27 September 2022

Sonal Badhan
Economist

RBI to hike again

In the upcoming credit policy of RBI which is scheduled on 30 Sep 2022, we expect MPC to raise repo rate by another 50bps. We expect rates to increase up till 6-6.25%. We maintain our growth and inflation forecasts. However significant risks to both have emerged. While risks to growth are driven by slowdown in global growth, risks to inflation are more domestic in nature. Deficient/untimely rains is estimated to have impacted output of rice and pulses. While government has announced rice export ban, the final impact on inflation is yet to be seen. Other key developments which will be considered by the RBI will include volatility in the currency and bonds market. To comfort the yields and address the issue of temporary liquidity deficit, RBI may also announce OMO purchase calendar.

What has changed since the last policy?: Since the last policy, RBI will be evaluating changes in oil prices, trends in inflation, monsoon and sowing, movement of high frequency indicators and global developments.

Oil prices: At the time of the last policy (5th Aug 2022), international crude oil price was trading at U$ 94.9/bbl, and since then it has come down to US$ 86.2/bbl, thus registering a 9% decline. This decline is despite supply side concerns ranging from lower output from OPEC+, ban on Russian oil imports by G-7 countries, and stalling of Iran nuclear deal. Aggressive rate hikes by major Central Banks to combat inflations has resurfaced fears of global recession, denting oil's demand outlook. In addition, strong US$ is also acting as a drag on dollar denominated oil prices.

Domestic inflation scenario: Most recent CPI print shows that retail prices still remain elevated and CPI inched back to 7% from 6.7% in Jul'22. It had remained sticky at 7% even in May-Jun'22. As RBI expects Q2FY23 CPI to be 7.1%, it implies the Central Bank is expecting price pressures to increase in Sep'22. While lower oil and commodity prices remain conducive for both CPI and WPI (fell to 11-month low of 12.4% in Aug'22), food prices remain a cause of worry. Food inflation remains heated at both wholesale (9.9% from9.4% in Jul'22) and retail (7.6% from 6.7%) levels. Apart from higher prices of vegetables, fruits and protein based items, prices of cereals are also adding to the woes. Prices of rice have gone up globally as well. Going ahead, impact of government's supply management (wheat/rice export controls) will be watched closely.

Monsoon and sowing: Inflationary pressures have also been aided by trends in monsoon and Kharif sowing. While overall rainfall has been above normal (+7% of LPA) till 26 Sep 2022, there has been deficits in key agricultural states such as UP, Bihar and Jharkhand. Overall sown area of Kharif crops is marginally less than last year. Further, deficient rains have negatively impacted the sown areas of rice (-5.5%) and pulses (-3.9%). Paddy output is also expected to have been impacted by untimely rains in Punjab and Haryana, which is estimated to have destroyed a percentage of final crop output. Lower production of both rice and pulses have the potential to cause pain in inflation. However, one positive development is the higher reservoir levels, which will bode well for winter crops.

High-frequency indicators: Government's GST collections continue to clock above Rs 1.4 lakh crore for the 4th consecutive month now, indicating steady consumption demand. Services PMI too improved in Aug'22 to 57.2 from 55.5 in Jul'22 and average for Q2FY23 (Jul-Aug) remains even higher (56.4) than pre-pandemic times (53.1 in Jul-Aug'19). Even port cargo volumes and rail freight movement remains significantly above pre-pandemic levels in Q2FY23 so far. Air passenger traffic is gradually improving. Manufacturing PMI in Q2FY23 remains above (56.3) compared with same period in 2019 (52.0). However, CMIE's new project announcement data and Ministry's IEM approvals have seen a slowdown in Jul'22. Overall, economic recovery seems to remain on track.

Global developments: Global Central Banks are on rate hiking spree with US Fed raising rates by 75bps to new target range of 3-3.25% in its Sep'22 meeting, making it the steepest rise since CY08. The Central Bank also significantly lowered its GDP projections for CY22 to 0.2% (1.7% in Jun'22) and revised upwards its core PCE projection to 4.5% (4.3% in Jun'22). The dot plot indicates that Fed is likely to continue hiking rates aggressively and Fed Fund rate is expected to settle at 4.4% by the end of this year and rise further to 4.75-5% in CY23. BoE too raised rates by another 50bps, marking it the 7th consecutive rate hike, thus bringing the policy rate up to 2.25% (level last seen in CY08).

Elevated sovereign yields: Since the announcement of policy decisions and economic forecasts by major Central Banks, global yields have inched up. With slowdown (US) or contraction (UK) in growth expected in the coming quarters, investors have become more risk averse. Since the rate decisions announced last week by Fed/BoE, US 10Y yield has risen by ~40bps, while UK's 10Y yield is up by 93bps. In line with global yields, India's 10Y is up by 13bps. There is also significant pressure on currencies with DXY up at its two decade high.

Where do our forecasts stand?: Looking at the factors mentioned above, we believe that while growth fundamentals still remain strong and fairly insulated from global economy, a key cause of concern for RBI will remain elevated levels of CPI. This will be driven by deficient/untimely rains and marginally weak Kharif sowing.

1. We maintain our growth forecast for FY23 at 7.2% (unchanged from last policy) with downward bias owing to risks emerging from global growth slowdown and tight monetary conditions. RBI may discuss lowering its growth forecasts, but is not expected to lower below 7%.

2. We expect headline CPI to remain elevated at 6.5-7% for the year. RBI may revise its forecasts (6.7% for FY23) upward if it expects trends in monsoon and sowing to significantly impact food inflation. Lower oil prices will be supportive for CPI and WPI in the coming months.

3. On external sector, INR has depreciated to a record-low of 81.63/$ and continues to hover around 81/$ mark. Risk averse sentiments due to heightened probability of global recession, higher domestic inflation, FPI outflows, depleting forex reserves and a widening trade deficit continue to weigh on the Rupee. We expect INR to trade in the range of 81- 82/$ though the RBI action on Friday and commentary will have a bearing on future movements.

4. Against this backdrop, we expect 50bps rate hike in the current policy and policy rate to gradually reach 6-6.25% in the current cycle. In addition, considering the liquidity did slip into deficit for some time, RBI may also announce measures, including OMOs, for liquidity management.

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
aditi.gupta3@bankofbaroda.com