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Sonal Badhan
Economist

RBI: Hawkish while holding horses

In the upcoming credit policy meet of RBI, which is scheduled on 6 Oct 2023, we expect MPC to maintain a hawkish pause and keep the rates unchanged. No change in stance is also expected, as RBI will keep liquidity tight to keep short-term rate higher and support INR. Liquidity tightening may also worsen close to election months. We have ruled out any rate cuts this fiscal year, and anticipate earliest possible rate cut in Q1FY25. Further, upward revision to RBI's CPI forecast for FY24 can be expected, by 10-20bps. However GDP forecasts are anticipated to remain unchanged. We expect 10Y yield to trade in the range of 7.15-7.25% next month.

What has changed since the last policy?: Since the last policy, RBI will be evaluating changes in oil prices, trends in inflation, monsoon and sowing, movement of high frequency indicators and global developments.

Oil prices: Since the last policy (10th Aug 2023), international crude oil prices have averaged ~US$ 89/bbl, sitting above US$ 85/bbl factored into RBI estimates (Apr'23 policy briefing). In fact, since early Sep'23 (8 Sep) prices have hovered above US$ 90/bbl. At the time of last policy, prices oil prices averaged ~US$ 79/bbl. This implies 12.6% jump in prices since the previous policy. Factors responsible for this trend include: tightened supplies (US crude stockpiles and extended voluntary production cuts by OPEC+ members) ahead of winter months, prospects of soft landing of the US economy, and pause in rate hike by major central banks which in turn may aide demand.

Domestic inflation scenario: Latest CPI print for Aug'23 shows that inflation came down to 6.8% from 7.4% in Jul'23. RBI has estimated 6.2% CPI for Q2, and to meet that target, inflation for Sep'23 needs to come in at ~4.3-4.5%. On the positive front, vegetable prices and core inflation has begun to soften. On the other hand, key upside risks persist owing to weak monsoon, pressure on sowing (particularly that of pulses), and recent build-up in oil prices. Our previous study shows that US$10/bbl increase in oil prices, leads to 40-60bps increase in CPI. Since we expect Sep'23 CPI print to overshoot RBI's estimates, we expect RBI to revise its current inflation forecast from 5.4% for FY24 to ~5.5%.

Monsoon and sowing: For the period 1 Jun 2023 to 27 Sep 2023, South West Monsoon was 6% below LPA compared with last year. IMD has stated that currently weak El Nino conditions over the equatorial Pacific region are prevailing which is expected to intensify in the later part of the year. Furthermore, IMD has confirmed that withdrawal of South West Monsoon has begun. In terms of cropping activity, overall kharif sowing, as of 22 Sep 2023, has been only by 0.3% higher compared with last year. However the performance has been varied. The sown area of coarse cereal has improved owing to higher sowing for Bajra and Maize. Sown area of rice and sugarcane have also advanced. However, pulses acreage continues to lag behind, led by Arhar and Urad. Moreover, sowing area for cotton, Jute and Mesta crops has also declined. This is expected to have impact on domestic food prices, and rural demand.

High-frequency indicators: Economic activity is signalling mixed trends. While some of the indicators such as, air passenger traffic, rail freight volumes, PV sales, tractor sales, and electricity demand have shown improvement in Q2 compared with Q1, other indicators such as services PMI is expected to remain broadly steady, while centre and states' tax collections, GST collections and toll collections have seen some easing. Moderation in tax collections is mainly on the back of softening inflation, as these are nominal numbers. As economic activity remains broadly resilient, RBI will remain in wait and watch mode and we do not expect any changes to central bank's GDP forecasts.

Banking sector growth: Bank credit continues to maintain a healthy pace of growth at 19.8% as of 8 Sep'23, compared with 16.2% as of 30 Jun'23. At the start of Q2, credit to services sector has been driving growth, while credit to industry is seeing some moderation. Within services, credit commercial real estate has rebounded, while credit to trade is stable. Credit NBFCs moderated as of Jul'23. Deposit growth has also picked up pace, registering 13.6% increase of 8 Sep 2023, compared with 12.9% growth as of Jun'23. Demonetarisation of INR 2000 note, has provided a boost to deposit growth.

System liquidity: On an average, liquidity has remained in deficit in the month of Sep'23 so far at Rs 0.1 lakh crore, compared with a surplus of Rs 1.2 lakh crore in Aug'23. A part of reason for pressure on liquidity in Sep'23 could have been due to advance tax payments and preparation for GST remittances. We expect RBI to maintain tight liquidity in the coming months as well, to maintain pressure on short-term yields, which may in turn support INR. Thus we expect RBI to keep its stance—"withdrawal of accommodation"—unchanged in the Oct'23 policy.

Hardening sovereign yields: Since the last policy, yields on 10Y G-sec have risen by ~10bps and are currently trading around the 7.25% mark, compared with 7.15% before the Aug'23 policy. Positive impact from the news of India's inclusion into JP Morgan's EM Government Bond index, has been outweighed by news of steep increase international crude oil prices and hawkish commentary from US Fed, which may keep rate higher for longer.

Global developments: At the recent Fed policy meet, the central bank maintained its hawkish pause but indicated that there might be room for one more rate hike this year. US economic activity is showing mixed trends. While on one hand, new home sales, consumer confidence and mortgage applications are signalling a slowdown, on the other hand, revival in durable goods orders, initial jobless claims, and ISM services PMI index are hinting at resilience in economic growth. This has fuelled fears that Fed may keep rates elevated for a longer period of time. Elsewhere, BoE held rates steady in its last policy, while ECB opted for a dovish hike. Investors are expecting BoE to remain on pause and cut rates from next year, while ECB will have to be watchful of impact of higher oil prices on CPI.

Where do our forecasts stand?: Looking at the factors mentioned above, we believe that growth fundamentals still remain strong. Key uncertainty remains around the impact of weak monsoon on agriculture production. This has potential upside risks for food inflation and rural demand.

1. We expect GDP growth to moderate to ~6.3% in FY24. Our slightly lower than RBI's 6.5% growth forecast is based on continued slowdown in Europe and China, weaker exports, and risks to rural demand on the back of weak monsoon activity this year. However, we do not

expect RBI to revise its GDP forecast for the time being, as it may await final agriculture production estimates and data on festive spending before tweaking the numbers.

2. We expect headline CPI to settle at ~5.5% in FY24, with risks tilted to the upside. Strains in sowing of pulses, cotton, jute and oilseeds, can have impact on retail inflation. Further, continued build-up in oil prices also poses a threat to CPI. RBI may thus revise its current forecasts (5.4% for FY24) upward by 10bps.

3. On the external sector side, INR has depreciated further by 0.6% since the last policy, as US$ continues to strengthen (DXY is up by 4% during the same period). It is currently hovering above 83/$ mark. As US economy is continuing to show signs of strength in certain sectors, Fed has maintained its hawkish stance so far. It has left the door open for one more rate hike, if prices and economic growth do not slow as much as anticipated. This has supported dollar strength. Further, increase in oil prices may also impact our CAD, which is further putting strain on INR. We expect it to trade in the range of 82.75-83.50/$ in the next fortnight.

4. Under these conditions, we expect RBI to maintain status quo on rates and stance. We do not expect any significant announcement on liquidity front either. In terms of forecasts, RBI may revise its CPI forecast higher and await more information before changing its growth forecasts for FY24. We continue to believe that no rate cuts will be announced in FY24 and the earliest possibility for a cut is in Q1FY25. We also do not expect any change in stance of “withdrawal of accommodation” by RBI.

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For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
sonal.badhan@bankofbaroda.com