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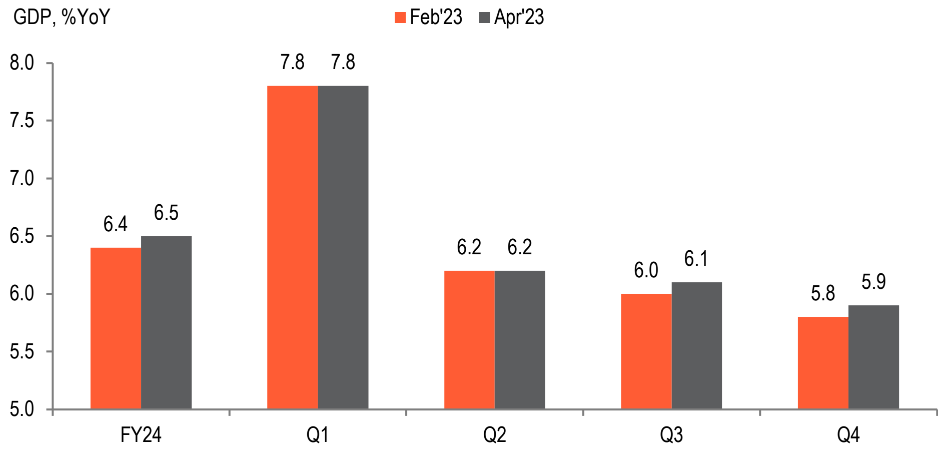
RBI surprises with a pause

MPC members today unanimously decided to keep the policy rates unchanged, after hiking continuously since May'22. With this, repo rate remains unchanged at 6.5%, SDF at 6.25% and MSF and bank rate at 6.75%. In doing so, the central bank maintained its stance of "withdrawal of accommodation" as inflation remains above RBI's targeted level. For FY24, inflation forecast was revised downward to 5.2% and GDP forecast upward to 6.5%. Given the baseline assumptions, we do not expect RBI to hike rates any further this year. However, in case upside risks for inflation play out and CPI begins to inch up again, RBI has kept its options open to increase rates. Our FY24 expectation for inflation is slightly on the higher side at 5.5%, while GDP forecasts are in line (6-6.5%) with the central bank.

Surprise pause: As against our expectation of 25bps hike, MPC members unanimously decided to keep the repo rate unchanged at 6.5%. Subsequently, SDF rate remains at 6.25% and MSF and Bank rate at 6.75%. Cumulatively, RBI has raised repo rate by 250bps since May'22. However, Governor in his statement clarified that "the decision to pause on the repo rate is for this meeting only" and that "while closely monitoring the evolving inflation outlook, the MPC will not hesitate to take further action as may be required in its future meetings". RBI governor further explained that today's decision has also been taken to assess the impact of previous rate hikes. The central bank also decided to keep its focus on "withdrawal of accommodation", as inflation currently remains above RBI's targeted band. This allows RBI to keep its options open for rate hike in case upside risks to inflation actually play out.

GDP growth forecast revised upward: For FY23, the central bank continues to assume 7% growth, which is line with NSO's estimates. However, for FY24 projection was revised upward by 10bps to 6.5% from 6.4% noted in Feb'23 policy. RBI's more optimistic economic outlook is on the back of: higher Rabi production, which will help boost agriculture sector and rural demand; continued strength in service sector activity which will help urban demand; and government's enhanced budget for capex spending in FY24. Investment activity is seen improving led by government's push to infrastructure spending and higher capacity utilization. The revisions have been made mainly for growth in H2FY24. Current RBI growth projections stand at: Q1 at 7.8%, Q2 at 6.2%, Q3 at 6.1% (6% in Feb'23 policy) and Q4 at 5.9% (5.8% in Feb'23 policy). Downside risks to growth have been sighted as: slowing global demand which can hamper our exports, prolonged geo-political tensions, and increased volatility in international financial markets.

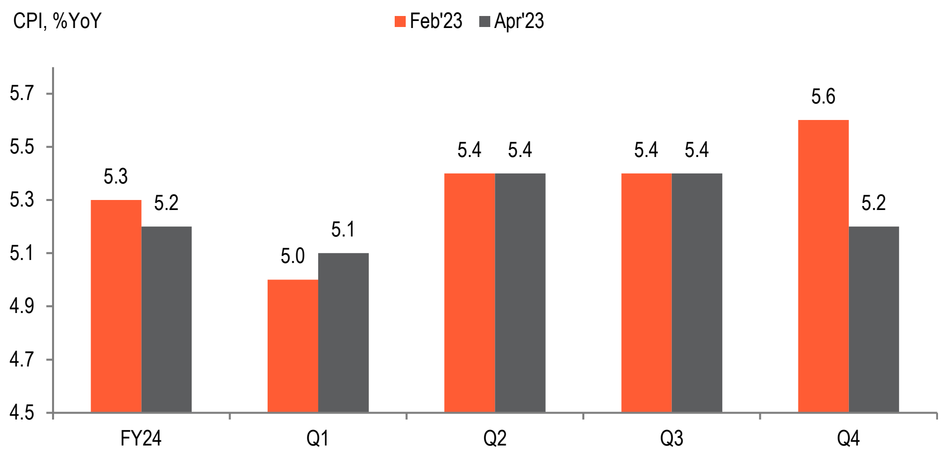
Figure 1: RBI growth projections



Source: RBI, Bank of Baroda Research

Inflation projections lowered: For the current fiscal year (FY24), RBI projects inflation to moderate to 5.2% compared with 5.3% estimated in its Feb'23 policy. Some of the key factors which led to the downward revision of CPI forecast included: correction in wheat prices, moderation in global commodity prices, dip in inflation expectations of households, and sharp downward revision in RBI's assumption of crude prices (US$ 85/bbl versus US$ 95/bbl assumed in Feb'23). On account of these factors, estimate for Q1 has been revised upward (5.1% versus 5%), while they remain unchanged for Q2 and Q3 (5.4%), and significant downward revision is noted in Q4 (5.2% versus 5.6%). Upside risks to inflation have also been flagged and these include: adverse climate conditions (heat waves and unseasonal rains), tight demand-supply in case of milk prices, increased fodder costs and imported inflationary pressures. As a result, RBI has kept its options open for future rate hike in case need arises.

Figure 2: Headline CPI forecast lowered for FY24



Source: RBI, Bank of Baroda Research

Impact

- As RBI hit the pause button and kept repo rate unchanged, 10Y G-sec yields have inched down by ~6bps. In its latest statement baseline projection for inflation in FY24 has been revised downwards, indicating that in case there is no severe deviation from the projected path, RBI is likely to opt for a prolonged pause. The 10-year rates will range between 7.2-7.3% in the near-term.
- We expect pressure on liquidity to remain in deficit in the coming months on account of maturing TLTROs (~Rs 73,000 crore this month) and lack of robust FPI inflows. Further as credit growth is still at a double digit pace of 15% and deposit growth is at 9.6%, so in the near term as well, a gap of around 5-6% cannot be ruled out. In addition, we also expect VRR and fine-tuning operations to continue in order to manage liquidity.
- GDP growth projection of 6.5% is on the higher side of the range projected by us at 6-6.5%. While we also expect disruptions to domestic economy to be minimal in the wake of global recession, we have concerns owing to stickiness of core inflation impact purchasing power of consumers and hence hitting the domestic demand. We await more information on monsoon forecasts to gauge the impact on GDP.
- Inflation forecast of 5.2% is lower than our forecast of 5.5%. Upside risks from adverse climate conditions hitting food inflation remain worrisome.

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