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No surprises: Another 25bps rate hike possibly in Feb and then pause

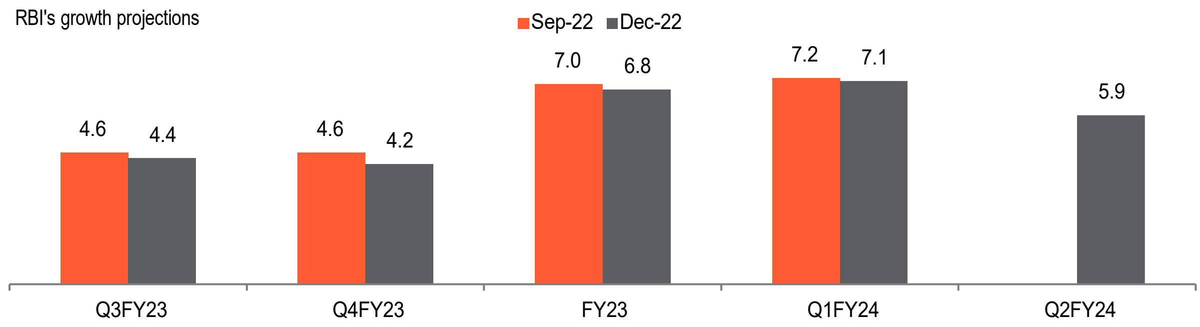
RBI's policy remains in line with expectation. A rate hike of 35bps materialized and the stance of withdrawal of accommodation has been retained. However, cautiousness prevailed with regard to anchoring of inflation expectations and the policy tone reflected need to be mindful of future inflationary shocks even though inflation forecast was unchanged at 6.7% for FY23. On liquidity management, RBI is expected to be 'nimble and flexible' in its approach. Going forward we expect, some comfort to CPI print emanating from favourable base. Even Rabi crop would get relief from good North East monsoon and adequate reservoir levels. However, wariness should prevail with regard to reversal of seasonality decline in tomato and potato prices. Demand pressure still persists as visible in resilient services activity which will tend to push up prices. Thus, our CPI forecast for FY23 stands a tad higher at 6.8% compared to RBI's estimate of 6.7% while our growth projection stand in line with RBI forecast. We expect terminal repo at 6.5% with another 25bps hike in its Feb policy and thereafter a pause. 1Y OIS curve is also trading above 6.5%.

Key Highlights:

- As per our expectations and in line with market consensus, RBI raised policy repo rate by 35bps, with stance continuing to be 'withdrawal of accommodation'.
- However, one important statement which has been added in the current policy is that 'inflation adjusted' policy rate still remains accommodative.
- Inflation forecast for FY23, retained at 6.7% and growth projection revised slightly lower to 6.8% from 7% earlier.
- Liquidity to get comfort from RBI's fine tuning operation. But RBI also highlighted that 'market participants must wean themselves away from the overhang of liquidity surpluses', which might be indicative of liquidity remaining in slight deficit mode.

GDP growth revised downward: RBI has revised GDP growth for FY23 downward by 20bps to 6.8%. Even Q3, Q4 and Q1FY24 trajectory underwent downward revision between 20-40bps. Despite resilient domestic activity, the downward revision was primarily on account of adverse global growth spillover, from which India might not be insulated for long. However, RBI has pointed out that India's growth stands strong in the current headwinds amidst growing consumer confidence, government's thrust on capital spending and resilience in services activity. We also believe that the pent up demand scene which has helped growth will tend to get diluted with inflation affecting spending power going ahead.

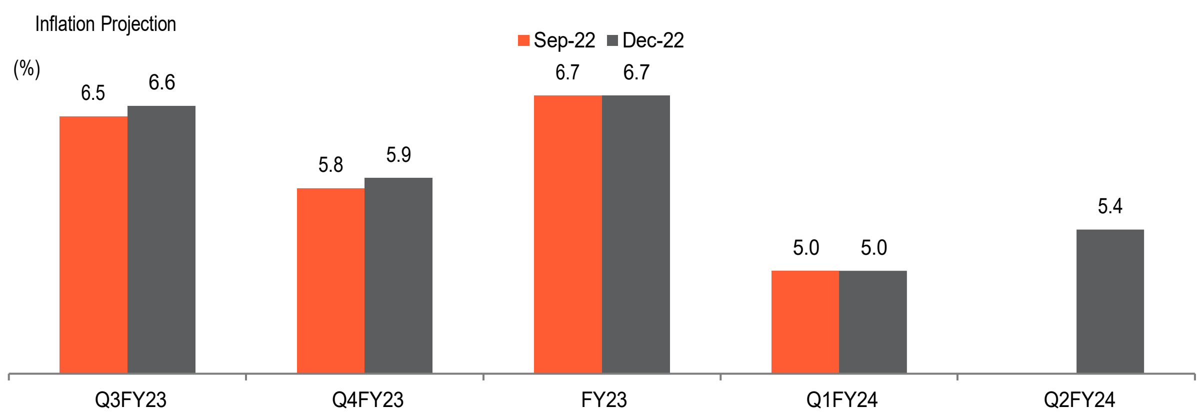
Figure 1: RBI revised downward its growth projection for FY23



Source: CEIC, Bank of Baroda Research

Inflation risks remain: Despite retaining CPI forecast at 6.7% for FY23, RBI Governor in his statement emphasized three key risks 1) for anchoring inflation expectation 2) problem with regard to stickiness in core inflation and 3) second round impact of higher inflation. This clearly reflected that RBI is not over with its rate cycle yet and remains quite cognizant of the next few CPI prints going ahead. Other upside risks to inflation includes imported inflation and pass through of higher costs by firms to consumers which is yet to materialize. Q2FY23 financial results of companies also reflected the same where margins of companies were impacted due to limited pass through. In Nov'22, price pressure in cereals, milk, pulses and spices persist, so considerable risk to headline CPI print cannot be ruled out completely, despite a favourable base. Our forecast of headline CPI for FY23 stands at 6.8%.

Figure 2: Headline CPI forecast kept unchanged for FY23



Source: CEIC, Bank of Baroda Research

How have different rates moved since last policy?

The tightening cycle was reflective in other rates as well which inched up. Since Sep'22, MCLR-overnight rate went up by 25bps, term deposit >1 year rose by 98bps. The weighted average call money rate is trading above repo at 6.13% in Nov'22. The degree of transmission was fastest for term deposit rate >1 year, call money rate, MCLR (IY) for PSBs and 91-day TBill.

Table 1. Movement of key policy rates

Major Rates	Sep-22	Oct-22	Nov-22
Policy Repo Rate	5.90	5.90	5.90
Bank Rate	6.15	6.15	6.15
Base Rate	8.28	8.45	8.45
MCLR (Overnight)	7.30	7.40	7.55
MCLR-1Y (SCBs)	7.75	7.90	8.05
PSBs	7.70	7.83	8.05
PVBs	8.75	8.75	8.90
Term Deposit Rate >1 Year	5.70	6.25	6.68
Call Money Rate (Weighted Average)	5.52	6.16	6.13
91-Day Treasury Bill (Primary) Yield	6.18	6.40	6.45
182-Day Treasury Bill (Primary) Yield	6.64	6.72	6.75
364-Day Treasury Bill (Primary) Yield	6.80	6.92	6.88
10Y Gsec Yield*	7.40	7.45	7.28
INR-US$ Spot Rate (₹ per Foreign Currency)	81.55	82.41	81.53
Forward Premia of US$ 1-month	3.83	3.28	2.21
3-month	3.38	2.86	2.16
Corp Bond 10Y spread with Gsec			
AAA	27	29	31
AA+	67	69	71

Source: RBI WSS, Bank of Baroda Research, Note: 10Y Bond yield closed at 7.25% as on 6 Dec and is trading at 5bps higher today, 91-day TBill closed at 6.31, 182-day at 6.68 and 364-day at 6.79, WACR at 6.13%

Liquidity situation

Two new lines have been added in the Governor's statement on liquidity front, to provide a balanced yet indicative view. First, Governor's address mentions that 'market participants must wean themselves away from the overhang of liquidity surpluses' which is indicative of some likely deficit to prevail in the near term. Secondly, the statement highlighted 'nimble and flexible' approach. Going forward, some comfort would prevail on the liquidity front with accretion in foreign currency assets. However, higher capital spending ahead of the budget, would drawdown government's cash balance and impact the durable liquidity numbers.

External situation

Interestingly the RBI has mentioned that asa result of the measures announced on July 6, 2022 to enhance forex inflows, new external commercial borrowing (ECB) agreements have been concluded for US$ 8.6 billion. This includes US$ 5.1 billion which exceed the earlier threshold of US$ 750 million under the automatic route. The size of forex reserves is comfortable and has also increased. It has gone up from US$ 524.5 billion on October 21, 2022 to US$ 561.2 billion as on December 2, 2022 covering around nine months of projected imports for 2022-23. This does help in stabilizing the external account as well as the exchange rate.

Where do we see terminal repo?

In the current cycle we see another 25bps rate hike which we expect to materialize in Feb'22. RBI was clear in its statement that it is quite cognizant of headline CPI print and intend to take policy course to bring down inflation gradually to the targeted level. Though some of the BRICS nation have already shown some relief on CPI numbers, domestic inflation is still likely to be elevated for FY23. A below 6% print may be feasible only in FY24, that too because of an inflated base and impact of lagged transmission on growth.

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