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RBI likely to stand pat

The Monetary Policy Committee is expected to keep the repo rate unchanged at 6.5% in the upcoming policy meet. While risks to inflation have risen, the MPC is likely to weigh on the transient nature of food prices and hence stand pat on rates. While food prices have seen an uptick, much of it could be temporary. Core inflation has also remained benign. We expect inflation to remain elevated in Jul'23 and Aug'23 led by food, before correcting in Q3FY24. Inflation in FY24, is likely to remain within RBI's target and hence a pause seems prudent. Policy stance is also expected to remain unchanged at "withdrawal of accommodation" as liquidity surplus in the system stands at over Rs 2 lakh crores. We rule out any rate action from the RBI till Dec'23. Beyond this, we do see room for a rate cut, probably in Feb'24 but will be data driven.

Inflation, upside risks persist: RBI in its last policy kept policy rates unchanged. Inflation prints subsequent to the meeting showed that inflation remained within RBI's target range at 4.3% and 4.8% respectively in May'23 and Jun'23. However, since then, inflationary pressures have increased. Soaring vegetable prices, driven by higher tomato prices threaten the trajectory of inflation. However, the increase in food prices appears to be temporary and prices are expected to cool once new harvest enters the market. Worryingly, price pressures can also be seen in other essential commodities (Please refer to our latest update on BoB Essential Commodities Index), which is likely to keep inflation elevated in Q2FY24. Apart from this, global oil prices have also started inching up led by production cuts from Russia and Saudi Arabia, which pose further risks to inflation. Overall, we expect inflation rate in Jul'23 to inch up closer to RBI's 6% upper limit. Even in Aug'23, inflation is expected to remain heated. It will be important to gauge RBI's assessment of recent spike in prices, and whether it leads to upward revision to its inflation forecast for FY24 which stands at 5.1%.

Growth steady: High-frequency indicators suggest a steady pace of economic activity. While manufacturing PMI remained stable in Jul'23, services PMI expanded to a 13-year high, with both sectors registering strong demand. Other indicators such as E-way bills, GST collections and credit growth are also witnessing momentum. Rainfall activity has picked up pace, which has translated into improved sowing of kharif crops. Government capex continues to be a key driver of growth. Centre's capex spending has increased by 59.1% in Q1FY24. Based on this development amongst others, we expect GDP growth in FY24 to broadly evolve as per RBI's projections. We expect GDP growth in the range of 7.5%-8% in Q1FY24, and maintain our forecast for FY24 at 6%-6.5%. Hence, the need to stimulate growth may not hold much appeal for the RBI at this juncture.

Liquidity conditions comfortable: Domestic liquidity continues to remain in surplus. Average liquidity surplus rose to Rs 1.6 lakh crores in Jul'23 from Rs 1.3 lakh crores in Jun'23. It has further increased to Rs 2.25 lakh crores in Aug'23 (8 Aug 2023). Demonetisation of Rs 2,000 notes as well as RBI's fine-tuning operations have lent support to domestic liquidity. We expect liquidity conditions to remain comfortable which suggests that RBI is likely to maintain its stance unchanged at "withdrawal of accommodation".

Global central banks, increasing policy divergence: Monetary policy divergence between countries is visible, with central banks in advanced economies (AEs) continuing to raise rates, while EM central banks opting for a pause or rate cut. The Fed, European Central Bank (ECB) and Bank of England (BoE), all raised policy rates by 25bps in their respective meetings last month. Even Bank of Japan, tweaked its yield control curve (YCC) policy. However, the future path of rates looks uncertain. There are indications from both the Fed and ECB that the interest rates might have peaked. This might not hold for the BoE, as inflation in UK continues to remain uncomfortably high. While RBI has maintained that its decision is based on domestic inflation and growth considerations, the fact that global central banks may be less aggressive in future rate hikes, should work in favour of RBI keeping rates on pause at least for some time.

Currency, under pressure once again: After remaining range-bound for a major part of the year, INR has once again come under pressure. Risk-off sentiment post US' rating downgrade as well as higher oil prices are weighing on INR. FPI inflows have also slowed down. However, RBI has steadily strengthened its forex kitty to above US$ 600bn which will help INR sail through the current period of heightened volatility. An unchanged policy rate and stance will also help improve confidence in the domestic currency.

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