistence of high inflation, the Fed could increase the pace of tightening further. Other major advanced central banks, too, have advanced the rate hike cycle to tackle surging inflation.

  All this could mean further tightening of global financial conditions is ahead. The 10-year US treasury yield recently reached 3% for the first time since 2018 in anticipation of tighter monetary conditions.

  The RBI is worried about the impact of tightening global financial conditions on foreign capital flows and the rupee. Foreign portfolio investors have remained net sellers in India since October 2021. So far in 2022, the rupee's depreciation has been moderate at 2.6%. However, the RBI noted that India cannot remain immune to external spillovers if global financial conditions tighten significantly.

  By raising the CRR, the RBI intends to mop up excess liquidity at a faster pace, in order to show its commitment to maintaining domestic financial stability.

Our view

Today's monetary policy measures show the RBI's policy of gradual normalisation has come to an end. A sharp rise in inflation outlook for this fiscal, along with increasing pace of monetary policy tightening by major global central banks have significantly reduced the policy space the MPC had.

CPI inflation, the main target of the RBI, has remained above 4%, the mid-point of its target range, for the past 3 fiscals. Continued rise in supply shocks have imparted more persistence to inflation. Already elevated inflationary expectations are at risk of rising further, particularly on account of rising food and fuel prices.

CPI inflation averaged 6.3% in the January-March 2022, above the RBI's target range of 2-6%. The RBI forecasts inflation for April-June at 6.3%. One more quarter over the 6% mark, and the central bank would owe the government an explanation.

The RBI will also need to tighten its policy in response to adverse external financial conditions. Rising external shocks, along with weakening domestic vulnerability risk more capital outflows ahead. S&P Global expects seven rate hikes by the US Fed in calendar year 2022, which will be the fastest seen post 2008.

India's vulnerability has also deteriorated on account of account of high crude oil prices as it will adversely impact major macros, including GDP growth, inflation, the current account deficit, and rupee, and possibly, the fiscal deficit.

Given these factors, we expect the RBI to hike the repo rate by another 75-100 bps this fiscal. The hikes are likely to be frontloaded, given that inflationary pressures remain significantly high at present.

Impact on the banking and financial services sector

- The standing deposit facility, or SDF, was introduced on April 8, 2022, to give the RBI the flexibility to absorb excess liquidity in the short term. Since then, the average 7-day liquidity has reduced from Rs 7,307 billion to Rs 5,227 billion, indicating the SDF has absorbed ~Rs 2,100 billion of surplus liquidity.
- The increase in the cash reserve ratio by 50 bps to 4.5%, effective May 21, 2022, will suck out Rs 870 billion from the money market.
- Banks could continue increasing their deposit rates to attract funds that help them meet the expected growth in credit this fiscal.
- The increase in the repo rate by 40 bps will crank up the cost of borrowing of both, banks and non-banks.
- The impact of higher borrowing cost will be limited for banks since they hold more time deposits with an average tenure of 2-3 years for which they are paying lower interest rates than non-banks.
- Non-banks with a higher proportion of fixed-rate loans in their books will have a competitive edge in the short to medium term. That's because their cost of funds would increase relatively slowly compared with peers that have a larger proportion of floating-rate loans in their franchise. The cost of funds for such entities will increase only after the resetting of their loan rates. Further, ~55-60% of all outstanding bank loans are linked to either the marginal cost of funds-based lending rate (MCLR), or to an external benchmark (EBLR), which will help banks to immediately pass on increases in interest rate to borrowers.
- Net-net, banks should be able to leverage the current milieu better than non-banks in the short to medium term.

Analytical contacts

Dharmakirti Joshi
Chief Economist, CRISIL Ltd.
dharmakirti.joshi@crisil.com

Pankhuri Tandon
Economist, CRISIL Ltd.
pankhuri.tandon@crisil.com

Aniket Dani
Director, CRISIL Ltd.
aniket.dani@crisil.com

Vikas Solanki
Senior Research Analyst, CRISIL Ltd.
vikas.solanki@crisil.com

Media Contacts

Hiral Jani Vasani
Media Relations
CRISIL Limited
D: +91 22 3342 5916
M: +91 982003 9681
B: +91 22 3342 3000
hiral.vasani@crisil.com

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