

5 August 2022

RBI hikes repo rate for third time in a row, to fight inflation

RBI's Stance

Withdrawal of Accommodation

Key Highlights

- **Unanimously hiked Repo Rate by 50 bps to 5.40%.**
- Cash reserve ratio (CRR) kept unchanged at 4.50%.
- The MPC voted on “**withdrawal of accommodation**” to ensure that inflation remains within the target going forward, while supporting growth; however, this decision was not unanimously.
- **Inflation** projection for FY23 retained at **6.7%**.
- **Growth** projection maintained at **7.2%** for FY23.
- While the **bond market** reacted negatively on a rather hawkish stance by MPC; the **equity markets** remained flat.

Policy Rates / Reserve Ratio	8 Jun '22	5 Aug '22	Status
CRR	4.50%	4.50%	↔
SLR	18.00%	18.00%	↔
SDF	4.65%	5.15%	↑
Repo Rate	4.90%	5.40%	↑
MSF	5.15%	5.65%	↑
Bank rate	5.15%	5.65%	↑
Fixed Reverse Repo Rate	3.35%	3.35%	↔

In a scheduled policy meeting held from **August 3 to 5** amid inflation peaking out, the MPC **unanimously announced a repo rate hike of 50 bps to 5.40%**. Consequently, the standing deposit facility (SDF) rate stands adjusted to 5.15%; and the marginal standing facility (MSF) rate and the Bank Rate to 5.65%. The MPC **voted on “withdrawal of accommodation”** to ensure that inflation remains within the target going forward, while supporting growth; however, this decision was not unanimously.

The background

Repo Rate hike & Stance: When the pandemic struck the world in March 2020, the monetary policy had shifted gears to an **ultra-accommodative mode**, with a large reduction of **75 bps** in the policy repo rate on **March 27, 2020** followed by another reduction of **40 bps on May 22, 2020**. Accordingly, the decision of the MPC to raise the policy repo rate by 40 bps in the off-cycle policy meet on 4 May and by 50 bps each in June and August, **keeping in line with the announced stance of withdrawal of accommodation set out in April 2022 is now above the pre-pandemic level of 5.15%**.

Liquidity: In April the RBI introduced the **Standing Deposit Facility (SDF)** as the floor of the **liquidity adjustment facility (LAF)** corridor thus raising the LAF by 40 bps; along with the policy repo rate hikes in May and June, have effectively resulted in withdrawal of accommodation by 130 bps.

Surplus liquidity in the banking system, as reflected in average daily absorptions under the LAF (both SDF and variable rate reverse repo auctions), **moderated to Rs. 3.8 lakh crore during June-July 2022** from Rs. 6.7 lakh crore during April-May.

Growth Outlook

- The **south-west monsoon rainfall and reservoir levels are above normal**; kharif sowing is progressing well, although it is marginally below last year's level due to uneven rainfall distribution.
- **On the demand side**, indicators such as production of consumer durables, domestic air passenger traffic and sale of passenger vehicles suggest improvement in urban demand. **Rural demand indicators**, however, exhibited mixed signals – while two-wheeler sales increased, tractor sales contracted in June over a high base though.

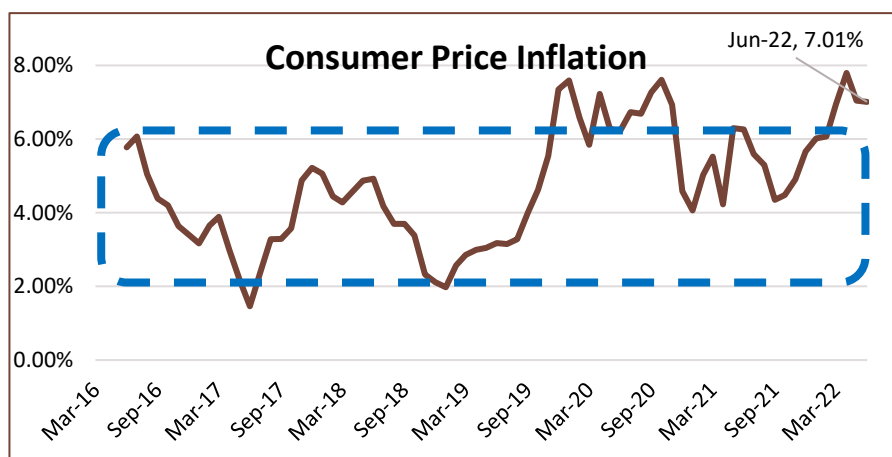
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- **High frequency indicators of the services sector** like railway freight traffic, port freight traffic, e-way bills, toll collections and commercial vehicle sales remained robust in June and July. **PMI** manufacturing rose to an 8-month high in July and PMI services indicated continued expansion in July. **Capacity utilisation** in the manufacturing sector is now above its long-run average, signalling the need for fresh investment activity in additional capacity creation. **Bank credit** growth has accelerated to 14.0% (y-o-y) as on July 15, 2022 from 5.4% a year ago.

Period	FY23	Q1FY23	Q2FY23	Q3FY23	Q4FY23	Q1FY24
Growth Projection	7.2%	16.2%	6.2%	4.1%	4.0%	6.7%

Inflation Outlook

- The CPI headline inflation in June cooled down to 7.0%. It was the **sixth consecutive month when inflation touched or was above the upper tolerance level of 6.0%**.



- The **global geopolitical situation remains fluid** and however now commodity markets has softened particularly in prices of industrial metals and some softening in global food prices;

Source: RBI DBIE

thus, now **inflation trajectory is now poised at a decisive point.**

- The below data assumes a **normal monsoon in 2022** and average **crude oil price (Indian basket) of US\$ 105 per barrel.**

Period	FY23	Q2FY23	Q3FY23	Q4FY23	Q1FY24
Inflation Projection	6.7%	7.1%	6.4%	5.8%	5.0%

Conclusion

While the bond market reacted negatively on a rather hawkish stance by MPC; the equity markets remained flat. The 10-year India Government bond yields rose from 7.16.% close of 4 Aug 2022 to a day high of 7.32% when the policy was announced and to close at 7.30%, while the Nifty 50 closed marginally higher by 0.09% from a day's high of 17,469 when the policy was announced.

With the RBI stance of **taking out excess liquidity from the system directly through CRR hike and interest rate hike initiated in the economy** we continue to maintain our stance of **investing in shorter end of the curve through mutual fund categories like Low Duration / Floating Rate Funds** till the time rates stabilize.

For **longer term investments Short Term Funds / Corporate Bond Funds & Target Maturity Funds** continue to be our preferred categories. Along with MF good quality **Corporate Fixed Deposits and Bonds** can be looked at allocation in the debt portfolio for diversification and enhancing overall return.

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