Press Release

RBI Policy Preview Sep-22: MPC likely to raise rates by 50 bps

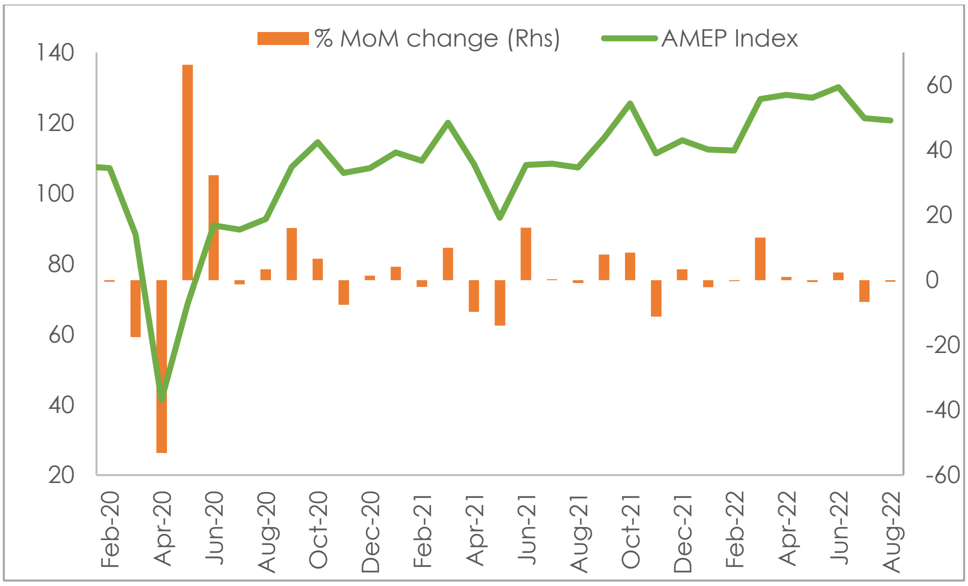
With RBI's focus on taming inflation, another 35bps rate hike possible in Dec-22

26-Sep-2022

Unnerved by persistently higher inflation, central banks across the globe have continued to press the hawkish button harder. Continuing with its path of monetary tightening, the US Federal Reserve raised interest rates by 75 bps for the third consecutive time (cumulative 300 bps between March to September) taking the policy rate to 3.0-3.25% with a view to combat the 40-year high inflation and tighten the current labour market that is causing a wage-price spiral. The dot-plot was also much more hawkish in Sep-22 that showed a 4.4% median Fed Funds rate by Dec-22 (3.4% in Jun-22) and a terminal Fed Funds rate of 4.6% next year (3.8% in Jun-22), clearly higher than market expectations. Tracking Fed's move, other central banks in the UK, South Africa, Turkey, Taiwan, Indonesia, Philippines, Hong Kong, Switzerland, Norway among a few others also joined the bandwagon to tame inflation by increasing their respective interest rates.

From domestic perspective, the overall economy continues to remain resilient with high frequency indicators displaying incremental strength, well into Q2 FY23. This is very well reflected in our **Acuité Macroeconomic Performance index (AMEP index)** that has continued to record a double-digit growth rate for the fifth consecutive month of 12.4% YoY in Aug-22 vs 20.0% in Jul-22 with services leading recovery aided by non-dissipating pent-up demand (especially in sectors such as tourism, hospitality), normalising personal mobility and an expansive vaccination coverage.

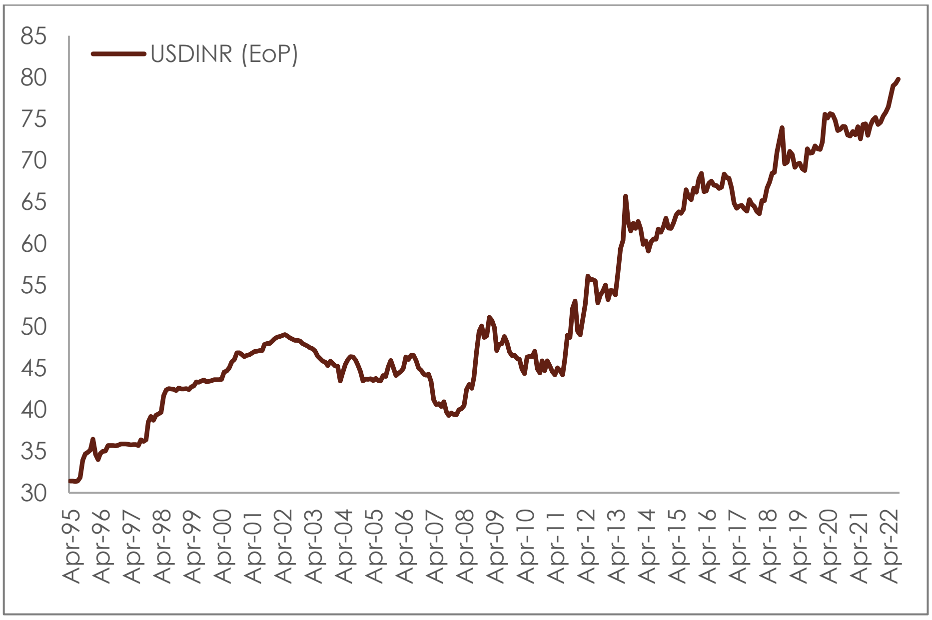
Chart 1: AMEP index continues to remain buoyant in Aug-22



On the other hand, the uptrend in inflation has propelled the RBI to hike rates by 140 bps in 2022 so far, taking the repo rate to the pre-pandemic level of 5.40% currently.

Taking into consideration food price trends, the ongoing depreciation of the rupee and the other high frequency price data, the average inflation for Q2 FY23 to likely to come in above 7% for the second consecutive quarter. While the onset of winter seasonality should bring in some relief to the food inflation trajectory in H2 FY23, the likelihood of the government extending the Pradhan Mantri Garib Kalyan Yojna (free food grain scheme) further and some drop in production of cereals in the current kharif season amid uneven rainfall distribution, may act as an upside risk for food prices. On the other hand, rise in services inflation amid strong demand for contact-intensive services along with the lagged pass-through of elevated input prices and impact of GST rate hike on certain household consumption items is expected to keep core inflation sticky at elevated level. The intensifying imported inflation amid significant rupee depreciation could outweigh the impact of the moderation in commodity prices thereby holding the headline inflation at elevated levels. With average headline CPI for FY23 expected to come in well above 6.0%, the upper tolerance threshold of RBI's inflation targeting band, the central bank is poised to continue its policy tightening approach through the next 2 quarters.

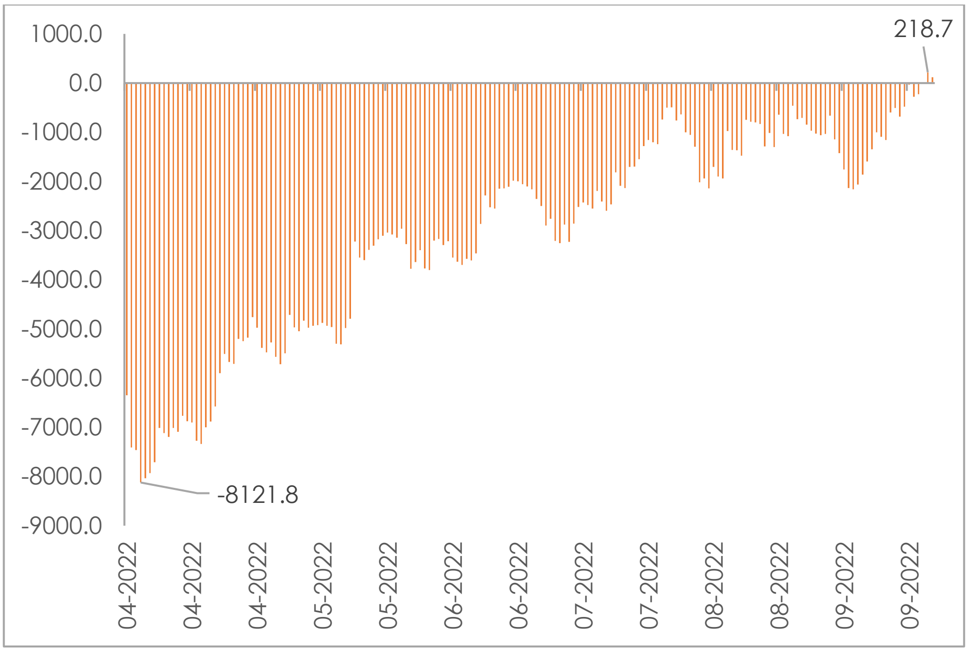
<u>Chart 2: INR is currently trading close to its weakest levels breaching 81 per USD</u>



In the current economic context, the central bank will have to balance the growth-inflation dynamics carefully wherein it is expected to engineer a soft-landing by tackling the price gains while trying to ensure that the growth impulses remain alive. Accordingly, we expect one more rate hike of 50 bps in the upcoming policy review. Subsequently we expect the RBI to begin dial down the pace of interest rates hike with a likelihood of a modest 30-35 bps rate hike in the Dec-22 policy review and pause thereafter. However, this view is subject to the evolving inflation trajectory and any other upside surprises from inflation perspective.

We also note that the banking system liquidity has also slid into deficit after remaining in surplus for over 40 months squeezed by advance tax payments and increasing government cash balances amid slow pick-up in government expenditure and buoyant tax collection. This liquidity squeeze in the banking system nudged up the overnight inter-bank rate above the policy repo rate of 5.4% prompting the RBI to conduct a Rs. 500 bn Variable Rate Repo (VRR) auction of one-day tenor under Liquidity Adjustment Facility. Looking ahead, we expect the liquidity to come under some pressure in H2 FY23 given RBI's continued FX intervention to cap rupee depreciation, pick-up in currency demand amidst the upcoming festivities along with the significant rise in credit growth seen in the current quarter. While we expect the RBI to go for additional fixed and variable rate repo auctions, the probability of the RBI opting for OMO to augment liquidity is low given the monetary policy is in tightening mode. Additionally, with the liquidity shrinking gradually, the RBI could decide to change the formal policy stance from accommodative to neutral.

Chart 3: Banking system liquidity slides into deficit after nearly 40 months



Note: Negative figures denote surplus and positive figures denotes deficit

Says Suman Chowdhury, Chief Analytical Officer, Acuité Ratings & Research "The narrative for the upcoming MPC meet will not just be driven by the concerns on the inflationary trajectory but the sharply rising interest rates in the developed economies that continues to have an impact on the INR and India's foreign exchange reserves. Given the expected trajectory of interest rates particularly in the US, the likelihood of another 50 bps hike by the MPC in Sep-22 meet has clearly increased. With higher demand for credit in the banking system, the pace of monetary transmission of higher interest rates is also likely to pick up in H2FY23. This will also start reflecting in a quicker uptick in bank deposit rates."

About Acuité Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 9,200 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in Kanjurmarg, Mumbai.

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