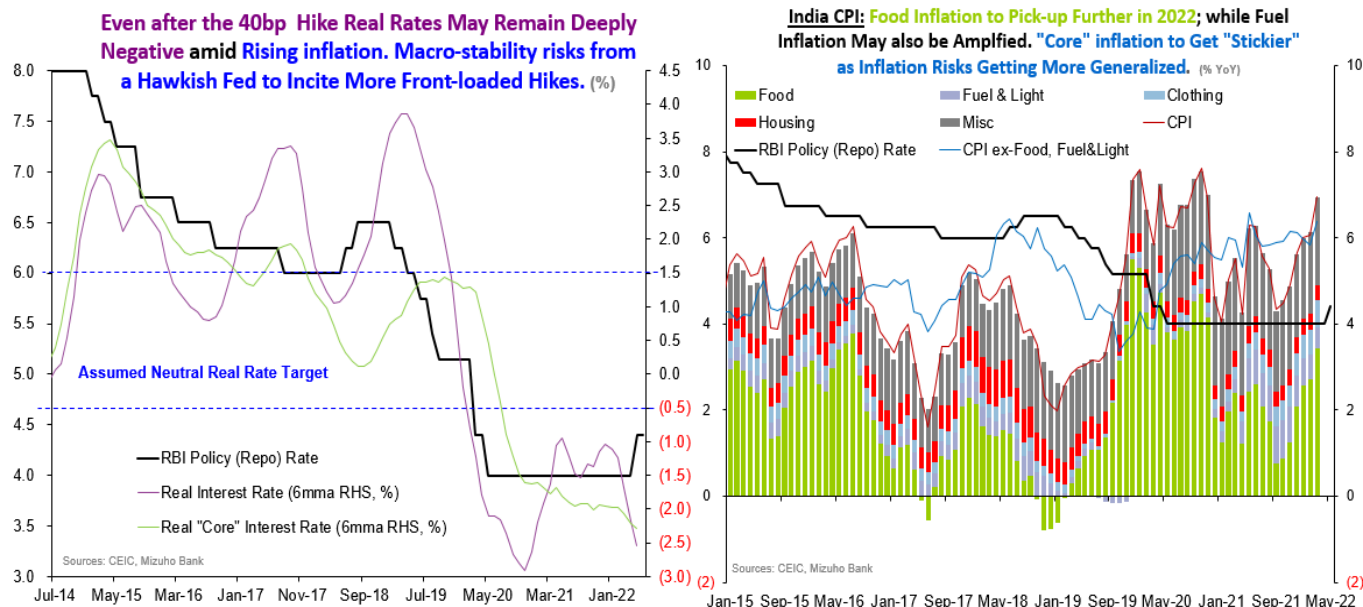


RBI: The Hawk & The (Leap-)Frog



“If ... losing you are, a different game you must play.” – Master Yoda, Star Wars

In a Nutshell: With an **unscheduled, and larger** than “conventional” (25bp) **hike of 40bps** the RBI has **pulled off a surprise re-positioning; in an attempt to wisely change the game.** Not just in absolute terms as an **unambiguous hawk** set to tackle enlarged inflation risks. But crucially also in a relative sense to **leap-frog** many other Asia-Pacific central banks (with the exception of the BoK and RBNZ).

Especially as the RBI braces for “*volatility spillovers*” that are **set to emerge from an aggressively hawkish Fed.** The upshot is that while policy setting may remain accommodative as of this point, **identifying inflation as the greater risk alongside mounting external threats to macro-stability,** means that policy will most likely have to be tightened significantly more in coming months. We **expect another 110bp of tightening to 5.50% by year-end** as our base case; as the RBI looks to adopt the *path of least harm rather than an unbridled hawkish charge.*

The Move: In an **off-cycle move** yesterday (4th May), the **RBI hiked the policy repo rate by 40bps to 4.40% alongside a 50bps lift in the cash reserve requirement (CRR) to 4.50%.** In tandem with the 40bp repo hike, the standing deposit facility (SDF) has been lifted to 4.15% and the marginal standing facility (MSF) is bumped up to 4.65%. This is an **unequivocal hawkish shift compared to April, when the RBI equivocated.**

April MPC’s (Intended) Ambiguity: To recap, at the scheduled policy meeting on 8th April, the RBI had on one hand stressed on *maintaining accommodation and kept the repo rate on hold at 4.00%.* Yet on the other hand, *began to insure against runaway inflation on the other* by introducing the SDF at 3.75%, which effectively lifted the LAF (liquidity) corridor floor by supplanting the reverse repo rate (3.35%).

Re-assessing Balance of Risks: In unveiling this surprise tightening (both in quantum and timing) the RBI

has alluded to “*heightened uncertainty (to) ... inflation trajectory ... heavily contingent upon the evolving geopolitical situation*” and **core inflation** that is “*likely to remain elevated*” amid high and volatile **energy prices**, renewed lockdowns as well as supply-chain disruptions. All of which culminating in “*significant upside risks to inflation trajectory set out in ... April*”. Whereas the RBI assesses that **domestic economic activity has stabilized**; with ebbing “third wave” amid wider vaccination coverage helping sustain recovery in high-contact services alongside public investments, which may induce “crowding in”.

And Identifying Inflation as the Overriding Risk: In short, **inflation has been identified as the overriding risk** (and growth less so) at this point. Notably, the **RBI**, in citing that the *IMF has revised up inflation outcomes for advanced economies 2.6%-pts to 5.7% and by 2.8%-pt to 8.7% for developing economies*, **appears to be conceding that its upward revisions to FY22/23 inflation to 5.7% (from 4.5%) in April may be inadequate**. Which in turn, **makes the case for a more unfettered shift in stance**.

Relinquishing Neutral for Hawkish: In other words said, despite the RBI reference “*to remain accommodative while focusing on the withdrawal of accommodation*”, the **policy stance now assumes an unequivocally hawkish bent** given that the “*MPC expects inflation to rule*” even as the economy “*is navigating a vortex of forces*”.

Especially Urgent Given a Hawkish Fed: What’s more, the **prospects of an aggressively hawkish Fed poses serious threats to macro-stability**, which **may easily overwhelm** any **benefits from policy accommodation**. And so, the **greater risk for the RBI is a being too slow to tighten rather than being too quick**. Especially as the **Fed embarks an aggressive hiking path**. With a 50bp Fed hike overnight, and suggestions of more such moves in coming months, the *RBI’s inter-meeting 40bp hike just before the Fed is hard to pass off as mere coincidence*. The “*spillover volatility*” risks from aggressive tightening by the Fed is clearly the co-pilot, if not the captain, of this hawkish RBI inflection.

Central Bank Policy Outlook

Country	Central Bank	2021				2022				2023	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US	Fed	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.25-0.50%	1.25-1.50%	2.00-2.25%	2.25-2.50%	2.50-2.75%	2.75-3.00%
India	RBI	4.00%	4.00%	4.00%	4.00%	4.00%	4.75%	5.25%	5.50%	5.75%	5.75%
Implied RBI-Fed Policy Spread		3.875%	3.875%	3.875%	3.875%	3.625%	3.375%	3.125%	3.125%	3.125%	2.875%

More and Front-loaded Hikes: Given the nature of the risks, comprised of inflation inflamed by geo-political prices shocks and the Fed gearing up for rapid successions of upsized (50bps) rate hikes in coming months, the **extent of the RBI’s policy normalization is as important as the timing**. It follows that **most of the RBI’s hikes may be front loaded**. And so, we could see **another 85bp of hikes by Q3** and 25bps in Q4. In other words **another 110bps by end-2022** (cumulative 150bp hikes for 2022) **to bring the repo rate to 5.50%**. But that said, the **RBI will be not be on a hawkish war path with abandon, but rather** navigating a (hike) **path of least harm to the economy** (involving macro-stability considerations as well).

Rupee Backstop, Not Immunity: Admittedly, the RBI’s hawkish inflection and leap-frog (relative to EM Asia central banks) will provide incremental backstop to the rupee. But this is not to be mistaken for immunity to Fed hawks and consequent USD bulls; especially as aggressive rate hikes and step-up in the Fed’s quantitative tightening come through in Q3. So downside (upside) risks to rupee (USD/INR) remain entrenched for now.

FX Forecasts	Jun 22	Sep 22	Dec 22	Mar 23	Jun 23	Sep 23
USD/INR	73.2 - 77.3 (76.5)	73.8 - 78.3 (75.8)	71.7 - 76.6 (74.4)	70.4 - 76.6 (74.2)	69.7 - 75.9 (73.5)	68.3 - 74.5 (72.0)

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