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Is the time right for RBI to moderate rate hikes?

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Given the persistent inflationary pressures, the RBI is likely to hike rates but by a smaller quantum

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Policy rates: Time for a pause | Photo Credit: FRANCIS MASCARENHAS

There is increased expectation that the global central banks including US Federal Reserve and the RBI could moderate the policy rate hikes going forward. While the Fed's action will impact the decision of other central banks including RBI, that will not be the prime driver. Let us look closely at factors that will impact RBI's decision.

The US dollar has halted its strengthening streak on the expectation of moderation in rate hikes by the Fed. This in turn implies lesser weakening pressure on Indian rupee. This definitely gives a breather to the RBI at a time when there are already many external vulnerabilities like widening of CAD (current account deficit) and lower capital inflows.

Talking about inflation there is some respite on that front too. CPI inflation has moderated to 6.8 per cent and is likely to moderate further (supported by base effect) and inch below 6 per cent by the end of the fiscal year. The moderation in global commodity prices is a big comforting factor. WPI inflation, which is impacted more by the global commodity prices, has halved from more than 16 per cent in May-June to around 8 per cent in October. But the global situation remains volatile and risk of commodity prices again spiralling up cannot be ruled out.

Moreover, core inflation has remained above 6 per cent for the last few months, reflecting the deep entrenchment of overall inflation. Food inflation remains high, with cereal inflation touching 12 per cent. Spike in food inflation runs the risk of putting further upward pressure on household inflationary expectations. Household inflationary expectations have inched up to more than 10 per cent, the highest level in the current year. So, while there is comfort on the inflation front, the central bank still needs to remain vigilant. As far as growth is concerned, while the Q2 GDP growth was on expected lines, the contraction in manufacturing sector is worrisome. On the positive side, service sector is recording strong momentum. Consumption and Investment GDP have recorded a healthy growth compared to the pre-pandemic period. But slowdown of external demand and widening of trade deficit remains a concern. Corporate results for Q2 shows healthy sales growth, but there is a sharp squeeze on profit margins.

As the last MPC meeting, two of the members had conveyed their concerns on interest rate hikes overshooting the requirement and hence denting growth. This is one aspect that RBI would be cautious of as the real interest rate moves to the positive territory.

Given the persistence of inflationary risks, RBI is likely to continue with rate hikes, but the quantum could be lower at 35 bps. It would like to evaluate the impact of rate hikes so far. The transmission in lending rate is varied across sectors, with more complete transmission in the loans linked to EBLR (External Benchmark Lending Rate).

The WADTDR (weighted average domestic term deposit rate) has increased by only around 35 bps in the fiscal year in contrast to 190 bps rate hike in the repo rate. With liquidity in the system reducing, the transmission through higher deposit rate is likely to pick up. This would improve effectiveness of the monetary policy tightening so far.

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