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RBI to maintain status quo

In the upcoming credit policy meet of RBI, which is scheduled on 8 Jun 2023, we expect MPC to remain on hold and keep the rates unchanged. We also expect no change in stance or any future rate hikes. In fact, we anticipate earliest possible rate cut in Oct'23. Downward revision to RBI's CPI forecast for FY24 can be expected, by 10-20bps. However GDP forecasts are estimated to remain unchanged. Demonetisation of INR 2000 note may provide temporary relief to liquidity and we thus project 10Y yield to trade in the range of 6.95-7.05% this month.

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 (6th Apr 2023), international crude oil price was trading at $ 85.1/bbl, and since then it has come down to US$ 76.1/bbl, thus registering a 10.6% decline. Worries of global growth slowdown led by China and the US, and US narrowly averting a debt default dragged the crude prices down. In addition, strong US$ (+2.2% during the same period) also acted as a drag on dollar denominated oil prices.

Domestic inflation scenario: Most recent CPI print shows that retail inflation has come down to 18-month low of 4.7% in Apr'23 from 5.7% in Mar'23. This was largely on account of favourable base. CPI food index also moderated on the same account. Core CPI was down to 5.2% in Apr'23, supported by dip in transport and communication. Current dip international oil prices, food prices and other commodity prices, we expect inflation to remain with RBI's targeted band in coming months. Persistent favorable base will also help. We thus expect RBI to revise its current inflation forecast from 5.2% for FY24 to 5-5.1%. However, upside risks do persist. Delayed onset of the monsoon, voluntary production cuts announced by OPEC+ members to support crude oil prices, and passing of the debt ceiling deal in the US might exert upward pressure on commodity/domestic food prices.

Monsoon and sowing: IMD has recently confirmed that onset of monsoon in Kerala has missed its 4th June 2023 deadline and is now expected to be delayed by another 2-3 days. Under normal circumstances, monsoon in Kerala begins from 1 June and it gradually covers the entire country by 15 Jul. Further it has also warned that conditions might change following the arrival and low pressure area may move away from the coast of India, thus impacting the progress of monsoon. This will have an impact on domestic food prices, and rural demand. RBI will await more details on status of actual rainfall before taking any action.

High-frequency indicators: Economic activity is signalling mixed trends. While on one hand, manufacturing activity seems to have picked up pace in May'23 (PMI at 58.7 versus 57.2 in Apr'23), service sector growth is showing some moderation (PMI off its peak of 62 in Apr'23 to 61.2 in May'23). GST collection data is in line with this, recording Rs 1.6 lakh crore as collections for May'23, compared with an all-time high of Rs 1.9 lakh crore for Apr'23. Slight easing also seen in rail freight movement, and PV sales. However, air passenger growth, toll collections, electricity demand seem to be improving. Central will remain in wait and watch mode before it takes a call on change in its GDP forecasts.

Banking sector growth: Bank credit continues to remain on strong footing, albeit slowing marginally in May'23. Growth eased a tad to 15.4% as of 19 May 2023, from 15.9% in Apr'23, dragged by slight moderation in non-food credit (15.6% versus 16.2%). up till Apr'23, credit growth was led by large industries and service sector. Credit to micro & small, and medium industries witnessed a slowdown. Credit to infrastructure, construction, engineering, base metal, and cement registered an uptick in Apr'23. Within services, transport operators, computer software, and trade services were the key drivers of growth. Deposit growth on the other hand, continues to inch up, recording 10.9% increase of 19 May 2023, compared with 10.4% growth in Apr'23. Following the demonetarisation of INR 2000 note, deposits and thus banks' liquidity to get further boost.

System liquidity: On an average, liquidity surplus was at Rs 0.72 lakh crore in May'23. In Apr'23, average system liquidity was also in surplus, to the tune of Rs 1.5 lakh crore. Durable liquidity rose to Rs 89,697 crore as on 31 May 2023 compared to Rs 79,885 crore as on 28 Apr 2023. In Jun'23, some pressure on liquidity might be visible due to maturity of Rs 0.13 lakh crore of securities. However with demonetarisation of INR 2000 note, RBI's need to infuse durable liquidity for the time being has reduced. Thus we expect RBI to keep its stance—"withdrawal of accommodation"—unchanged in the Jun'23 policy.

Softening sovereign yields: Since the last policy, yields on 10Y G-sec have fallen sharply by 22bps and are currently trading around the 7% mark, compared with 7.26% before the Apr'23 policy. Possible pause by US Fed and decline in international oil prices has helped. In addition, reduced need of RBI to infuse liquidity in the system has also taken off the pressure.

Global developments: US Fed is likely to pause to wait and watch the impact of its already aggressive monetary policy tightening so far. The economy is giving mixed signals with weakening manufacturing sector activity, waning consumer confidence, elevated inflation expectations, and pick up in real estate activity and relatively tight labour market. Elsewhere, surprisingly sticky inflation in the UK has raised the probability of 2 more rate hikes by BoE. In Eurozone, ECB officials continue to signal that further tightening is needed to bring inflation down on sustainable basis.

Where do our forecasts stand?: Looking at the factors mentioned above, we believe that growth fundamentals still remain strong and are fairly insulated from global economy. Key uncertainty remains around the progress of monsoon. This has potential upside risks for food inflation and rural demand.

1. We expect economy to moderate by 6-6.5% in FY24 against the headwinds of global economic slowdown, weaker exports, lower services sector due to waning pent-up demand and dwindling agriculture growth assuming the monsoon is not normal or spatially distributed and aggravating heat wave conditions (El Nino). These remain key risk to our growth projections. We do not expect RBI to revise its GDP forecast for the time being.

2. We expect headline CPI to cool down in the range of 5-5.5% in FY24. RBI may revise its current forecasts (5.2% for FY24) downward by 10-20bps, in view of lower international commodity prices and moderation in core CPI.

3. On the external sector side, INR has depreciated further by 0.5% since the last policy, as US$ continues to strengthen. It is still hovering above 82/$ mark. Risk averse sentiments which persisted during the month of May’23 (risk of US debt default, probability of rate hike by Fed) have now begun to fade. Dovish comments from Fed officials indicate that Fed might pause in Jun’23. In addition, lower trade deficit, FPI inflows and lower oil prices will also support INR. We expect it to trade in the range of 82-83/$ in the next fortnight.

4. Under these conditions, we expect RBI to maintain status quo on rates and stance. We do not expect any significant announcement on liquidity front either. In terms of forecasts, RBI may revise its CPI forecast lower and await more information before changing its growth forecasts for FY24. Earliest possible cut in rates can be expected in Oct’23 policy meeting and we anticipate no more than 50bps reduction in rates in FY24.

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