RBI POLICY

10 February 2022

Inflation underestimated, growth still a priority

Dipanwita Mazumdar
Economist

RBI has kept all policy rates unchanged. There has been focus on liquidity management. We believe the 4.5% inflation forecast for FY23, is on the lower side in the wake of crude running at US$ +90/bbl and high global commodity prices among others. Our forecast for CPI is ~5.5% in FY22 and at 5.0-5.5% in FY23. Growth forecast of RBI at 7.8% seems realistic. We expect RBI to remain on hold in the coming two policies as well.

RBI maintained status quo: As against our expectation of a 25bps hike in reverse repo rate, RBI kept policy rates unchanged. Its forecast for FY22 is unchanged at 5.3%. There has been no mention of liquidity withdrawal and focus is on management through the use of VRR and VRRR. Stance has also been kept accommodative with the indication that it will remain so in next year too.

CPI forecast at 5.3% for FY22 and 4.5% at FY23: RBI has kept inflation forecast for FY22 unchanged at 5.3%, with Q4FY22 print expected at 5.7%, as said in the Dec'21 policy. Here few things need to be mentioned. 1) During Dec'21 policy, crude was trading at ~US$ 70/bbl, 2) global inflation was less of an issue and 3) global central banks were not so hawkish. But things have changed with crude reigning at ~US 92/bbl, geopolitical tensions increasing and elevated supply concerns with core inflation remaining fairly sticky. We believe the full pass through of input cost inflation is still to be realized. We expect transport and communication inflation to increase post State elections. Thus, the trajectory of inflation as projected by RBI (between 4-5% in FY23), is on the lower side. Notably, the FY23 CPI projections are also 20bps lower compared to that in Apr'21 policy when crude was at $ 60/bbl.

Where inflation will go: We believe based on the underlying situation of elevated supply cost in terms of escalated energy cost and lengthened supply delivery timelines, CPI is likely to be elevated. We expect it to settle at ~5.5% in FY22 and at 5.0-5.5% in FY23, with risks tilted to the upside. Notably, another upside risk to inflation is the possibility of a below normal monsoon. Statistically, with six successive monsoons, there could be a sub-optimal one this year. Thus it might push food inflation further in the coming fiscal. Our forecast also incorporates 10% increase in crude price which will impact CPI by ~0.4-0.6%.

Growth forecast realistic: RBI has estimated growth to be at 7.8% in FY23. This is in line with our estimation of 7.75-8% in FY23. RBI has pointed that better rabi sowing, pick up in exports, capex of government and rising business investment which will make up for slower growth in consumption.

No sign of liquidity rollback: RBI has not spoken of liquidity withdrawal. It has instead indicated that Variable rate repo (VRR) auction will once again be in vogue along with Variable rate reverse repo auction (VRRR). Further, 14-day VRRR has been reemphasized to be the main tool. System liquidity currently is on an average at Rs 6.6tn (1-9Feb 2022), and close to Rs 7tn surplus seen during Q3. So, it is clear that liquidity is likely to remain well managed to support financing requirements of the economy**.** Notably, the Governor mentioned that 'effective reverse repo rate which accounts for both fixed and variable rate has increased from 3.37% in Aug'21 to 3.87% in Feb'22. Thus, it clearly reflects that reverse repo is nearing the repo rate, not by policy change but through liquidity management. We believe that this is likely to continue in the coming two policies as well. Bond markets reacted favorably and came down by 5-6 bps post announcement.

No rate hike in the coming two policies: RBI's communication reflects that **rate hike is unlikely in FY23.** The coming two policies are not likely to see any change in rates unless there are sharp price shocks. The GDP growth forecast also reflects the same which as trajectory is at 7% in Q2FY23 and down to 4.3% and 4.5% in Q3 and Q4 respectively. Thus, RBI which has been backing the growth objective since 2020 and will be tracking progress here. Thus RBI would hence have limited scope in changing policy rate in the first two quarters of FY23.

Other measures: Regulatory measures include extension of 1) term liquidity facility of Rs 500bn to emergency health services till Jun'22 from Mar'22 earlier, 2) extension of on-tap liquidity window for contact intensive sectors by another 3 months till Jun'22, 3) Enabling Better Infrastructure for MSME Receivables Financing by increasing the amount of the NACH mandate from Rs 0.01bn to Rs 0.03bn and 4) allowing banks in India to undertake transactions in the offshore Foreign Currency Settled Overnight Indexed Swap (FCS-OIS) market with non-residents and other market makers.

Disclaimer

Visit us at www.bankofbaroda.com

For further details about this publication, please contact:

Chief Economist
Bank of Baroda
+91 22 6698 5134
chief.economist@bankofbaroda.com