5 Apr 2022

Dipanwita Mazumdar
Economist

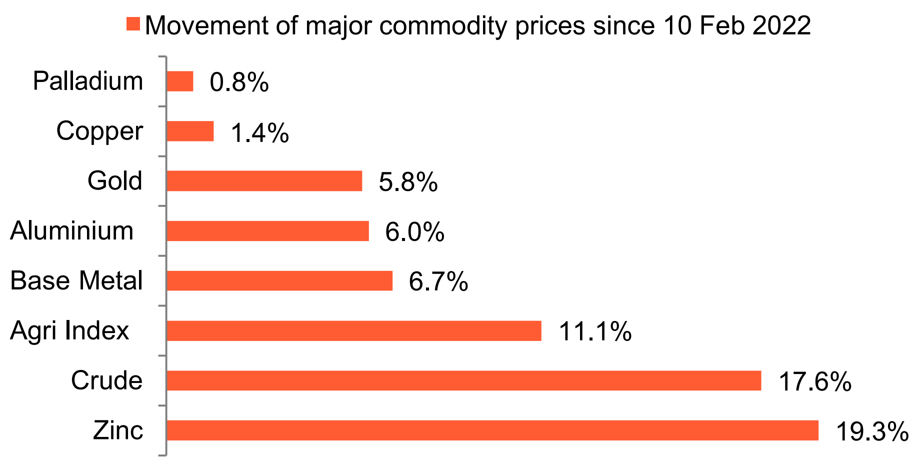
Stance to be changed, rates on hold

In the upcoming credit policy of RBI which is scheduled on 8 Apr 2022, we expect MPC to change stance from accommodative to neutral. We expect no change in rates. This includes also the reverse repo rate given that the weighted average reverse repo rate in the term auctions (under VRRR) is close to the repo rate (4%). RBI is likely to scale down the growth projection from current 7.8% in FY23. However, inflation projections are likely to be revised upward for FY23 from Feb estimate of 4.5%.

Since the last policy which was held on 10 Feb 2022, the macro fundamentals have changed:

1) **Supply side pressure exacerbated with rising oil prices:** International crude prices was trading at US$ 90+/bbl in the last policy. However, subsequetnly it rose to a high of US$ 120+/bbl and is presently trading at US$ 108/bbl. Along with oil, other commodity prices also rose considerably. This is primarily on account of geopolitical tension surrounding Russia-Ukraine war situation.

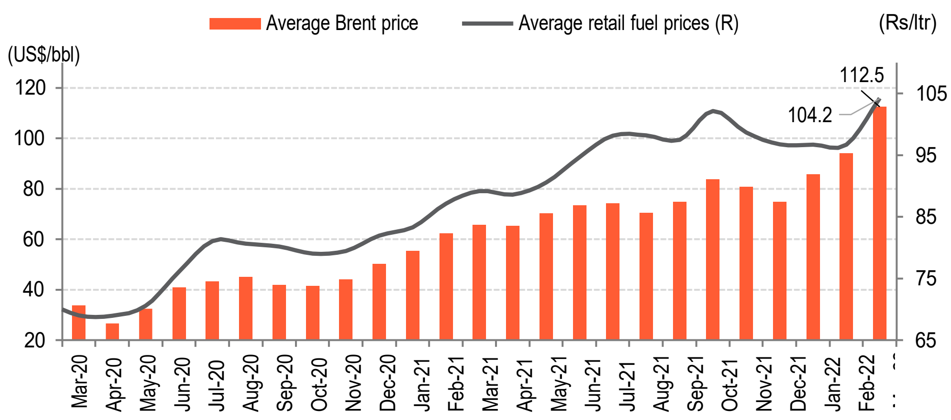
Fig: 1 Since last policy, prices of major commodities remained elevated, despite recent correction



Source: Bloomberg, Bank of Baroda Research

2) **Pass through of international oil to domestic oil prices:** After a freeze of 137days, domestic retail prices of petrol and diesel went up for the 13th session in the past two week by Rs 9.2/lt. Even commercial LPG prices rose by Rs 250/cylinder, as also kerosene prices in PDS (by 15.4% on an average in past two months). Petrol, diesel, LPG and Kerosene related products have a share of 4.2%. These are likely to remain elevated in the near term. The Russia-Ukraine crisis is likely to put pressure on the prices of edible oils, which have already been in double digits in the last 23 months.

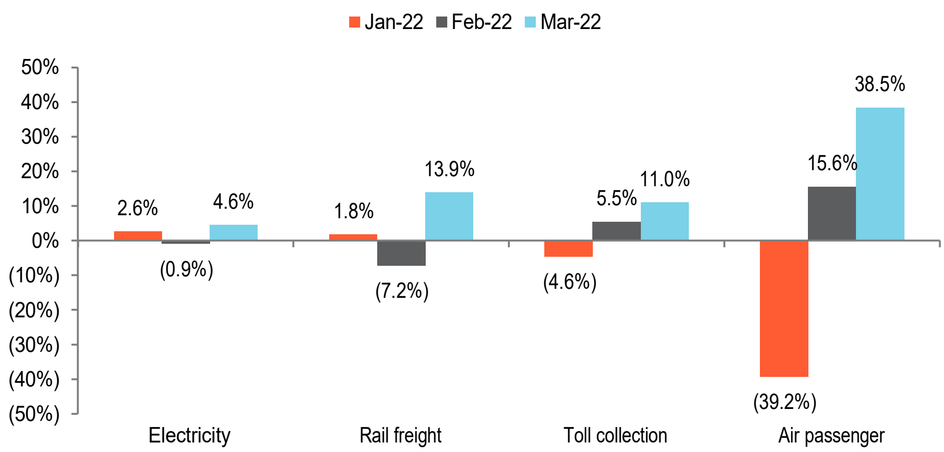
Fig: 2 Pass through to retail prices



Source: CEIC, Bank of Baroda Research, Note: Average retail price of petrol and diesel of Delhi, Kolkata, Mumbai and Chennai is taken

3) **Inflation has surpassed RBI's peak:** In the last policy, statement observed that inflation had already peaked in Jan'22, but in Feb'22 inflation surpassed that level marginally at 6.1% against 6% in Jan'22. In Feb'22, however, price pressure due to the impact of war was not very evident, which will emerge significantly in the Mar'22 print. It may be recollected that 7 out 10 food items exhibited inflationary pressure. Core inflation is likely to be sticky as economic activity has gained considerable momentum (toll collections, electricity demand and mobility indicators-showing improvement). With services running at better capacity across all States, demand side pressure might impact core CPI in the near term as service providers raise their prices to recoup losses over the last two years.

Fig: 3 Movement of high frequency indicators on MoM basis is picking pace

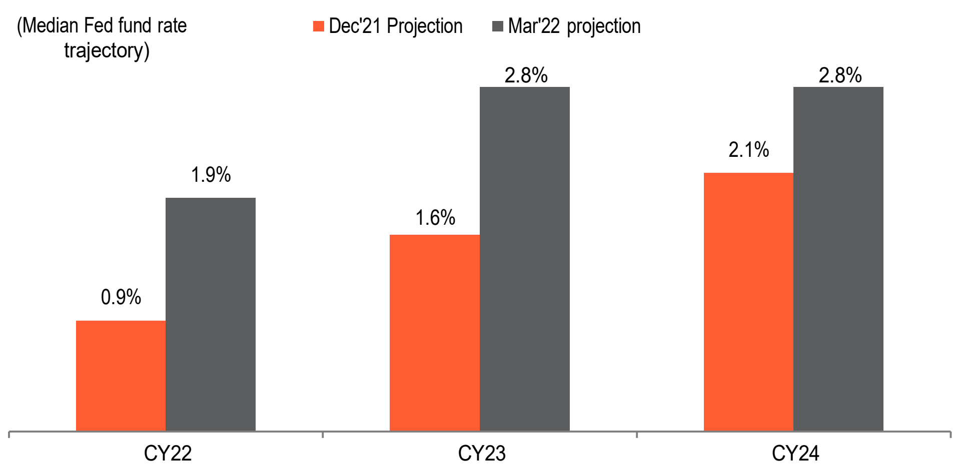


Source: CEIC, POSOCO, Bank of Baroda Research

4) **Global policy tightening has picked pace with US Fed:** In its Mar'22 policy, US Fed has hiked the federal fund rate for the first time since CY18. FOMC projections reveal another 6-7 hikes

in CY22. This is on account of elevated price pressure as inflation overshot its target for 11 months. This has impacted global yields worldwide, with US 10Y yield rising by 25bps post Fed's policy announcement. Even Bank of England has gone for three consecutive rate hikes, steeply upgrading its inflation peak to 8% In Q2CY22 (against 7.25% expected earlier). Eurozone's inflation also rose to its record high of 7.5% in Mar'22, which might prompt ECB to go for a rate hike.

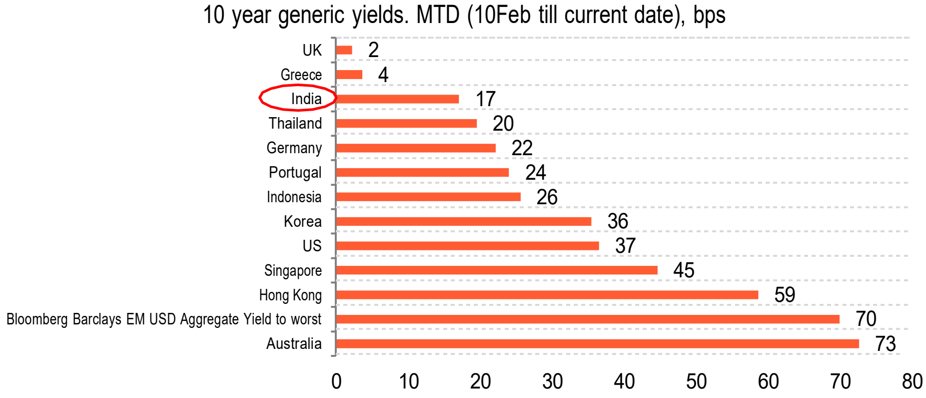
Fig: 4 Fed fund rate to increase up to 2.8% in CY23



Source: Federal Reserve, Bank of Baroda Research

5) **Domestic yields have inched up:** In consonance with global yields and keeping in mind the upshot in inflation as well as the expanding borrowing plan of the centre, domestic yields rose by 11bps. Post the announcement of H1FY23, yields rose by 6bps as the government has announced that it will borrow around 60% of the budgeted amount during the first half of the year. This has impacted rates on Monday- the first trading day post this announcement. Further, the reliance towards long end securities (+10years, issuance at 63% of total issuance), also impacted market sentiments over absorption of these securities in a rising interest rate regime. The bond yields are nervous with the 10-year crossing 6.90% on Monday the 4^{th} as the MPC starts its meetings on the 6^{th}.

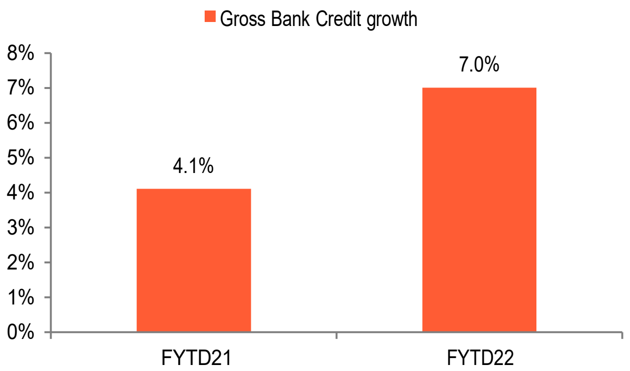
Fig: 5 Global yields inched up so has India's, albeit, by 17bps since the last policy



Source: Bloomberg, Bank of Baroda Research

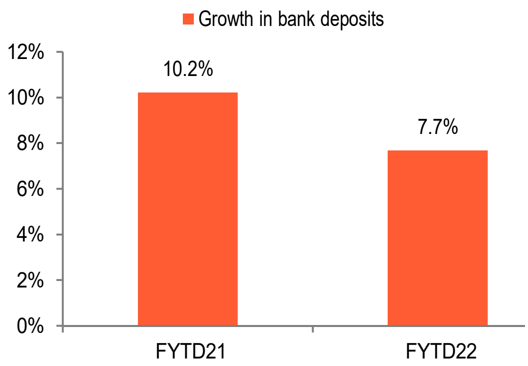
6) **State of credit and deposits:** On FYTD basis, there has been an improvement in credit demand, while deposit growth have slightly moderated in low interest rate regime. Recently with few banks announcing rise in FD rates, deposit accretion is likely to pick pace.

Fig: 6 Credit growth is picking pace



Source: CEIC, Bank of Baroda Research

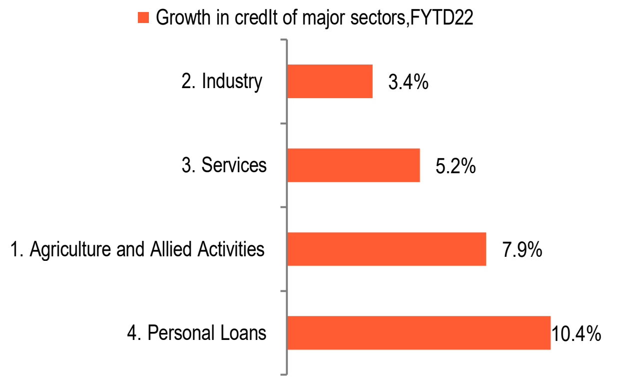
Fig: 7 Deposits growth moderated



Source: CEIC, Bank of Baroda Research

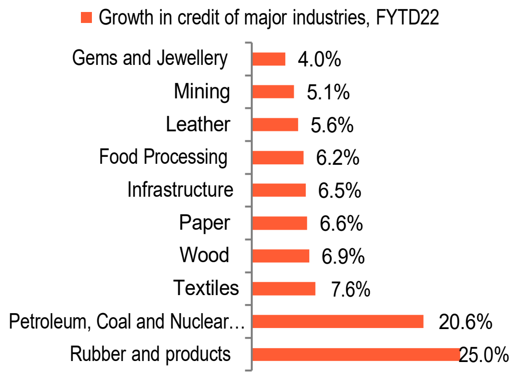
6.1) Details of how credit has grown across sectors:

Fig: 6 Credit demand of personal loans picked up the most



Source: RBI, Bank of Baroda Research

Fig: 7 Within industry, credit demand of gems and jewellery and mining picked up



Source: RBI, Bank of Baroda Research

Against this backdrop we expect RBI to 1) change its stance from accommodative to neutral 2) revise its inflation projections upward for FY23 3) revise downward its growth projection on account of the impact of the impact of war on growth 4) Rates are likely to remain unchanged. Even reverse repo is likely to be retained at the same level as the weighted average rate of VRRR auctions are close to the repo rate.

Our forecast on Growth and inflation: *We expect GDP to grow by 4.8-5.3% in Q4FY22. In FY23, we expect a growth of 7.5-7.75% (25bps downgrade from our earlier projections due to Russia-Ukraine war). For inflation we expect, headline CPI to settle between 5.5-6**%** in FY23 (against our previous forecast of 5-5.5%) and risks remain tilted to the upside*.

Risks to currency outlook: INR is likely to remain under pressure in the near-term. Fed's rate hike will put pressure on INR. Further, higher oil prices remain a key risk to India's external balances. In FYTD22, CAD has expanded to 1.2%, compared with a surplus of 1.7% of GDP in FYTD21. Even though oil prices have seen some correction recently, it continues to hover above US$ 100/bbl, which is likely to push *CAD even higher to 2.5% of GDP in FY23*. This too will have a dampening effect on INR. *The second round of swap by RBI will provide some temporary comfort to INR. For FY23, INR is likely to trade in the range of 76-77/$.*

Conclusion: *Against action taken by global central banks, RBI is following a different path. Inflation concerns have aggravated since the last policy as oil prices rose, pass through to retail prices began and secondary impact will be witnessed in the coming months. Even on the demand side, economic activity has picked pace with services operating with enhanced capacity. We expect though the rates will be on hold in the current meeting, there might be a space of 50bps rate hike in FY23, considering the pressure on inflation. However, the change in stance to neutral will signal to the market that the RBI is cognizant of inflation being more than transitory.*

Disclaimer

Visit us at www.bankofbaroda.com

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
chief.economist@bankofbaroda.com