RBI raises rates and hikes CRR: First of many to follow

- **RBI delivered a surprise with an off-cycle policy repo rate hike of 40bps. Notably, CRR was increased by 50bps to absorb excess liquidity**
- **Within a month, the lower end of the rate corridor (now the SDF) has increased by 80bps showing the extent of RBI pivot**
- **We continue to expect terminal repo rate at 6% with a back-to-back hike in each policy. Initially, this may be accompanied with liquidity absorption via CRR hikes or sell/buy swaps**
- **We do not rule out frontloading of policy rate hike like today if US Fed delivers higher than anticipated rate hike/ QT**

Off-cycle hike, a first since July 2010: Given the background of rising global and domestic inflationary pressures and an impending 50bps hike by US Fed tonight along with announcement of QT, RBI choose to frontload the Indian monetary policy cycle with a 40bps increase in repo rate. In addition, it also increased CRR by 50bps to absorb excess liquidity. Both the quantum of policy rate hike and increase in CRR were a surprise.

Upside risks to inflation: MPC now believes that there are upside risks to India's inflation trajectory set out in April 2022. Notably, then RBI had estimated inflation for FY23 at 5.7% (4.5% in February 2022). While it was a large increase from earlier forecast, actual inflation trajectory is pointing towards an even higher print. We expect CPI inflation at 6.2% with upside risk. More importantly, food inflation is showing broad-based increase. Global food prices rose by 33% YoY in April 2022. Input costs such as fertiliser and diesel are rising implying upward pressure on food inflation (our note: Rural India: Higher incomes, but higher inflation too). Edible oil prices will rise after Indonesia decided to restrict exports. Even core inflation is on the up led by higher fuel prices. Given the extent of increase in energy and commodity prices (ferrous and non-ferrous metals), domestic producers are and will continue to raise prices to pass-on higher input costs.

Economy reviving: Economy is recovering on the back of 1) exports—goods and services, 2) opening up of contact intensive sectors, 3) bright prospects for rural India with a fourth successive normal monsoon, exports and better terms of trade, and 4) IT sector and start-up ecosystem creating jobs. Capacity utilisation of Indian firms is rising and has increased to 72.4% as of December 2021. Notably, exports and non-oil-non-gold imports have been buoyant even in April 2022. The latter shows the buoyant domestic demand. Revival in domestic consumption and investment is also putting upward pressure on India's current account deficit which is expected to increase to 2.6% of GDP in FY23. The underlying recovery shows that growth is likely to be at 7.4% in FY23 (RBI at 7.2%).

Liquidity and policy cycle: Normally, a rising rate cycle is more effective when liquidity is at a much more balanced level. From a high of INR 9.1tn in September 2021, system liquidity has come down to INR 5.3tn now (SDF and VRRR absorption at INR 6.4tn). Prior to the pandemic, liquidity surplus was ~INR 3tn (2.4% of NDTL). As of now, liquidity surplus is 3.2% of NDTL. If liquidity surplus has to come down to 1.5% of NDTL in April 2023, that would call for INR 2.5tn reduction in liquidity from the current levels. CRR hike done today would absorb liquidity to the tune of INR 870bn. In fact, for rate hike cycle to be effective, liquidity should be in neutral zone implying much larger absorption may be required. This could be done through 1) CRR hikes, 2) sell/buy swaps, 3) OMO sales, and 4) currency leakage. Out of these, 1) and 2) would be preferred options right now.

How do we see repo rates playing out?: We had expected terminal repo rate at 6% (our note: MPC minutes: Inflation and non-inflationary growth finds priority). We continue to see that playing out with back-to-back rate hikes. However, today's rate hike was a surprise and higher than our June estimate of 25bps hike. If US Fed delivers a higher than 50bps rate hike, we do not rule out further frontloading with a higher than 25bps rate hike by RBI as well. Terminal repo rate can be higher if US Fed's terminal rate is higher. In the last cycle, US Fed rate (upper bound) was 2.5% and India's repo rate was 6.5%. Given the unanticipated off-cycle hike today, the 10-year G-Sec touched high of 7.41%. We expect the the yields to move up during the year with 1) elevated government borrowing, 2) CPI prints higher than MPC's upper tolerance level, and 3) rising US yields. We see 10-year settling in 7.5-7.75% range in the next few months.

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