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ICRA COMMENTS ON RBI'S OFF- CYCLE MONETARY POLICY MEETING

**MPC completes inflation pivot with
hike in policy repo rate by 40 bps in
off-cycle meeting; RBI raises CRR by
50 bps to withdraw liquidity**

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HIGHLIGHTS



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In a unanimous decision, the MPC raised the policy repo rate by 40 bps to 4.40% in an off-cycle meeting in May 2022

The Committee has displayed its nimble-footedness and clearly completed the pivot back to inflation management

We foresee additional 35-60 bps of rate hikes in remainder of H1 FY2023, and a terminal repo rate of 5.5% by H1 FY2024

In an off-cycle Monetary Policy meeting held on May 4, 2022, the Monetary Policy Committee (MPC) voted unanimously to raise the policy repo rate by 40 basis points (bps) to 4.40%, while remaining accommodative with a focus on withdrawal of accommodation. After a pause in 12 Bi-Monthly policy meetings, the repo rate was raised in May 2022 to the level that prevailed in Apr-May 2020 (upto May 21, 2020). Moreover, the cash reserve ratio (CRR) was hiked by 50 bps to 4.50% of the Net Demand and Time Liabilities (NDTL), which is expected to withdraw liquidity amounting to Rs. 870 billion. By advancing the rate decision by approximately one month as compared to the next scheduled meeting in June 2022, the MPC has focused on preventing inflationary expectations from unanchoring in an increasingly uncertain environment. After an expected rise in the CPI inflation to 7.4% in April 2022, we see a higher base softening the May 2022 CPI inflation print, although it will likely remain above 6.0%. While a back-to-back hike in the June 2022 policy is not yet certain, we do foresee an additional 35-60 bps of rate hikes in the remainder of H1 FY2023. If a de-escalation in geopolitical tensions cools commodity prices, then we expect a pause to reassess the impact on growth, followed by another 25-50 bps of rate hikes to a terminal repo rate of 5.5% by H1 FY2024.

- In an off-cycle monetary policy meeting held on May 4, 2022, the MPC voted unanimously to raise the policy repo rate by 40 bps to 4.40%. Accordingly, it also raised the SDF, Bank rate and MSF rates by 40 bps each to 4.15%, 4.65% and 4.65%, respectively, in May 2022. Moreover, the CRR was hiked by 50 bps to 4.50% of the NDTL with effect from May 21, 2022; this move is expected to lead to a liquidity withdrawal to the tune of Rs. 870 billion.
- The MPC has refrained from providing the revised forecasts of growth and inflation in its May 2022 meeting. Nevertheless, it has highlighted significant upside risks to the CPI inflation trajectory for FY2023, compared to an average inflation of 5.7% that was indicated in the April 2022 meeting. ICRA expects the high base to soften the CPI inflation in May 2022 from an expected 7.4% in April 2022, but remain above the MPC's tolerance level of 6.0%. ICRA expects the real GDP to grow by 7.2% in FY2023, in line with the MPC's April 2022 projections. At present, we foresee an additional 35-60 bps of repo rate hikes in the remainder of H1 FY2023.

Outlook: While a back-to-back hike in the June 2022 policy is not yet certain, we do foresee an additional 35-60 bps of rate hikes in the remainder of H1 FY2023. If a de-escalation in geopolitical tensions cools commodity prices, then we expect a pause to reassess the impact on growth, followed by another 25-50 bps of rate hikes by H1 FY2024. This entails a terminal rate of 5.5%, in our view, as growth concerns are unlikely to disappear completely.

The surprise moves by the MPC and RBI expectedly caused G-sec yields to jump. If the US Federal Reserve's decision tonight is more hawkish than expected by the markets, then the 10-year G-sec yield could test 7.5% as early as tomorrow, the cap that we had foreseen for H1 FY2023.

MPC RAISED POLICY REPO RATE BY 40 BPS TO 4.40%, CRR BY 50 BPS TO 4.50% IN AN OFF-CYCLE POLICY MEETING

In a surprise move, the MPC hiked the policy repo rate and CRR by 40 bps and 50 bps, to 4.40% and 4.50%, resp., on May 4, 2022

The Committee stated that the inflation trajectory continues to be highly uncertain, depending on the ongoing geopolitical situation

It expects core inflation to remain elevated going forward, led by high domestic pump prices and pressures from prices of essential medicines

Strengthening inflationary impulses along with the persistence of adverse global price shocks poses upward risks to the inflation trajectory presented in the April 2022 MPC resolution

In an off-cycle Monetary Policy meeting held on May 4, 2022, the MPC voted unanimously to raise the policy repo rate by 40 bps to 4.40% (refer Exhibit 1), raising it to the level that prevailed in Apr-May 2020 (upto May 21, 2020). Accordingly, it also raised the SDF, Bank rate and MSF rates by 40 bps each to 4.15%, 4.65% and 4.65%, respectively, in May 2022. Moreover, the MPC raised the CRR by 50 bps to 4.50% of the NDTL effective from May 21, 2022. Notwithstanding the rate hike, the Committee decided to remain accommodative while focusing on withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth.

Significant upside risks to the inflation outlook for FY2023: The CPI print for March 2022, that was released post the MPC's April 2022 meeting, had revealed that the headline YoY CPI inflation had surged to a 17-month high of 7.0% in March 2022 from 6.1% in February 2022 (refer Exhibit 2). This was the fourth consecutive month of a print above the MPC's upper threshold of 6.0%. The core-CPI (CPI excluding food and beverages, fuel and light and petrol and diesel index for vehicles) inflation hardened to 6.2% in March 2022 from 5.6% in the previous month, reflecting the persisting input price pressures and higher logistical costs.

Going forward, there are various factors that are imparting significant upside risks to the inflation trajectory for FY2023 that was set out by the MPC in its April 2022 meeting (CPI inflation in FY2023: +5.7% → Q1: +6.3%; Q2: +5.8%; Q3: +5.4% and Q4: +5.1%). The domestic food inflation is taking cue from the global commodity dynamics, including the prices of inflation sensitive items (such as edible oils, wheat poultry feed, etc.) that are impacted by the ongoing global supply shortages as well as export restrictions by key producing nations (such as palm oil export ban by Indonesia). Moreover, global crude oil prices are elevated and volatile, weighing on the inflation trajectory both through both direct and indirect channels. In addition, the MPC expects the core-CPI inflation to remain elevated in the near-term, led by high domestic retail fuel prices, and pressures from prices of essential medicines. Further, the renewed lockdowns and supply disruptions due to rising Covid-19 cases in major countries like China are likely to keep logistical costs high for a longer period.

In our view, the broad basing of inflationary pressures is a major cause for concern. The share of items in the CPI basket that witnessed a sequential increase in prices surged to 78% in Mar 2022 from 68% in Jan 2022 and 70% in Feb 2022. These levels are well above their respective pre-pandemic (FY17-20) averages, implying that price increases have been relatively generalised in the recent months. This widening of inflationary pressures is likely to impart stickiness to the inflation trajectory going forward, pushing the FY2023 average CPI inflation print above 6.0% as against the MPC's projection of 5.7% indicated in the April 2022 meeting.

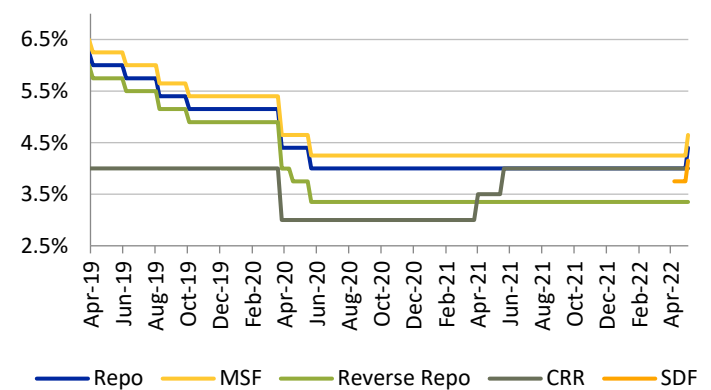
After an expected rise in the CPI inflation to 7.4% in April 2022, we see a higher base softening the May 2022 CPI inflation print, as of now, although it will likely remain above 6.0%. While a back-to-back hike in the June 2022 policy is not yet certain, we do foresee an additional 35-60 bps of rate hikes in the remainder of H1 FY2023. If a de-escalation in geopolitical tensions cools commodity prices, then we expect a pause to reassess the impact on growth, followed by another 25-50 bps of rate hikes by H1 FY2024. This entails a terminal rate of 5.5%, in our view, as growth concerns are unlikely to disappear completely.

The MPC believes that the recovery in contact-intensive services is expected to sustain, after the rapid abatement of the third wave as well as rising vaccine coverage

Investment activity is also likely to get a boost from robust government capex, improving capacity utilisation, and healthy financial conditions

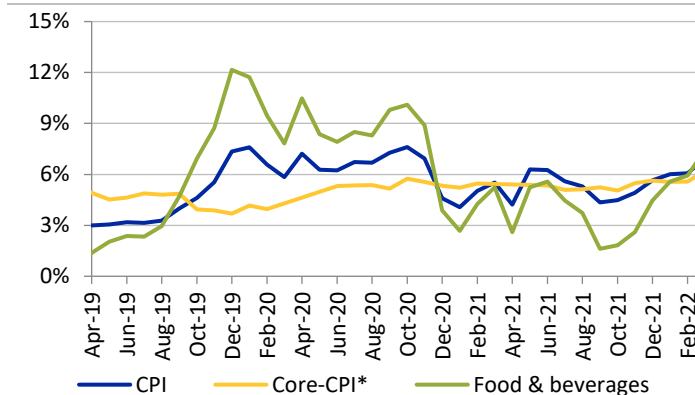
However, worsening external environment, elevated commodity prices and persistent supply bottlenecks, along with volatility spillovers from monetary policy normalisation in advanced economies pose considerable risks for the growth outlook

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 Mar-Apr 2020, we have not excluded prices for petrol and diesel of vehicles during March-May 2021; Source: NSO; CEIC

Underlying fundamentals of domestic growth are strengthening amidst worsening external environment: With regard to the domestic growth outlook, the MPC expects the recovery in contact-intensive services to continue, with the abatement of the third wave and the widening vaccination coverage. Additionally, it anticipated a pick-up in investment activity, supported by robust government capex target, improving capacity utilisation levels, stronger corporate balance sheets and congenial financial conditions. Moreover, it also highlighted that the Indian Meteorological Department’s forecast of a normal southwest monsoon season in 2022 augurs well for the kharif production. The MPC also stressed on the headwinds to the growth trajectory laid out by it in the April 2022 meeting (FY2023: +7.2% → Q1: +16.2%; Q2: +6.2%; Q3: +4.1% and Q4: +4.0%); these include worsening external environment, elevated commodity prices, persistent supply bottlenecks and spillovers from monetary policy normalisation in advanced economies. However, on balance, the Committee believes that the Indian economy, at present, appears capable of withstanding the deterioration in geopolitical conditions, but continuous monitoring of those risks is prudent.

Overall, while the MPC has averted to provide the revised forecasts on growth and inflation in the May 2022 meeting, there are significant upside risks to the CPI inflation for FY2023, compared to an average inflation of 5.7% that was indicated in the April 2022 meeting. ICRA expects the real GDP to grow by 7.2% in FY2023, in line with the MPC’s April 2022 projections. While early signs of a pick-up in private investments are visible, government capex, especially by state governments, remains critical to support investment demand. We are a little less optimistic on agri outlook for FY2023; with contact-intensive jobs reviving in urban areas, we remain concerned that a shift in labour availability may constrain acreage for the kharif season. Thus, even with a normal monsoon and healthy reservoir levels, acreage and therefore output may not rise meaningfully in FY2023, constraining agricultural GVA growth to 2.0-3.0%, especially if the availability of fertilisers poses a challenge.

The daily average liquidity surplus eased from Rs. 6.88 trillion in February 2022 to Rs. 6.42 trillion in March 2022, before increasing slightly to Rs. 6.54 trillion in April 2022

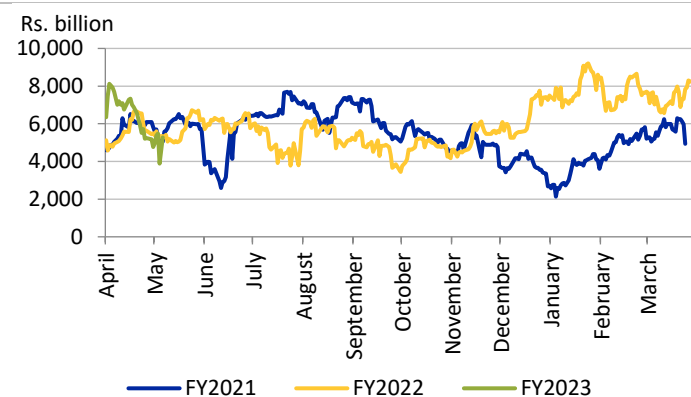
The daily weighted average call rates have inched up to 3.65% as on May 2, 2022 from 3.24% as on April 7, 2022 (pre-April 2022 policy), while remaining below the SDF rate.

The daily average liquidity surplus under the LAF has eased slightly from Rs. 6.54 trillion in Q4 FY2022 to Rs. 6.37 trillion in Q1 FY2023 (till May 3, 2022; refer Exhibit 4), while remaining substantial. On a monthly basis, the daily average liquidity surplus eased from Rs. 6.88 trillion in February 2022 to Rs. 6.42 trillion in March 2022, before increasing slightly to Rs. 6.54 trillion in April 2022. During April 2022, the RBI conducted one 3-day variable rate reverse repo (VRRR) auction worth Rs. 6.0 trillion on April 5, 2022, one 14-day VRRR auction worth Rs. 8.0 trillion on April 8, 2022, followed by another 14-day VRRR auction worth Rs. 7.0 trillion on April 22, 2022, and lastly, one 28-day VRRR auction worth Rs. 0.5 trillion on April 19, 2022. Moreover, the RBI also undertook a sell/buy swap auction worth US\$5 billion on April 26, 2022, with a view deferring liquidity injection through forward delivery. The bid-cover ratios of recent 14-day VRRR auction (0.67), 28-day VRRR auctions (1.1) and USD/INR sell-buy swap auction (2.86), remain favourable, also suggesting that the system liquidity remains ample.

Post the introduction of the SDF in the April 2022 policy, the amount parked under the fixed rate reverse repo auction (FRRR) decreased from an average of Rs. 3.6 trillion during April 1-7, 2022 to nil thereafter, while the amount parked under the SDF averaged at Rs. 1.8 trillion during April 8- May 3, 2022. Additionally, the average surplus liquidity in the banking system, reflected in total absorption through SDF and VRRR auctions, eased to Rs. 7.2 trillion during April 8- May 3, 2022, compared with Rs. 8.7 trillion during April 1-7, 2022.

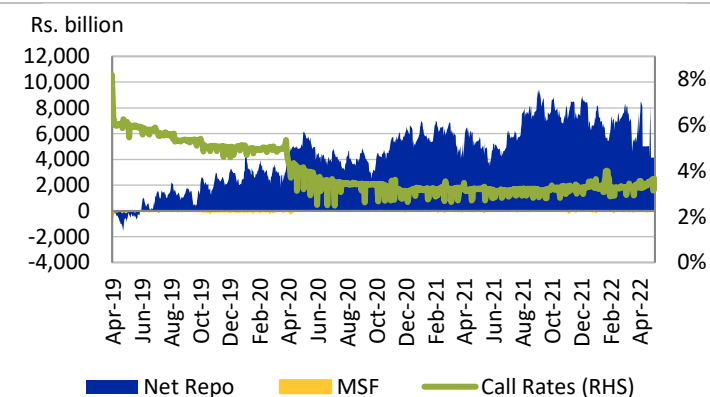
The daily weighted average call rates have inched up to 3.65% as on May 2, 2022 from 3.27% as on April 7, 2022 (pre-April 2022 policy), while remaining below the SDF rate. Moreover, the weighted average rate of VRRR and FRRR/SDF increased from 3.73% in Apr 1-7, 2022 to 3.93% in Apr 8- May 3, 2022. Similarly, the rates for the 91-day T-bills, 182-day T-bills, and 364-day T-bills rose from 3.79%, 4.32% and 4.64%, respectively, in March 2022, to 3.95%, 4.38% and 4.75%, respectively, in April 2022, and further to 4.03%, 4.43% and 4.84%, respectively, till May 4, 2022.

EXHIBIT 3: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; MSS)



*Data for FY2023 is available upto May 3, 2022; **Source:** RBI; ICRA Research

EXHIBIT 4: Call money rates



Source: RBI; ICRA Research

The RBI decided to increase the CRR by 50 bps to 4.50% of NDTL, effective from the fortnight beginning May 21, 2022

In today's policy review, the RBI decided to increase the CRR by 50 bps to 4.50% of net demand and time liabilities (NDTL), effective from the fortnight beginning May 21, 2022. The hike in the CRR rate will force banks to park more money with the RBI and leave them with less to loan to customers. The Governor highlighted that the CRR hike would withdraw liquidity in tune of Rs. 870 billion from the banking system. Even with the CRR hike, the RBI reiterated that it would ensure adequate liquidity in the system to meet the productive needs of the economy. **Overall, we continue to expect a gradual calibration in liquidity absorption in the near term, in line with policy normalisation and the RBI's continued assurance of 'gradual withdrawal over a multi-year time frame'.**

The 10-year G-sec yield breached 7.4% post the policy announcement, jumping 30 bps higher than the previous day close. If the US Fed's decision tonight is more hawkish than expected, then the 10-year G-sec yield could test 7.5% as early as tomorrow, the cap that we had foreseen for H1 FY2023.



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