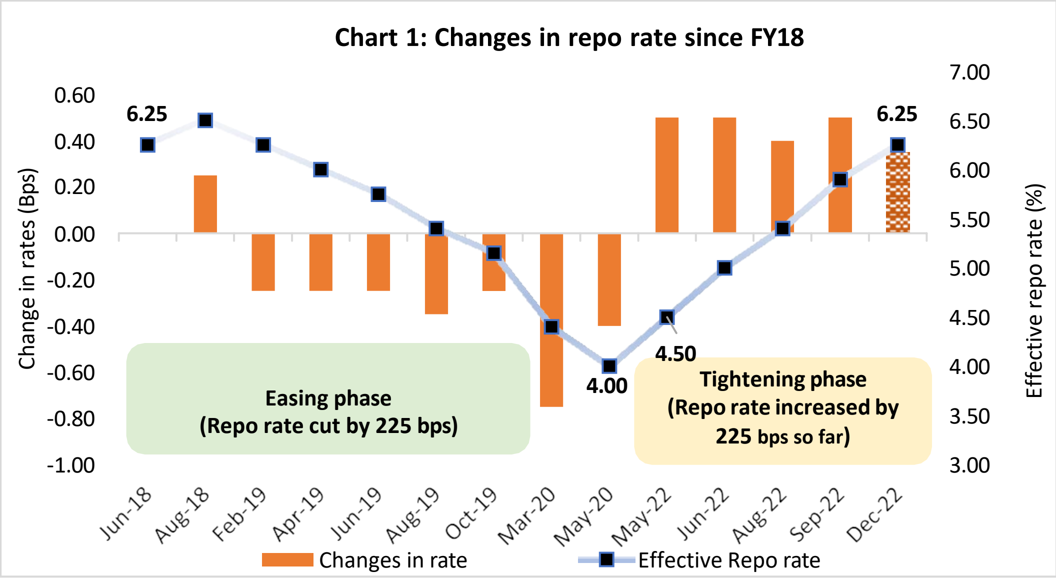
Growth - Inflation Dilemma: Modest hike in policy rates by RBI likely

RBI likely to raise repo rate by 25 bps; may take pause beginning April MPC

The balancing act of supporting growth and controlling inflation remains a priority for RBI's MPC. After going through successive shocks such as Covid pandemic, lockdowns and geopolitical crises, the domestic economy is expected to grow at a rate of 7% in the current fiscal (FY23). This growth is lower than the 8.7% reported in the previous fiscal (FY22). In addition to the growth slowdown, the Indian economy has also experienced elevated price pressures in 2022 due to supply chain disruptions following the Russia-Ukraine war. The war, which started in February 2022 continued for a prolonged period resulting in sharp increases in energy and food prices. Crude oil prices surged to record levels and the consequences of supply disruptions resulted in the CPI inflation peaking to 7.8% in April 2022. Since January 2022, the inflation rate remained above the upper limit threshold of 6%, until October 2022, and the RBI has missed its inflation target range of 2% to 6% for three consecutive quarters. While in the last two months, the CPI inflation rate has softened below the RBI's upper tolerance limit of 6% due to ease in food and fuel inflation though the core inflation remains elevated. Further, the inflation rate remains well above the mid-point target of 4%. The average inflation for FY23 so far (April to December 2022) stood at 6.8% compared to 5.2% in the corresponding period previous year (Chart 1).

The better-than-expected employment data and the expectation of the interest rate hike in the U. S can also lead to increase in the outflow of FII and the present instability in the stock market does not help matters. The pressure on current account and the exchange depreciation and its pressure on prices could also weigh in the decision of the MPC. Under the circumstances, it is likely that the MPC will continue tightening in its upcoming policy meeting, despite slowing growth and may increase the repo rate by **25 bps**. At the same time, considering the situation, they may withdraw the accommodating stance.



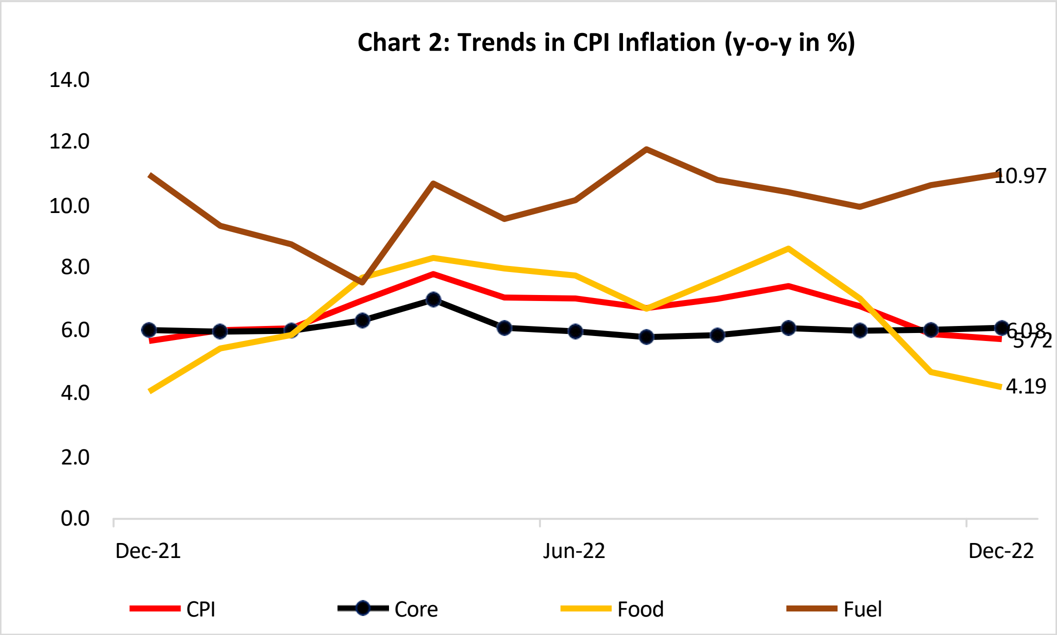
Source: RBI, BWR Research

Ease in inflation entices moderation in policy tightening phase

The CPI inflation had crept above the RBI's tolerance range since January 2022 and it remained above the target range for ten months before returning to below the upper end of the target range of 6% in November 2022. The inflation has eased further to 5.72% in December 2022 due to softening in food inflation. Most of the major food components of CPI inflation basket eased, while the services items are still under pressure. The major cause of concern is higher core inflation, which continued to remain sticky at around the 6% level in the current fiscal (Chart 2).

We expect the inflation rate to moderate in the coming months, supported by some cooling of crude oil prices, an easing outlook on food inflation in addition to the base effect. Crude oil prices have moderated from their record highs and fuel inflation in the wholesale price index has also been exhibiting a fall in recent months. However, the fuel inflation in the CPI basket has softened marginally compared to WPI due to a lagged effect. The pressures on inflation could soften if crude oil prices remain range bound. Easing energy and commodity prices globally would also help keep imported inflation in check.

RBI may retain its projections on overall CPI for FY23 **at 6.7%** in the upcoming MPC meeting. For Q1 and Q2 FY24, the RBI has projected 5% and 5.4% inflation, respectively, which is well below the upper tolerance target of MPC, but higher than the mid-point target of 4%. Hence, the February policy is keenly watched for RBI's inflation guidance for FY24, which will pave way for the policy direction for next fiscal.

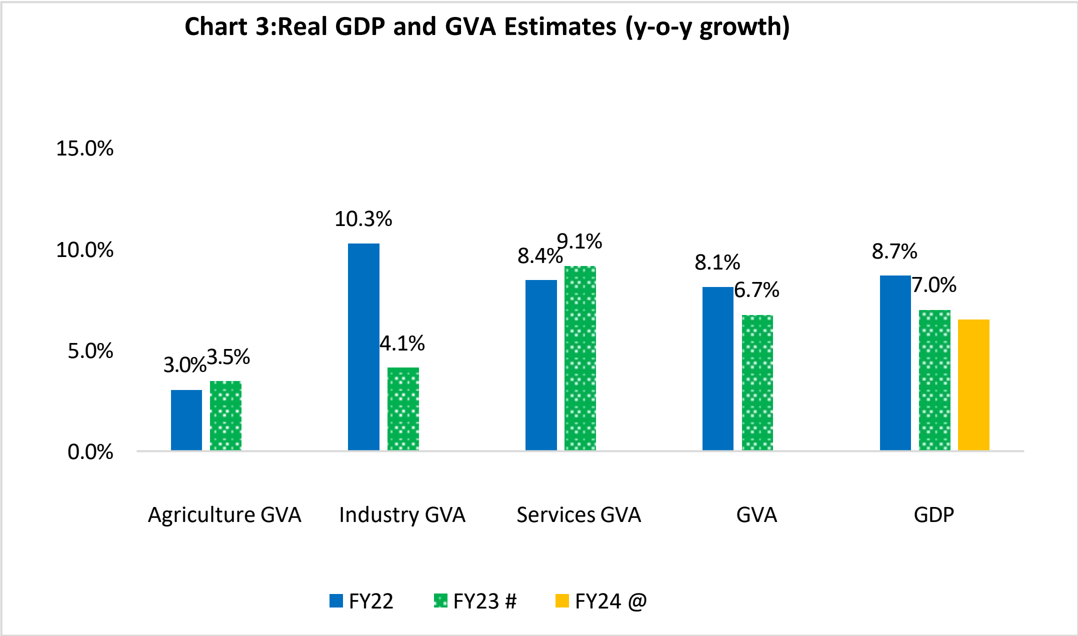


Note: Core inflation excluding food and fuel items
Source: MOSPI, BWR Research

Mixed outlook on growth confounds monetary policy path for FY24

Although broader economic activity has remained resilient, the global economic slowdown has been impacting the domestic economy and many multilateral agencies have been revising India's growth outlook downwards. Meanwhile, the first advance estimates of GDP for FY23 released by MOSPI (Ministry of Statistics and Programme Implementation) are higher at 7% as against RBI's estimates of 6.8%. Economic Survey 2022-23 projects a baseline GDP growth of 6.5% in FY24. This is again an optimistic outlook, given the impending global uncertainties.

The economy is still facing headwinds due to the tightening global monetary conditions and weakening external demand situation. However, some of the high-frequency indicators are showing signs of acceleration in domestic demand. The composite PMI output index continued to expand at 57.5 in January 2023, while the GST collection in January 2023 was the second highest ever at Rs 1.56 trillion. More importantly, the RBI data shows that the outstanding bank credit growth has risen to 16.5% as on 13 January 2023 (y-o-y), as compared to 8.1% in the corresponding period last year.



#: First Advance Estimate, @ Estimate by Economic Survey
Source: MOSPI, BWR Research

We expect the RBI to maintain its GDP outlook for FY23 at 7% and continue to provide the necessary support to sustain the recovery process. To support economic growth, RBI may take a cautious approach in its policy stance in its meeting and continue to utilise its liquidity management tools.

Our Expectations from the February MPC

Considering the global central banks continuing their tightening policy stance albeit with some moderation in the recent meetings, RBI too will continue its monetary tightening cycle. We expect **25 bps** increase in key policy rates, in the upcoming meeting. The MPC may take a pause beginning April 2023, however, these actions will largely depend upon the inflation and growth outlook for FY24.

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