RBI: PRE-POLICY VIEW

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Time to Hike: Reverse Repo

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Elevated crude oil and commodity prices continue to add to India's inflation concerns. It may be expected that the RBI will reprioritise and focus back on inflation. Excess liquidity in the system is another issue to contend. We expect RBI will hike reverse repo rate by 25bps and thus reduce the gap in policy corridor. Short term rates have also been inching towards Repo rate. We anticipate no change in repo rate, while GDP forecast is likely to revised lower for FY22.

Ongoing Challenges for economy: In the last 2 months, countries across the globe once again fought the new variant of Covid-19. India too was caught in the winds once again as it bravely battled the third wave of covid-19. States re-imposed restrictions in order to curtail the spread of Covid-19. With service sector challenges, the economy is again expected to witness some slowdown. However, the impact is expected to be mild as things have improved for the better with Covid-19 cases ebbing lower and states slowly and gradually reopening up.

GDP remains in the target range: Given recent headwinds to growth, India's economy is expected to grow by 8.8% in FY22 and 7.75% to 8% in FY23. This is on the back of revival in demand including credit.

Can RBI be behind the curve? : Global central banks have sprung in to action by tightening the monetary policy with BoE hiking rates consecutively in its last two meetings. There has also been anticipation of rate hike from US Fed. With this, there is an expectation of rate hike from RBI too as it returns to its mandate of price stability.

Inflation remains worrisome: An uptick in CPI inflation has been observed lately as it climbed up to 5.6% in Dec'21 from 4.9% in Nov'21. Given the spike in crude oil prices, along with increase in global commodity prices, these factors are likely to impinge on inflation. Further, once the state elections are over, inflation is expected to increase further as fuel prices are changed.

Expectations from RBI: Given the revision in FY21 estimates by NSO, we expect RBI too revise its growth forecast for FY22 downwards. However, no change in inflation forecast is expected at this juncture. Overall, we expect a reverse repo rate hike by 25bps and reduce the asymmetric gap in the policy corridor. Apart from this, we expect RBI to retain Repo rate at 4%. We also do not expect any changes in the CRR in this policy meet.

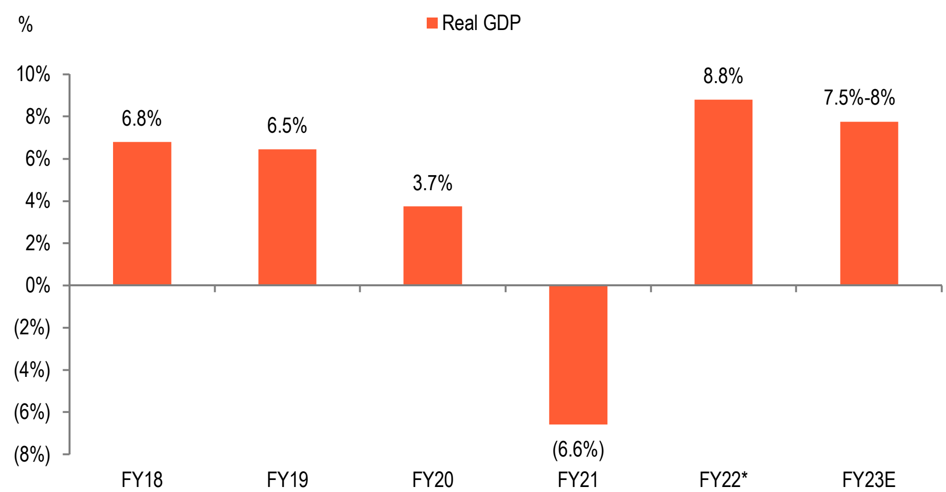
Where do we stand: Macro View

All eyes in the coming week will be on RBI as it comes out with its last policy for FY22. Will there be any change in its stance (currently it is accommodative), policy rates, and revision in GDP and inflation forecast? Before the RBI unveils what it holds in its repertoire, it is important to note where does the economy stand and whether there are any headwinds for growth, and whether sticky inflation is a concern now. These will be discussed in greater detail along with our expectations from RBI.

GDP growth on target

Global growth came to a standstill in the wake of Covid-19 pandemic and contracted by 3.1% in CY20 from an increase of 2.8% in CY19 (WEO,IMF). However, rapid pace of vaccinations along with other country specific monetary and fiscal tools helped countries tide over this ongoing crisis. With this, global growth rebounded back sharply to 5.9% in CY21. In line with the world economies, India too was deeply impacted with GDP growth contracting to 6.6% in FY21 compared with an increase of 3.7% in FY20. However, there has been a significant revival in the overall economy, on the back of policy intervention by government in the form of stimulus packages and higher rate of vaccinations. RBI too has stepped in to provide requisite cushioning the economy. With this, India is expected to grow by 8.8% (Revised Estimate) in FY22. We expect the economy to further grow by 7.5%-8% in FY23.

Fig 1 – GDP growth in FY23 expected to be in the range of 7.5%-8%



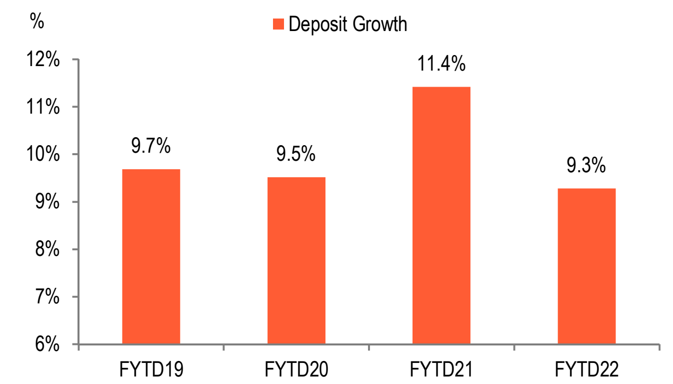
Source: CEIC, Bank of Baroda Research Note: FY22 is revised estimates, E: Bank of Baroda Estimates

Bank Deposits and Credit Story

Deposit growth scaled new highs in FYTD'21 as it clocked double digit growth at 11.4% compared with 9.5% in FYTD20 as savers began to deposit large sum of money in banks in the wake of Covid-19 pandemic. There has been some moderation in the same lately (FYTD22). Credit story on the other hand started slower though has picked up pace as there is renewed demand for credit thereby signalling pick-up in economic activity too.

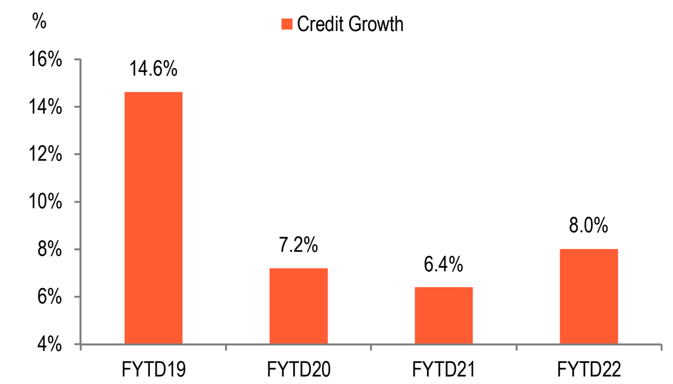
Against this backdrop, some of the banks have already begun raising deposit rates across maturities.

Fig 2 – Deposit growth has lately been moderating…



Source: Bloomberg, Bank of Baroda Research | Fortnightly data as of 14 Jan 2022

Fig 3 – …though credit growth has picked up



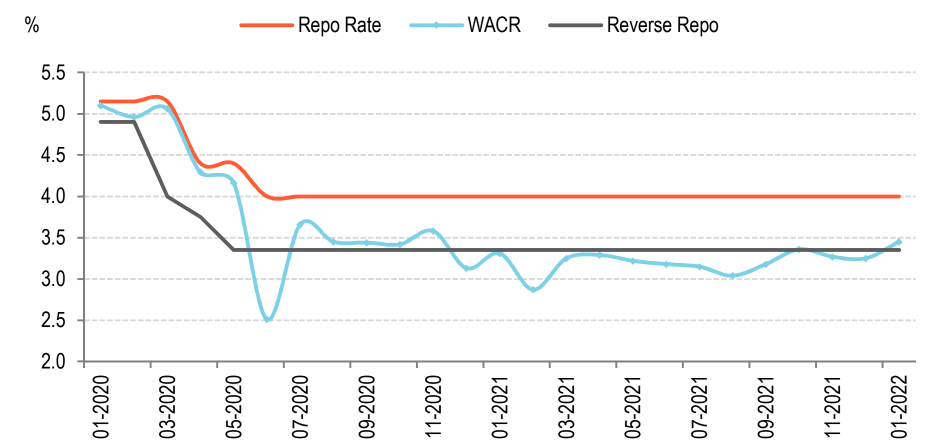
Source: Bloomberg, Bank of Baroda Research | Fortnightly data as of 14 Jan 2022

Interest rates

In the beginning of FY21 as the country was battling the Covid-19 pandemic with lockdown restrictions and uncertainty at large, RBI reduced repo rates in May'20 with the objective to support the economy. With lower repo rates, Banks were flushed with additional liquidity and were risk averse to lend these funds during the given period. It is at this time, reverse repo enters the picture as RBI had also reduced this rate by over 65bps from Mar'20 to May'20 thereby making it became less attractive for the banks to easily park their funds with Central Banks. With this, the reverse repo became the new benchmark rate as banks were pushed to lend more.

Notably, with this the gap between both repo and reverse repo rates widened by 65 bps from 40bps in Mar'20. It has been since May'20 that RBI has changed these policy rates. With this, it also interesting to note that the short term rates have moved past the reverse repo and is now inching towards repo rate.

Fig 4 – Policy corridor widening, WACR inching toward Repo

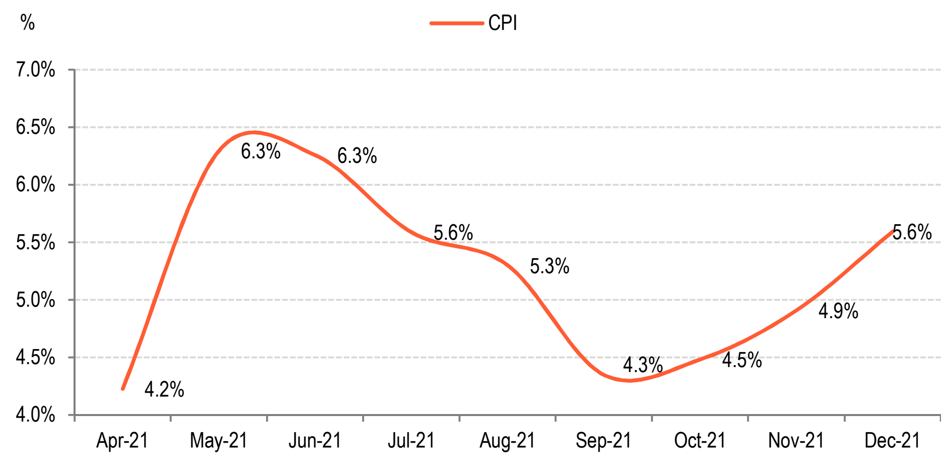


Source: CEIC, bank of Baroda research

Inflation woes to continue..

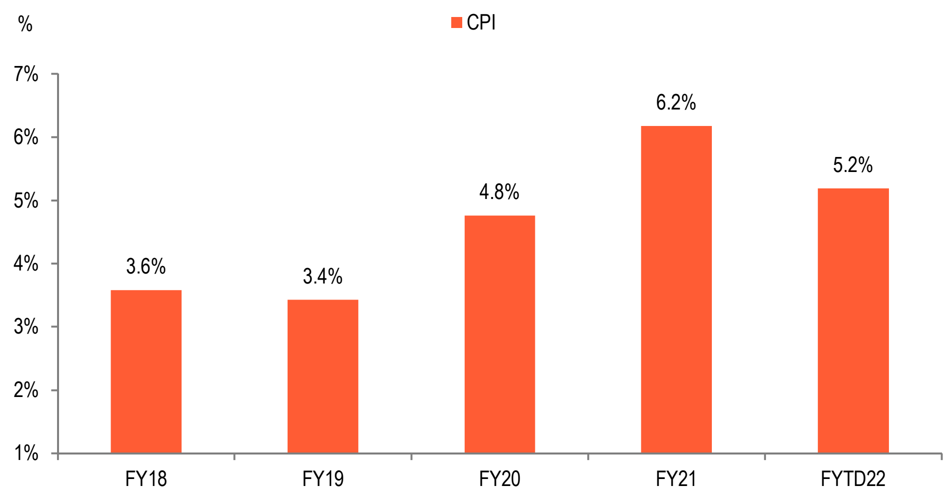
RBI in its last policy had kept inflation forecast for FY22 at 5.3%. Currently on a FYTD basis, inflation is at 5.2% which is marginally lower than RBI's forecast for entire year. It is important to note the significant uptick in inflation from 4.9% in Nov'21 to 5.6% in Dec'21. In addition, rising crude oil prices (hovering near the $ 85-90 mark) remains a cause of concern and will feed in to higher inflation. We expect inflation to continue it upwards trajectory and accelerate by 5%-5.5% in FY22.

Fig 5 – Uptick in CPI inflation



Source: Bloomberg

Fig 6 – Inflation over the years



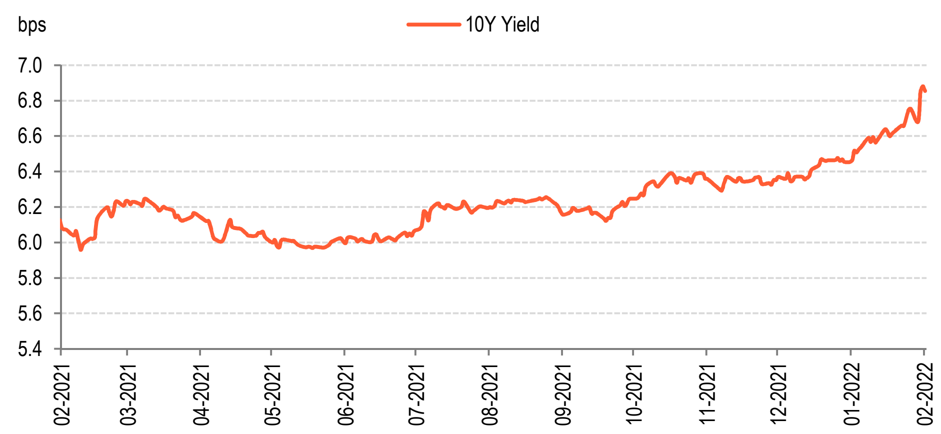
Source: Bloomberg, Bank of Baroda Research

Bonds hold a different narrative

Bond yields have been hardening recently. A variety of factors have contributed to this surge including the announcement in the Budget of the centre's borrowing plan of Rs 14.95tn, spike in crude oil prices, Fed's hawkish commentary as it is likely to hike rate as soon as Mar'22 and growing risk to inflation.

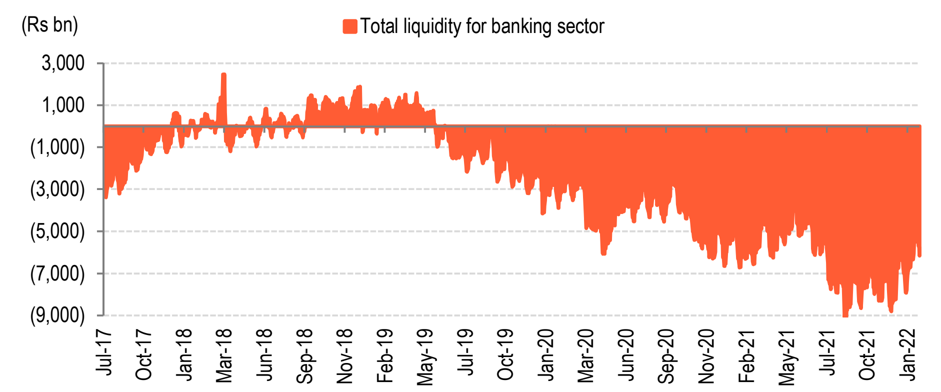
Bond market will closely track RBI's commentary on liquidity. The fine tuning operation haven't provided the necessary comfort with reversal of RBI's VRRR auctions in the past week and surging implicit cut off yield across all tenor. System liquidity is again rising to its Rs 7tn amount seen during Q3.

Fig 7 – 10Y Bond yield



Source: Bloomberg, Bank of Baroda Research

Fig 8 – Banking Liquidity



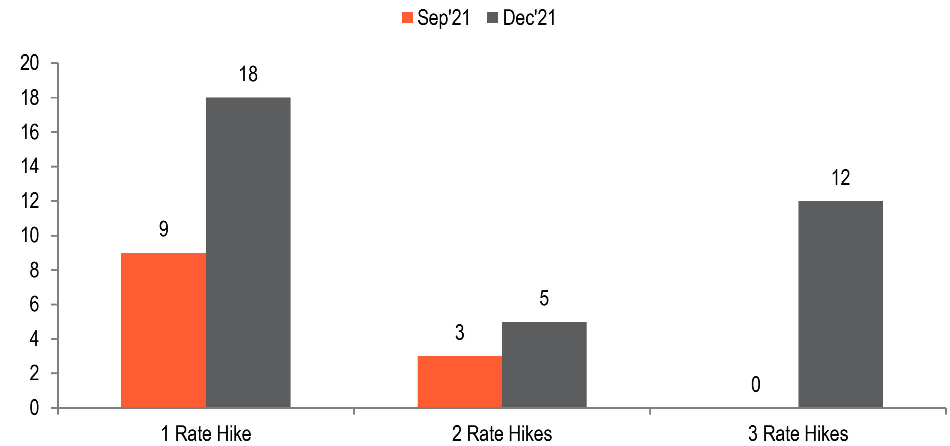
Source: RBI, Bank of Baroda Research

What will RBI do?

Central Banks across the globe have been looking to tighten the extremely accommodative monetary policy. It seems the era of ultra-low policy rates is behind us as Central Banks begin to dial back. Bank of England in Dec'21 became the first central bank to hike rates. It has recently hiked rates once again to 0.5% in order tame the accelerating inflation print. BoE expects inflation to soon touch the 7% mark. ECB while remaining hawkish in its commentary in the last policy meet has maintained status quo.

There has been an anticipation of a possible rate hike in the coming months by US Federal reserve too. Fed members have been increasingly signally towards hiking rates in CY22. The signal for the same was given in it Dec'21 policy meet, wherein a majority of over 12 members expect at least 3 rate hikes in CY22, compared with the Sep'21 projections of no member voting for at least 3 rate hikes. Recently, US Fed has been pretty vocal about rate hike cycle beginning form Mar'22 (Core PCE at 4.7% in Nov'21, way ahead of Fed's target of 2%) the same has also been pencilled in by the market.

Fig 9 – Fed Members voting for rate hike



Source: Federal Reserve, Bank of Baroda Research

RBI has maintained the status quo and kept the key policy rates unchanged for the ninth month in a row. In the last policy, it had retained both its growth and inflation forecast at 9.5% and 5.3% respectively in FY22. In the last policy 5-1 members had voted to retain the accommodative policy stance.

Given the factors mentioned above, RBI is expected to change its position on growth and put emphasis on government borrowing and inflation as the main challenges going ahead. Real rates have been negative for over 2-year now. Further, the asymmetric gap in the corridor between repo and reverse repo needs to be reduced. Reduction by 25bps in reverse repo rate may be expected in this meeting. We expect no change in repo rate or CRR, while RBI can continue its fine tuning measures. We expect RBI to also revise its GDP forecast downwards from 9.5% in FY22.

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