Monetary Policy | RBI moves in tandem with global central banks

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Most major central banks are now acting in a co-ordinated fashion to tame inflation. On June 7, Australia's central bank raised interest rates by 50 bps — the most in 22 years, and flagged more tightening to come. The European Central Bank (ECB) will meet on June 9, and is widely expected to lay the groundwork for more interest rate hikes.

With quantitative easing getting replaced by quantitative tightening, there is a view that the US Federal Reserve may raise policy rate by 100 bps in the coming summer. Rising bond yields in the US and mounting concerns about inflation that may prompt aggressive rate hikes by the Fed has increased the strength of the US dollar.

On June 7 also, the Reserve Bank of India (RBI) had to step up its intervention in the foreign exchange market to cap the rupee's slide. Surging crude oil prices, foreign fund outflows, and broader dollar strength have brought the Indian rupee under tremendous pressure. By frontloading the rate hikes in close co-ordination with other central banks and staying focused on withdrawal of accommodation, the RBI is not just controlling inflation but also promoting stable macro-financial conditions.

The RBI's monetary policy committee (MPC) has noted that the inflationary pressures have intensified further, and inflation is likely to remain above the RBI's upper tolerance band of 6 percent through the first three quarters of FY23. In fact, the MPC has raised its inflation projection for FY23 by 100 bps from the earlier projected 5.7-6.7 percent based on the assumptions of a normal monsoon in 2022, and average crude oil price (Indian basket) of $105 per barrel. However, it is not clear why the MPC has not taken into account the impact of the today's (June 8) monetary policy actions, while working out the inflation projection for FY23.

Despite an increase of 50 bps in the repo rate to 4.9 percent, the prices of government securities increased, as the move was in line with the market expectations. Moreover, the RBI did not raise the Cash Reserve Ratio (CRR), which would have put the system in a kind of liquidity deficit. According to Informist, liquidity surplus in the banking system as of June 8 is Rs 3.17 trillion, which is closer to neutral liquidity condition or 2 percent of the net demand and time liabilities of the banking system. A hike in the CRR at this stage would have put the system in liquidity deficit, and constrained the credit disbursements.

However, the MPC appears to be too optimistic on the growth outlook. Notwithstanding the increased risks to growth coming both from the domestic domain (delayed monsoon, heightened month on month fluctuations in high frequency indicators, likely power shortage, lingering weakness in demand, high interest rates, etc.) and the external domain (spill overs from geopolitical tensions, weak global growth, tightening of global financial conditions, elevated commodity prices, etc), the MPC has retained its GDP growth projection at 7.2 percent, with risks broadly balanced. In fact, growth outlook remains grim across the globe. Recently the World Bank has reduced its estimate for global growth this year to 2.9 percent from a January prediction of 4.1 percent due to soaring commodity prices, supply disruptions, and moves by central banks to hike interest rates.

So far as other developmental measures are concerned, the RBI has taken steps to ensure better credit flows to the residential housing sector, in the wake of rising residential housing prices. It has revised upwards the limits for housing loans extended by urban and rural co-operative banks by over 100 percent, considering an increase in house prices.

To respond to the growing needs of the affordable housing sector, it has allowed rural co-operative banks to extend financing to commercial real estate-residential projects to augment the credit flow. While the objective behind these steps is to give a boost to the real estate sector — a strong driver of overall economic growth, suboptimal risk management capabilities of co-operative banks may pose a critical challenge for financial regulators, going ahead.

The RBI also proposed linking of credit cards to UPI payments and its beginning will be made by the Rupay credit cards. This is a progressive move as it will provide additional convenience to the users, and enhance the scope of digital payments.

With the June 8 monetary policy move, interest rates for floating rate retail loans such as home loans or auto loans that are linked to an external benchmark set by the RBI will start rising. Currently, around 40 percent loan rates in the Indian banking system are linked to external benchmarks. As credit picks up, banks will start passing on the benefit to depositors also. In anticipation of the monetary policy tightening, 'fundraising' through corporate bonds in India had increased nearly 50 percent on month in May, 2022. According to the NSDL statement, corporate, financial institutions and housing finance companies had raised Rs 376.15 billion in May through the placement of 158 bonds, as against Rs 251.45 billion raised in April through 113 bonds.

With the likely rate hikes already priced in, we expect the yields on government as well as corporate bonds to rise further hereon. The actual magnitude of this 'increase' will however get influenced by the future CPI inflation prints.

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