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No new surprise: Another 50bps rate hike

RBI's policy was in line with expectations. A rate hike of 50bps materialized, withdrawal of accommodation remained. Inflation forecast for FY23 was unchanged at 6.7%. Liquidity is likely to be in deficit in H2 as well and RBI would rely on fine tuning operations. Going forward we expect, inflation worries to continue from seasonal food price shock and demand conditions gathering momentum. We expect CPI to be in the range of 6.5-7%. Our terminal repo forecast stands at 6.5%, thus a rate hike of another 50-60bps in the current cycle seems feasible. With the current 50bps rate hike, transmission to MCLR could be another 20-30bps, 10Y GSec yield is likely to trade in the range of 7.3-7.4% in the near term. Our growth projections at 7.2% remain in line with RBI's forecast of 7% for FY23 (will be revisited once more real sector data is available).

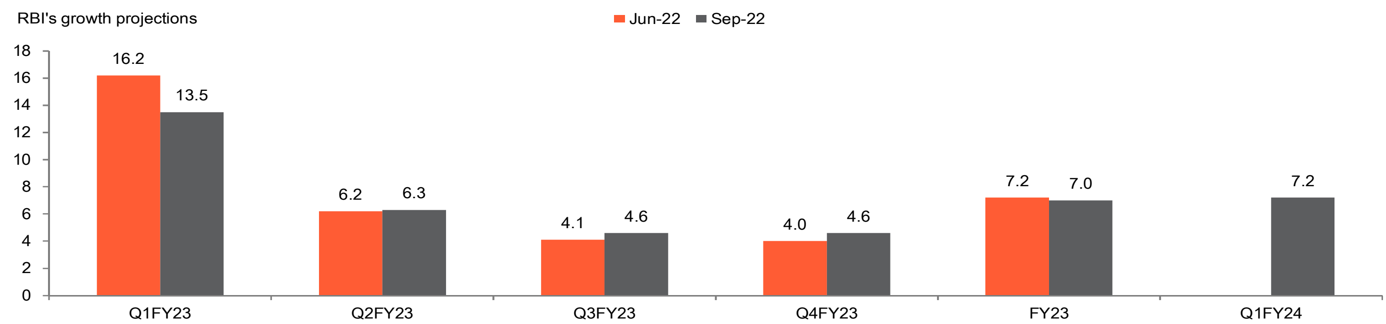
Key Highlights:

- As per our expectation and in line with market consensus, RBI raised policy repo rate by 50bps. However, stance continued to be 'withdrawal of accommodation'.
- Inflation forecast for FY23, retained at 6.7% for FY23 and growth projection revised slightly lower to 7% from 7.2% earlier.
- Fine tuning with respect to liquidity operations continued by replacing 28-day VRRR with 14-day based on the evolving liquidity scenario. This will ensure that excess liquidity does not get locked in for a longer tenure thus creating liquidity shortages.

Domestic growth insulated: Today's policy highlighted that Indian economy remained resilient in the midst of unsettling global macroeconomic environment. Governor has also highlighted sell off risks which have crept in domestic bond and currency market, as a result of spill over to global risks. The high frequency indicators of Indian economy also pointed to recovery. Capacity utilisation is improving with a 3-year high of 74.3 in Q1FY23, government capex is picking pace and credit growth have remained in double digit since 22 Apr 2022-all exemplify that domestic demand held ground.

On this backdrop, real GDP is expected to be 7% in FY23. The slight downward revision from previous forecast was simply because the Q1FY23 print of 13.5% real GDP growth was lower than RBI's expectation of 16.2%. Our real GDP growth forecast is also in line with RBI's projection of 7%.

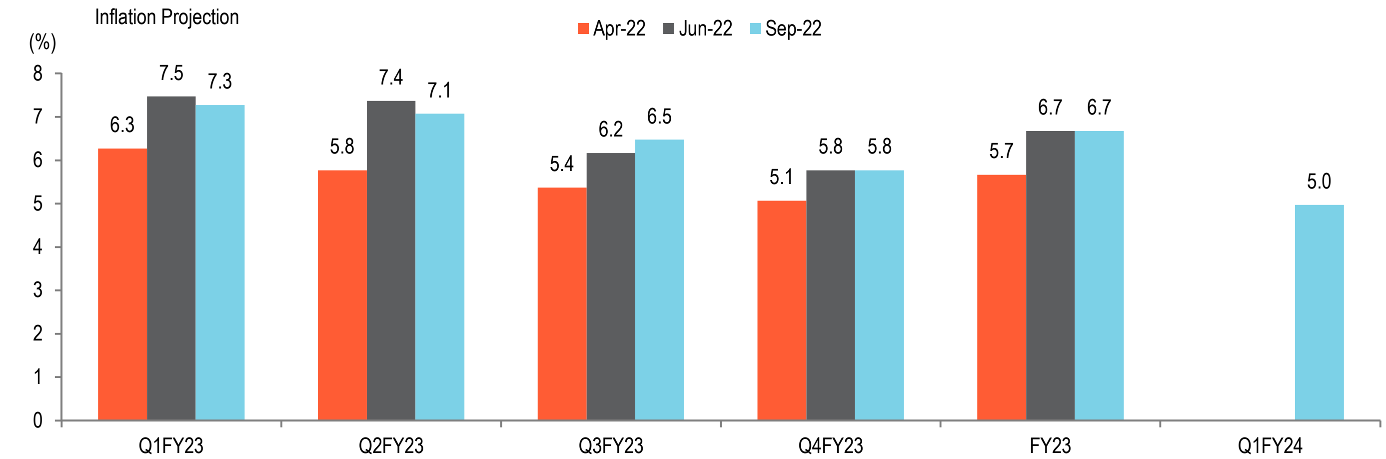
Fig 1 – RBI revised downward its growth projection for FY23



Source: CEIC, Bank of Baroda Research,

Inflation risks remain: Though headline CPI projections have been retained at the same 6.7% level, and there have hardly been any change in the trajectory (except 10bps upward revision in Q3FY23 data); yet policy tone reflects some impinging inflationary risks. First, the unanticipated food price shock in terms of tomato prices surging, lower sowing of rice (-5.5%) and pulses (-3.9%) might pose threat to the forecast. Apart from this, demand pull inflation might also emanate from economy running at full capacity and so far showing some degree of resilience. Thus we expect headline CPI to be elevated in the range of 6.5-7% in FY23.

Fig 2 – Headline CPI forecast kept unchanged for FY23



Source: CEIC, Bank of Baroda Research

How far the transmission worked and where would rates be?

Fig 3 – Movement of key policy rates

Rates (%)	April-22	May-22	Jun'22	Aug'22	Sep'22	Change since the beginning of the cycle
Repo rate	4.00	4.40	4.90	5.40	5.40*	140
MCLR (Overnight)	6.75	6.80	7.00	7.23	7.30	55
Term Deposit Rate >1 Year	5.30	5.38	5.38	5.70	5.70	40
10Y Gsec yield	7.14	7.42	7.45	7.19	7.34	20
364 Days Tbill	4.76	5.94	6.24	6.31	6.77	201

Source: Bloomberg, RBI, Bank of Baroda Research, Note: Only terminal rates are taken, * excludes today's 50bps rate hike

1. In the first cycle, between Apr-May'22, when RBI reduced rates by 40bps, MCLR (overnight) went up by 5bps. But in the next two cycles (May-Jun'22 and Jun-till date), with 50bps rate hike, MCLR (overnight) increased in the range of 20-30bps. We expect with the current 50bps rate hike, another 20-30bps rise in MCLR will take place.

2. Deposit rates are fairly sticky as in the first cycle, the term Deposit Rate >1 Year has only increased by 8bps. In the next two cycles, it rose in the range of 15-17bps. The same is likely to persist even with the current rate hike. Thus transmission to lending rates are sharper than deposit rates.

3. For 10Y Gsec, the transmission of policy rate has only happened in the first cycle which resulted in yields inching up by 28bps. But in the next two cycles, 10Y GSec yield has dropped by 9bps, as sentiments were impacted by reports of India's inclusion in the Global EM Bond Index. We do not foresee major upswing in yields as markets have already priced in today's 50bps rate hike. Thus, during policy announcement 10Y benchmark yield have broadly remained stable in the range of 7.3-7.4%. We expect the same to continue and in the medium term, if terminal repo reaches 6.5%, 10Y yield would be in the range of 7.5-7.6%.

Liquidity situation

In Sep'22, liquidity slipped into deficit mode for 4 days in the range of Rs 5,800-21,900 crore. This was last seen on 28 May 2019. In May'22, when the rate hike cycle began, system level liquidity surplus averaged Rs 4.3 lakh crore against Rs 6.5 lakh crore in Apr'22 and currently in Sep'22 is hovering at surplus of Rs 71,400 crore. RBI has done 15 auctions of term reverse repo Rs 15.79 lakh crore. Notably, in the current auction held on 23 Sep 2022, out of Rs 2lakh crore offered, only Rs 3,748 was received, representing the tight liquidity situation. For variable rate repo, two auctions of Rs 50,000crore each have been conducted.

Further, in today's policy it seemed that slight deficit situation which is being observed now might be prevalent in the second half and it might increase as well. Primarily on account of government spending and RBI's forex intervention. Thus RBI seems to be comfortable with a slight deficit in liquidity. However, the daily fine tuning operations will provide the comfort. Thus, 14day VRRR becomes the main tool now as against 28 day earlier.

Where do we see terminal repo?

In the current cycle we see another 50-60bps rate hike as headline CPI needs to be brought down to the targeted 4+/-% level, which is a mandate.

Global perspective of policy rates and real policy rates

The table below gives the latest policy rates in some countries along with the relevant inflation rate. Most countries have negative real policy rqates today.

Fig 4 – Policy rates of India vis a vis major global central banks

Countries	Policy Rate	Inflation	Real Rates	Change in Policy rate since May'22
US	3.3	8.3	-5.1	275
UK	2.3	9.9	-7.7	150
Japan	-0.1	3.0	-3.1	0
China	3.7	2.5	1.2	-5
India	**5.9**	**7.0**	**-1.1**	**190**
ECB	1.3	9.1	-7.9	125
Brazil	13.8	8.7	5.0	100
Russia	7.5	14.3	-6.8	-650
South Africa	6.3	7.6	-1.4	200

Source: Bloomberg, Bank of Baroda Research, Note: for China 1Y LPR is taken

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