RBI REPO Rate Hike (May 2022)

Everyone is still wondering why the central bank made an unscheduled announcement this week, raising the benchmark interest rate and withdrawing substantial liquidity from the banking system. The move stunned the market because only 25 days ago, in its scheduled monetary policy statement, the RBI had decided to continue its "accommodative" policy to support growth by keeping the benchmark repo rate unchanged at 4%. However, within a month the RBI chose to reverse its stand and came down with a sledgehammer to not only raise the repo rate by 40 basis points but also withdraw about Rs 87,500 crore immediately from the banking system by raising the Cash Reserve Ratio (cash banks have to mandatorily keep with RBI) by half a percent.

The twin moves were totally unexpected and sent stock markets into a tailspin.

The question is, why did the RBI change its position so quickly?

Simple: the central bank had miscalculated the extent of inflation. The RBI projected consumer price inflation at 5.7% for 2022-23 in its early April statement. However, sources say the monthly inflation number for April due to be announced next week is likely to be 7.5-8%. This is a huge underestimation by the RBI. For 2022-23, the RBI is projecting inflation at 6.3% in Q1, 5.8% in Q2, 5.4% in Q3 and 5.1% in Q4. All these numbers may have to be revised in its scheduled statement early next month.

Experts believe that the RBI hurried to raise the repo rate because US bond yields were rising dramatically and were perilously narrowing the gap with Indian government security yields. This could have resulted in a big flight of capital from the Indian market to the relatively safe and high-yielding US bonds, putting the rupee under more pressure. In fact, the RBI has already spent over $25 billion from its reserves to defend the rupee. But for its intervention, the exchange rate may have been near Rs 80 to a dollar.

Forex reserves, are already down over $40 billion from its October 2019 peak of $640 billion. Reserves may go down further as India's growing current account deficit may not be covered by fresh capital flows. Many economists forecast a negative balance of payments for 2022-23.

Some say the desperation to push the LIC IPO could be because the government hopes the infusion of fresh foreign capital will help its depleting forex reserves and serve as a signal that India is attracting foreign investment in spite of bad global financial market conditions.

The differential between US and Indian government bond yields remains critical. US bond yields of various tenures have nearly doubled. The RBI is feeling the heat and is compelled to raise rates in tandem. The sudden repo rate hike may have been in anticipation of the big 50 basis points increase in the benchmark interest rate by the Federal Reserve the next day.

India's inflation story is still unfolding as the domestic effect of energy prices has not been fully felt. Meanwhile, wheat and edible oil prices are on fire. Wheat procurement was expected to be 44 million tonnes but may be halved, according to experts. The private sector has bought off much of the stock from farmers at prices above MSP. This will certainly lead to higher wheat prices. So food inflation will have to be watched very carefully, and will eat into GDP growth.

Overall, the quarters ahead are likely to have inflation at 7-8% and GDP growth of 4-4.5% for all of 2022-23, barring the first quarter, which gets distorted by the low base of economic activity in April-June 2021 caused by the severe second wave of Covid. The way things are unfolding in the political economy, Modi may have to give Nehru some much-needed rest and start looking within.

Source : The Wire