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Monetary policy: More rate hikes on the cards

In the upcoming credit policy of RBI which is scheduled on 8 Jun 2022, we expect MPC to raise repo rate by another 25-35bps. In the current rate hike cycle we expect repo rate to increase to 5.15% gradually. Inflation forecast is expected to be revised upward from its current projection of 5.7% for FY23. Our forecast is ~6% for FY23. To comfort the yields, OMO purchase announcement/operation switch is expected. 10Y yield is already trading +34bps compared to the last off cycle policy announcement. Further, normalisationon liquidity front (much lower currently at ~+Rs 3tn from its record high of +Rs 9tn seen during Sep'21), recent higher cut off yield at auctions across all tenor, signal higher interest rate in the near term.

What has changed since last off-cycle policy held on 4 May 2022?

1) **Centre intervention**: The centre has announced several measures to assuage supply side concerns. Major ones include additional excise duty on petrol and diesel, fertilizer subsidy and subsidy on gas cylinders, reduction in customs duty on few products. These measures though will provide temporary relief on the inflation front; will entail a fiscal impact of Rs ~2.9 lakh crore. Fiscal deficit may slip to 6.6-6.7% in FY23. Thus through the fiscal channel as well, there might be a secondary impact on inflation.
2) **Oil prices remain elevated:** International crude prices was trading at US$ 105/bbl in the last policy. However, post that it rose by 14.1% to US$ 120+/bbl. Even OPEC+ recent decision to increase output by 648,000/bpd/month (432,000bpd/month earlier), could not support prices. Notably, another important development has been EU countries reaching an agreement to ban most of Russian oil imports under the 6th set of sanctions on Russia. The President of European Council has confirmed that this will immediately impact 75% of Russian oil imports and ~90% imports by end of CY22.
3) **Inflation still elevated:** Major food items which has a prime share in CPI food basket is seen inching up in May'22 as well. Even core inflation is creating a pressure.

Table 1. Movement in prices of major items in the food basket in May'22 over Apr'22

Retail prices of major commodities	Jan-22	Feb-22	Mar-22	Apr-22	May-22
Vegetables					
Cabbage	0.1%	-4.0%	-12.4%	2.0%	12.8%
Potato	-13.0%	1.0%	2.3%	6.1%	11.2%
Tomato	-41.5%	-12.9%	-14.9%	22.6%	63.3%
Fruits					
Apple	-0.4%	0.4%	5.5%	7.5%	16.3%
Pineapple	0.2%	6.1%	0.6%	-0.2%	3.8%
Edible Oil					
Soya Oil	-2.6%	1.6%	9.0%	4.0%	3.3%
Mustard Oil	1.2%	1.07%	1.18%	-4.53%	2.54%
Dal					
Urad	-4.4%	0.1%	0.0%	-0.2%	1.9%
Others					
Sugar	-0.7%	-3.3%	0.8%	-1.1%	1.4%

Source: CEIC, Bank of Baroda Research note: Darker shade of red indicates steeper price increase

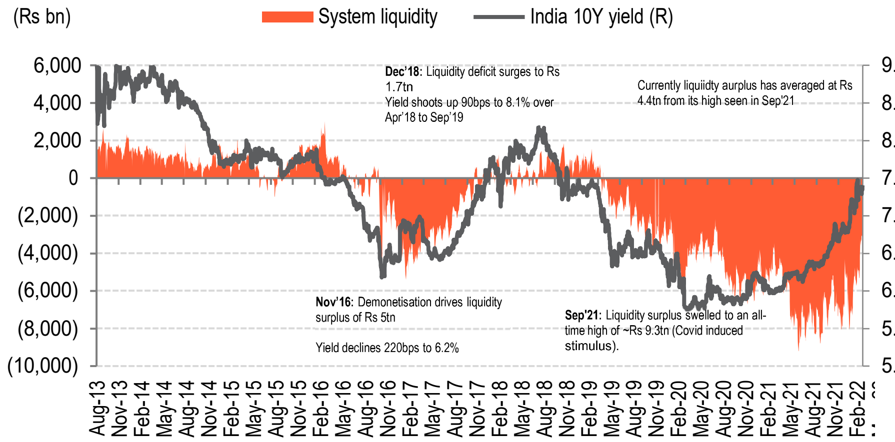
Table 2: Pain points for inflation in FMCG, clothing, footwear, transport and communication and health

Components of Core	Wts	Inflation, YoY				No: of months above 4% (Apr-21-Apr-22)
		FY20	FY21	FY22	Apr'22	
Core Inflation	47.3	4.0	5.7	6.1	7.1	13
Pan,Tobacco and Intoxicants	2.4	4.2	9.9	4.6	2.7	7
Clothing and Footwear	6.5	1.6	3.4	7.2	9.9	12
Housing	10.1	4.5	3.3	3.7	3.5	0
Miscellaneous	28.3	4.4	6.6	6.7	8.0	13
w/w Household goods and Services	3.8	3.1	3.0	5.8	8.0	11
FMCG	3.6	3.3	3.6	6.6	7.6	13
Durable	0.3	1.1	2.1	2.9	5.5	10
Health		6.3	5.1	7.5	7.2	13
Hospital expenses	0.4	8.0	4.6	6.3	6.7	13
Medicine Non-Institutional	5.4	4.8	4.8	6.1	6.5	13
Others	0.1	10.9	2.3	6.4	7.8	12
Transport and communication		2.4	9.8	10.1	10.9	13
Petrol, Diesel & Other lubricants	2.4	-0.9	9.5	15.3	14.8	13
Transportation fares	4.0	1.9	14.2	8.6	7.9	13
Communication	2.2	3.1	6.1	5.6	6.0	13
Recreation and Amusement		4.9	5.1	6.5	7.3	13
Education		5.5	2.8	2.9	4.1	1
Books, Journals, Stationery etc.	0.9	4.4	3.8	4.2	4.5	8
Tuition fees & Others	3.5	5.0	3.0	4.5	4.0	9
Personal Care and Effects		5.6	11.3	4.3	8.6	6
Gold, Silver and other ornaments	1.2	11.4	30.6	7.7	5.2	6
Others	2.7	2.5	3.1	5.2	6.2	9

Source: CEIC, Bank of Baroda Research, Note: Components whose Apr'22 inflation print surpassed 6% have been highlighted.

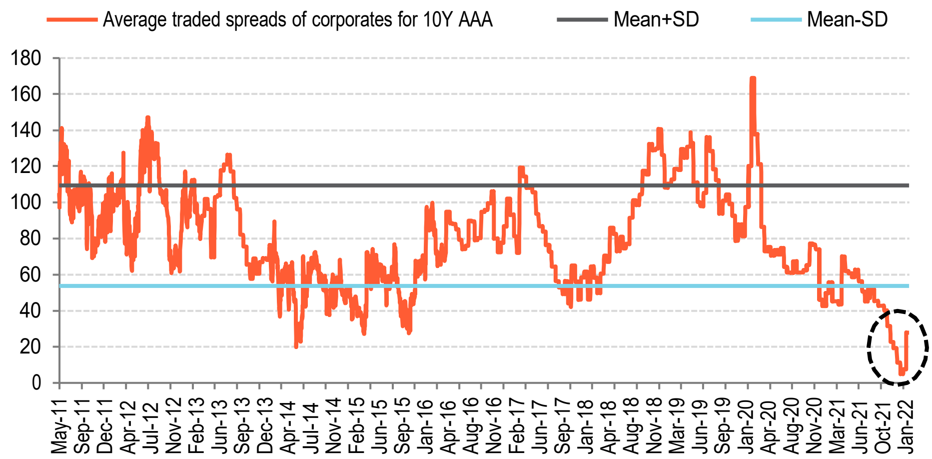
4) **Market rates signal more rate hikes:** The cut off yield for both short and long end yields are increasing off late, clearly signaling rising interest rate cycle. Even the recent 10Yr corporate bond spread rose from its record low in May'22. We expect 10Y bond yields to remain elevated in the range of 7.5-7.75%. We also expect some intervention in the form of OMO purchase announcement/operation twist by RBI. Normalisation on liquidity front is quite visible as in May'22 as it averaged at Rs 4.5tn (currently at + Rs 3tn), far below its high of aboveRs 9tn seen in Sep'22. In the past whenever, liquidity withdrawal has occurred, 10Y yield has risen.

Fig 1: Liquidity normalisation is clearly visible with withdrawal of surplus liquidity, thus yields will rise



Source: RBI, Bloomberg, Bank of Baroda Research

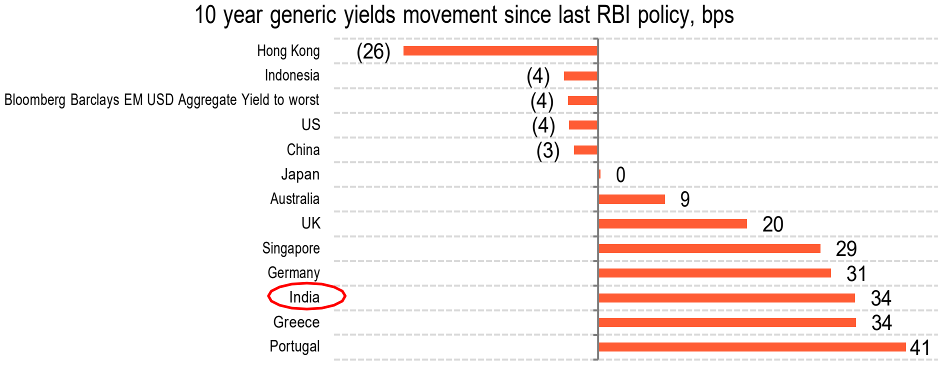
Fig 2: Corporate 10Y spread is also inching up from its record low, signalling faster pace of rate hike



Source: Bloomberg, Bank of Baroda Research

5) **Domestic yields to remain elevated in line with global yields:** Global central banks continued juggling between growth and inflation. San Francisco's Fed President, Cleveland Fed President and Fed governor Waller also spoke of 50bps rate hike in the coming meetings. Even ECB official also said that a 50bps rate hike cannot be ruled out in Jul'22. Further, record high inflation print in the UK, Eurozone and above 8% in the US, would prompt central banks to remain hawkish in the future as well. Thus, in line with global yields, domestic 10Y yield will increase.

Fig: 3 Global yields inched up so has India's, albeit, by 17bps since the last policy

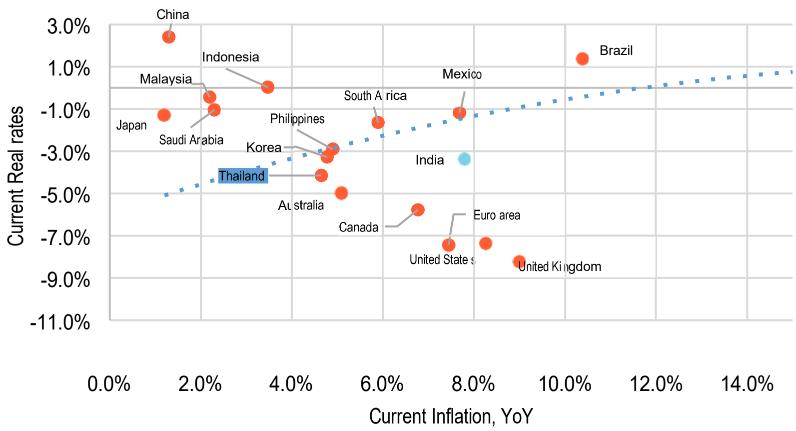


Source: Bloomberg, Bank of Baroda Research

Where our forecast stands?

1) We expect the economy to clock 7.2% growth in FY23 (against our earlier forecast of 7.4-7.5%) with downward bias against the risk of global slowdown and elevated global inflation print.
2) We expect headline CPI to remain elevated at ~ 6% against our earlier forecast of 5.5-6%. Even RBI is likely to revise upward its inflation projection upward against its current forecast of 5.7% in FY23.
3) On external sector, INR depreciated to a record-low of 77.73/$ in the last fortnight but has since found support at the 77.5/$ level. However, higher domestic inflation, FPI outflows, risks to domestic growth outlook and a widening trade deficit continue to weigh on the Rupee. We expect INR to trade in the range of 77.5- 78/$ in the next fortnight with a depreciating bias.
4) *Thus against this backdrop, we expect 25-35bps rate hike in the current policy and policy rate to gradually reach 5.15% in the current cycle.* An argument which can be put forth is that India still has a very high negative real rates. This leaves RBI with more option to maneuverer the policy rate (in terms of raising rates), so that the negative real rates actually don't dent savers and in turn investors and have a second round downward impact on growth.

Fig 4: India still has a very high negative real rates



Source: BIS, Bank of Baroda Research

State of credit and deposits: Credit demand is increasing at a sharper pace. Few of the macro indicators such as services PMI, eight core data print, rail freight, air passenger and GST collections, all signal that economy is gaining momentum. Even deposit growth is picking pace, with rising rates.

Fig: 5 Credit growth is picking up at a sharper pace

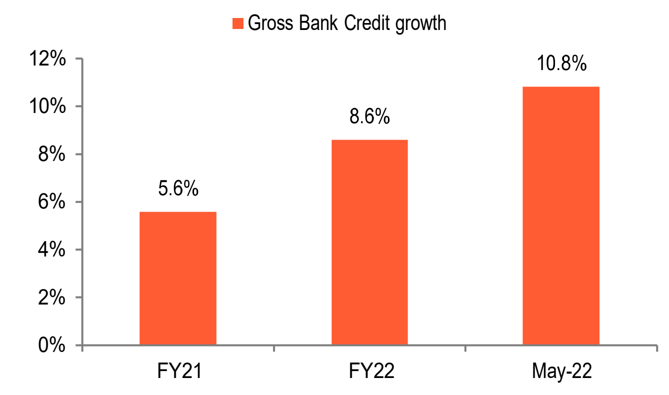
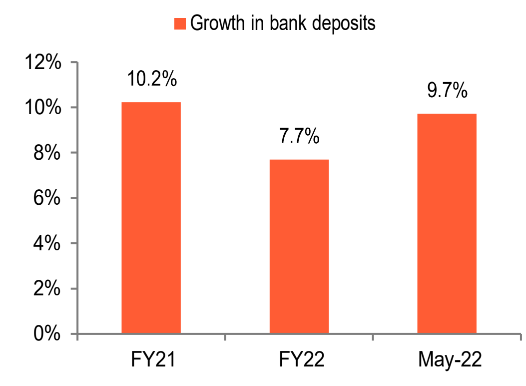


Fig: 6 Deposits growth also rising



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