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ICRA COMMENTS ON RBI'S JUNE 2022 MONETARY POLICY MEETING

MPC delivers front-loaded repo rate hike of 50 bps; further rate hikes clearly on the cards

June 2022

HIGHLIGHTS

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In a unanimous decision, the MPC raised the policy repo rate by 50 bps to 4.90%

The committee raised its inflation projections for FY2023 quite sharply to 6.7% from 5.7% earlier

We foresee further rate hikes of 35 bps and 25 bps in the August 2022 and September 2022 policies, respectively

After the 40 bps rate hike in the off-cycle policy meeting in May 2022, the Monetary Policy Committee (MPC) voted unanimously to raise the policy repo rate by 50 bps while remaining focused on withdrawal of accommodation, in its second scheduled Bi-monthly policy review meeting for FY2023. The rate hike was slightly more front-loaded than our expectation of a 40 bps increase, with the focus on keeping inflationary expectations anchored and restraining a broadening of price pressures. The MPC revised its inflation projections for FY2023 upwards quite sharply by 100 bps to 6.7%, similar to our projection of 6.5% (with an upward bias), with a larger revision in H1 FY2023 vis-à-vis H2 FY2023, while highlighting that there was considerable uncertainty around the inflation trajectory. Growth projections, however, were retained at 7.2%, in line with our forecasts. The RBI Governor stressed that the repo rate remains below the pre-pandemic level, clearly signaling that more rate hikes lie ahead. We anticipate additional policy rate hikes of 35 bps and 25 bps, respectively, in the August 2022 and September 2022 policy meetings, respectively, with a resultant repo rate of 5.5% by end-September 2022. This is likely to be followed by an extended pause to gauge whether the currently uneven growth is broad basing.

- In the June 2022 Monetary Policy meeting, the MPC voted unanimously to increase the policy repo rate by 50 bps to 4.90%. Accordingly, the standing deposit facility (SDF) rate stands adjusted to 4.65% and the marginal standing facility (MSF) rate and the Bank Rate to 5.15%. The MPC modified its stance slightly, dropping the statement that it would continue 'to remain accommodative' while highlighting that it would focus on withdrawal of accommodation.
- The MPC raised its inflation projections for FY2023 quite sharply to 6.7% from 5.7% earlier, while highlighting the underlying assumptions of a normal monsoon in 2022 and average price of the Indian basket of crude oil at US$105/bbl. It revised the inflation projections upwards for all quarters of FY2023 - Q1 FY2023 (to +7.5% from +6.3%), Q2 FY2023 (to +7.4% from +5.8%), Q3 FY2023 (to +6.2% from +5.4%) and Q4 FY2023 (to +5.8% from +5.1%).
- The MPC indicated that domestic economic activity was gaining strength while highlighting downside risks owing to prolonged geopolitical tensions, elevated commodity prices, continued supply bottlenecks and tightening global financial conditions. It maintained its FY2023 real GDP growth projection at 7.2%, with risks broadly balanced.

Outlook: We expect the repo rate to be hiked by another 60 basis points (bps) over the next two policy reviews, which is likely to be rapidly transmitted by Banks to their lending and deposit rates, amidst the halving in the systemic liquidity surplus. However, the measures that are actually brought forth by the Central Bank to ensure the orderly completion of the Government borrowing programme, would determine where bond yields settle in the coming months.

MPC DELIVERS A REPO RATE HIKE OF 50 BPS; FURTHER RATE HIKES EVIDENTLY ON THE CARDS

The MPC raised the policy repo rate by 50 bps to 4.90% while highlighting that it would continue to focus on withdrawal of accommodation

In the June 2022 meeting, the MPC voted unanimously to raise the policy repo rate by 50 bps under the liquidity adjustment facility (LAF) to 4.90% (refer Exhibit 1) with immediate effect. Accordingly, it also increased the SDF, Bank rate and MSF rates by 50 bps each to 4.65%, 5.15% and 5.15%, respectively, in June 2022. While this is the second consecutive round of rate hike announced by the MPC (repo rate was increased by 40 bps in an off-cycle meeting in May 2022), the revised repo rate remains below the level seen prior to the onset of Covid-19 pandemic (5.15%). Moreover, the MPC remain focussed on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. The words 'to remain accommodative' have been dropped from the stance that was published in May 2022. This modification appears entirely appropriate in the context of high inflation, rising policy rates and a desire to drain excess liquidity.

CPI inflation forecast for FY2023 revised upwards by 100 bps to 6.7%: The CPI print for April 2022, that was released post the MPC's May 2022 meeting, had revealed that the YoY CPI inflation soared to 7.8% in April 2022, the highest level since March 2014 (refer Exhibit 2). This was the fourth consecutive month of a print above the MPC's upper limit of 6.0%. The share of items in the CPI basket with >6% reading has increased continuously to 60% in April 2022 from 46% in Nov 2021, indicating that inflationary pressures have become broad-based.

While a normal monsoon and kharif season as well as recent supply-side measures taken by the GoI may help in cooling price pressures to some extent, the MPC expects the inflation trajectory to remain uncertain with the fast-changing geopolitical situation

Going forward, there persists considerable uncertainty with regard to the inflation trajectory emanating from global geopolitical tensions and elevated commodity prices. While the recent ban on wheat exports will improve the domestic supplies, the Committee cautioned that the impact can be offset by the shortfall in rabi wheat production, reflecting the impact of the heatwave. Notwithstanding the GoI's recent decision of scrapping import duties on some crude varieties of edible oils, as well as the lifting of Indonesia's export ban, domestic prices of such items remain elevated. Nevertheless, the expectation of a normal monsoon in 2022 augurs well for kharif output and food inflation outlook, according to the MPC. While the domestic prices of petrol and diesel have moderated post the excise duty cut by the Government, there are risks of an impending transmission of the recent rise in crude oil prices. In addition, early results from the RBI's surveys of manufacturing, services and infrastructure companies reveal further input and output price pressures, going forward.

With assumption of crude oil averaging US$105/bbl and a normal monsoon season in 2022, the MPC sharply raised its CPI inflation forecast for FY2023 by 100 bps, to 6.7% from 5.7% projected in the April 2022 policy review

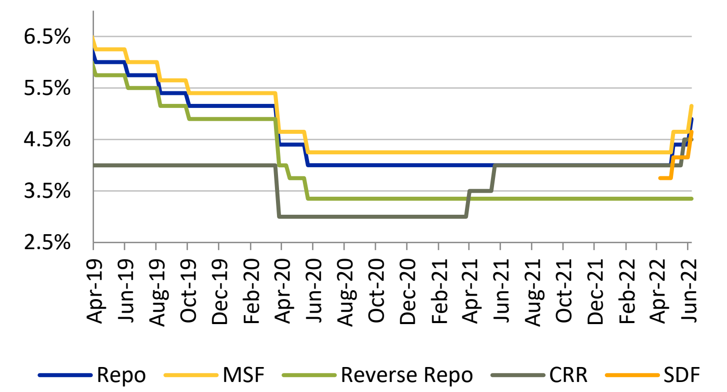
Taking into account these factors, as well as the assumption of a normal monsoon in 2022, and crude oil price of Indian basket averaging US$105/bbl, the Committee has raised the CPI inflation forecast by 100 bps to 6.7% with risks broadly balanced from the 5.7% projected in April 2022, with the caveat that the latest projection doesn't take into account the current monetary policy action. The inflation forecast for all the quarters of FY2023 has undergone an upward revision, relative to the April 2022 projections - Q1 FY2023 (to +7.5% from +6.3%), Q2 FY2023 (to +7.4% from +5.8%), Q3 FY2023 (to +6.2% from +5.4%), and Q4 FY2023 (to +5.8% from +5.1%).

The revised CPI inflation forecast of 6.7% for FY2023 laid out by the MPC is similar to our own projection of 6.5% (with an upward bias) amidst our expectations of a crude oil price range of US$100-120/barrel for the Indian basket. The Governor's reminder that the repo rate is still below the pre-pandemic level serves as a clear signal that more rate hikes lie ahead. We anticipate further hikes of 35 bps and 25 bps, respectively, in the next two policies, with a resultant repo rate of 5.5% by end-Sep 2022. This should be followed by an extended pause to gauge whether the currently uneven growth is broad basing.

The MPC retained its real GDP growth projection for FY2023 at 7.2%, as indicated earlier in the April 2022 policy

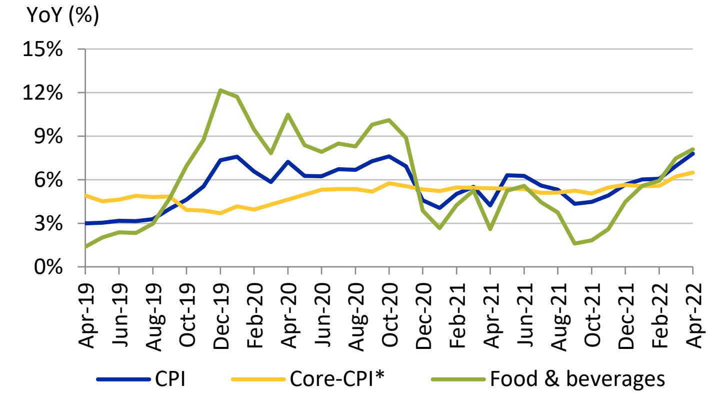
However, negative spillovers from geopolitical tensions, elevated international commodity prices, rising input costs, tightening of global financial conditions, and slowdown in world economy are likely to pose downside risks to the growth outlook

EXHIBIT 1: Movement in Key Rates



***Source:** RBI; CEIC; ICRA Research*

EXHIBIT 2: CPI Inflation, CPI-food and core-CPI inflation (YoY)



Due to unavailability of data for March-May 2020, we have not excluded petrol and diesel indices for vehicles in computation of core CPI index for these months; **Source: NSO; CEIC; ICRA Research*

EXHIBIT 3: RBI's earlier and current GDP growth and CPI inflation forecasts

YoY (%)	CPI Inflation*		GDP Growth (at constant 2011-12 prices)	
MPC Policy Reviews	April 2022	June 2022	April 2022	June 2022
Q1 FY2023	6.3%	7.5%	16.2%	Retained at the April 2022 levels
Q2 FY2023	5.8%	7.4%	6.2%	
Q3 FY2023	5.4%	6.2%	4.1%	
Q4 FY2023	5.1%	5.8%	4.0%	
FY2023	**5.7%**	**6.7%**	**7.2%**	

Assuming average crude oil price (Indian basket) of US$105/bbl; **Source: RBI; ICRA Research*

FY2023 GDP growth forecast retained at 7.2%: The MPC highlighted that the domestic economic activity was gaining strength. It foresees rural consumption to benefit from the expectation of a normal monsoon in 2022 and the consequent improvement in agri prospects. Moreover, it expects urban consumption to rise going forward following a rebound in contact intensive services, which is also in line with our expectations. In addition, it expects investment activity to be supported by improving capacity utilisation levels, ambitious capex target of the Government, and strengthening of non-food bank credit. Further, it foresees the recent buoyancy in merchandise and services exports to sustain going ahead; while we concur that the robustness will continue for services exports, the exports of goods are likely to be partly weighed

The MPC has placed its quarterly GDP growth forecasts at a base-effect led surge of 16.2% for Q1 FY2023, plunging to 6.2% for Q2 FY2023, followed by anaemic prints of 4.1% for Q3 FY2023 and 4.0% for Q4 FY2023

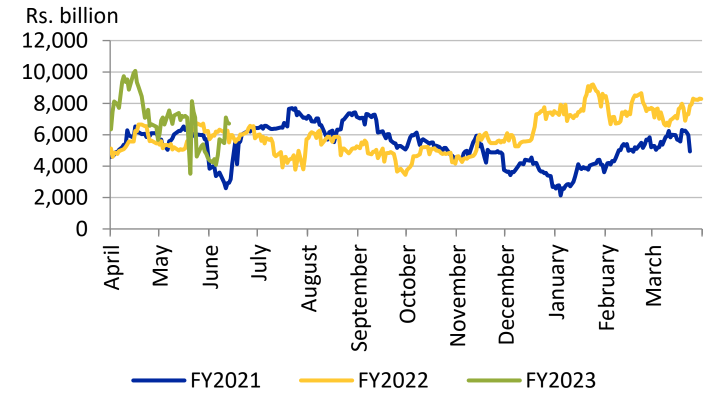
The daily average liquidity surplus under the LAF has eased from Rs. 6.54 trillion in Q4 FY2022 to Rs. 5.20 trillion in Q1 FY2023 (till June 7, 2022)

The average cut-off yields of VRRR auctions had gradually risen from 3.99% during March-April 2022, to 4.39% during May-early June 2022, in line with increase in the policy rates

down by the expected decline in world trade volumes and output amidst geopolitical tensions; nonetheless elevated commodity inflation will continue to play as an offsetting factor. The MPC also highlighted some downside risks to the FY2023 growth outlook, including spillovers from prolonged geopolitical tensions, elevated commodity prices, continued supply bottlenecks and tightening global financial conditions. Taking all these factors into consideration, it has retained its April 2022 growth projections of 7.2% for FY2023, in line with our own projection.

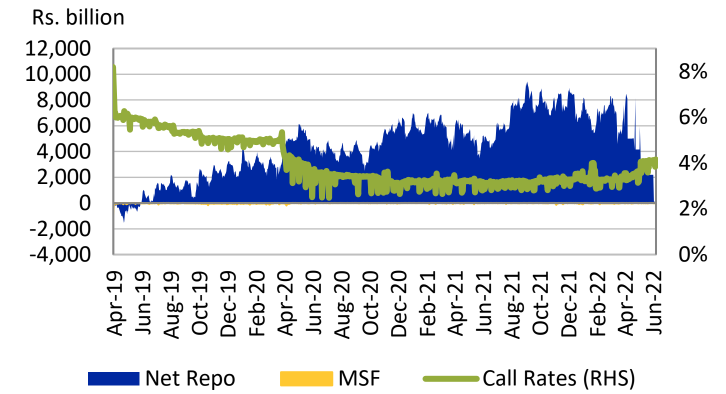
The MPC has placed its quarterly GDP growth forecasts at a base-effect led surge of 16.2% for Q1 FY2023, plunging to 6.2% for Q2 FY2023, followed by anaemic prints of 4.1% for Q3 FY2023 and 4.0% for Q4 FY2023. Our quarterly projections differ from the MPC's; we anticipate a relatively lower growth in Q1 FY2023, given the impact of the elevated commodity prices on demand and margins. Additionally, we remain circumspect about the impact of the heatwave on wheat yields, agri GVA growth and rural demand in Q1 FY2023. At the same time, we expect a higher growth in H2 FY2023, partly based on our view that private capex will be back ended, notwithstanding the higher than expected capacity utilization of 74.5% in Q4 FY2022.

EXHIBIT 4: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; MSS)



Data for FY2023 is available upto June 7, 2022; **Source: RBI; ICRA Research*

EXHIBIT 5: Call money rates



***Source:** RBI; ICRA Research*

The daily average liquidity surplus under the LAF has eased from Rs. 6.54 trillion in Q4 FY2022 to Rs. 5.20 trillion in Q1 FY2023 (till June 7, 2022; refer Exhibit 4), while remaining in large surplus, driven by the decrease in foreign currency assets (from US$550.5 trillion on Mar 25, 2022 to US$537.0 trillion on May 27, 2022), and increase in currency with the public (from Rs. 30.4 trillion on Mar 25, 2022, to Rs. 31.2 trillion on May 20, 2022), partially offset by decline in GoI cash balances (from Rs. 3.1 trillion on Mar 25, 2022 to Rs. 2.4 trillion on May 20, 2022). Moreover, during the May 2022 policy, the CRR was hiked by 50 bps to 4.50% of the NDTL with effect from May 21, 2022; this also led to the withdrawal of liquidity to the tune of Rs. 870 billion. On a monthly basis, the daily average liquidity surplus rose from Rs. 6.42 trillion in March 2022 to

Post the introduction of SDF in April 2022 policy, the daily weighted average call money rate rose from 3.32% in April 1-7, 2022 to 3.49% during April 8-May 2, 2022, and further to 3.99% during May 4-June 7, 2022 after the policy rate hike of 40 bps on May 4, 2022

Measures that are actually brought forth by the Central Bank would determine where bond yields settle in the coming months

Rs. 6.54 trillion in April 2022, before easing to Rs. 4.3 trillion in May 2022. Subsequently, the daily average liquidity surplus under the LAF stood at Rs. 3.4 trillion in June 2022 (till June 7, 2022).

During May 2022, the RBI conducted two 14-day variable rate reverse repo (VRRR) auctions worth Rs. 10.0 trillion and one 28-day VRRR auction worth Rs. 500.0 billion. Subsequently, during June 2022, the RBI conducted one 14-day VRRR auction worth Rs. 4.0 trillion on June 3, 2022. The average cut-off yields of VRRR auctions across tenors had gradually risen from 3.99% during March-April 2022, to 4.39% during May-early June 2022, in line with increase in the policy rates. Despite this, the bid-cover ratios of recent 14-day VRRR auction remained low at 0.16 (vs. 0.67 in April 2022), indicating markets expectations of a higher yield.

Moreover, the amount parked under the SDF averaged at Rs. 1.9 trillion during April 8-30, 2022, Rs. 1.8 trillion in May 2022 and Rs. 2.9 trillion during June 1-7, 2022. Additionally, the total absorption through the SDF and VRRR auctions, eased from Rs. 7.4 trillion during April 8-30, 2022 to Rs. 5.5 trillion during May 2022, and further to Rs. 4.7 trillion in June 1-7, 2022. Nevertheless, the overnight money market rates continue to trade below the policy repo rate, due to the overhang of excess liquidity in the system.

Post the introduction of SDF in April 2022 policy, the daily weighted average call money rate rose from 3.32% in April 1-7, 2022 to 3.49% during April 8- May 2, 2022. Following the unscheduled policy rate hike of 40 bps on May 4, 2022, the daily weighted average call money rate rose further to 3.99% during May 4 - June 7, 2022. The average rates for the 91-day T-bills, 182-day T-bills, and 364-day T-bills rose gradually from 3.54%, 3.81% and 4.09%, respectively, in Q3 FY2022, to 3.74%, 4.24% and 4.56%, respectively, in Q4 FY2022, and further to 4.45%, 4.94% and 5.38%, respectively, in Q1 FY2023 (till June 8, 2022), following increase in cut-off yields of VRRR auctions.

The RBI continued to manage liquidity via net OMO sales in Q1 FY2023, similar to the trend seen in Q4 FY2022. Net outright OMOs sales of Rs. 8.7 billion were conducted in April 2022 and Rs. 52.6 billion during May 2022, resulting in net OMO sales of Rs. 61.3 billion in Q1 FY2023 so far, compared to Rs. 78.9 billion OMO sales conducted during Q4 FY2022.

In today's policy review, the Governor highlighted that the Central Bank would focus on orderly completion of the GoI's borrowing programme. Moreover, the Governor reiterated that the pandemic related extraordinary liquidity accommodation will be normalized over a multi-year time frame and that the RBI would ensure adequate liquidity in the system to meet the productive needs of the economy. **Given the Central Bank's commentary, we continue to expect a gradual calibration in liquidity absorption in the near term, in line with policy normalisation.**

While further rate hikes remain clearly on the table, with the reference to the revised repo rate of 4.9% remaining below the pre-pandemic level, the comment on the orderly completion of the government borrowing programme has served to cool the 10-year G-sec yield. Given our expectations of a total of 60 bps by end-September 2022, the upmarch in the yields is likely to continue but will now be somewhat shallower than our earlier expectations. Further, measures that are actually brought forth by the Central Bank would determine where bond yields settle in the coming months.

The RBI's statement on development and regulatory policies focused on taking supportive steps towards facilitating higher growth for Urban Co-operative Banks (UCBs) and Rural Cooperative Banks (RCBs), while the measures on payment and settlement systems largely aim at expanding unified payment interface (UPI) throughput in the country.

1) Measures taken to enhance growth and profitability prospects for UCBs and RCBs

Enhancement in lending limits for individual home loans for UCBs is likely to support growth and profitability

The limits on the quantum of individual home loans that can be extended by the Tier-I and Tier-II UCBs has been doubled to Rs.6 million and Rs.14 million respectively from earlier limits. Besides, the limits for RCBs are more than doubled to Rs.5 million (from Rs.2 million for RCBs with a net worth< Rs.1 billion) and to Rs.7.5 million (from Rs.3 million for other RCBs). Additionally, the RBI has permitted RCBs including State Co-operative banks and District Central Co-operative banks to extend loans to commercial real estate (residential housing-CRE-RH), subject to a cap of 5% of their total assets. In order to enhance and facilitate better services, the RBI has decided to allow door-to-door banking by the UCBs to their customers.

Impact: Growth in advances for UCBs has lagged that of the Scheduled Commercial Banks (SCBs) over recent years which is reflected in their low credit-to-deposit ratio, which stood at ~59% as on March 31, 2021 (~61% as on March 31, 2020) as against 70-74% for the SCBs during the same period. The enhancement in lending limits for housing loans extended by the UCBs and RCBs as well as permitting RCBs to lend to the commercial real estate segment in the residential housing segment will support book growth and profitability for these entities as they will be able to cater to wider set of customers. This may however increase competitive intensity in micro-markets where UCBs operate alongside other SCBs and NBFCs.

Extending UPI linked payments to RuPay credit cards will encourage users to shift some of their upfront spending to credit cards. This could lead to higher card utilization levels and an increase in the average unit spends for these cards

2) Linking of credit cards to UPI allowed for RuPay credit cards

Currently UPI payments are linked to the savings/current accounts through the debit cards of the users. The RBI has decided to permit the linking of UPI to credit cards for making payments, although the facility will be available only to RuPay issued cards for now.

Impact: UPI-based payment throughput more than doubled to Rs. 84.16 trillion in FY2022 from Rs.41.04 trillion in FY2021. Permitting UPI-based payments to credit cards could lead to some of the upfront spending from savings/current accounts to shift to credit cards which could drive higher card utilization levels and increase spends per card for banks that operate a higher share of RuPay issued cards.

However, as RuPay issued credit cards are still gaining market share, the overall credit outstanding against credit cards which stood at ~Rs.1.5 trillion as on April 22,2022 is un-likely to materially grow in the near term unless the enhancement in UPI linking is also expanded to other card platform operators.

Enhancement in the e-mandates limits for recurring payments on cards will largely be an added convenience to users, while the overall value of transactions covered under mandates will grow

3) **Enhancement in e-mandates on cards for recurring payments**

Given the increasing number of e-mandates (~62.5 million) registered under the framework for processing of e-mandate based recurring payments, the RBI has decided to triple the limits to Rs.15,000 per recurring payment for which specific instructions will be issued by the RBI shortly.

Impact: Increase in the e-mandate limits will largely facilitate users to undertake recurring payments of higher values. In addition to user convenience, the aggregate value of transactions processed under the e-mandate will also increase.

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