RBI moves towards a positive real rate of interest

India's CAD to widen to 3.1 percent of GDP and Balance of Payment deficit of around $65-70 billion in FY23, implying that the RBI would remain cautious on the external front

RAJANI SINHA

AUGUST 06, 2022 / 06:55 AM IST

RBI Governor Shaktikanta Das. (File photo)

The August 5 **monetary policy of the Reserve Bank of India (RBI)** comes at a very dynamic juncture. The CPI inflation is still above the RBI's comfort zone (at 7 percent); but it appears to have peaked, and is expected to fall below 6 percent by the end of the fiscal year.

Global commodity prices have fallen sharply in the recent past, but are still high. Bloomberg Commodity Price index has gone down by 12 percent in the last two months; but the index is still 18 percent higher than the beginning of the year. Globally, while inflation continues to rage, there are heightened concerns around economic slowdown. With the US economy slipping into technical recession, there are expectations in the markets that the US Federal Reserve may go slow with its rate hiking cycle.

In the given volatile macro backdrop, the RBI has chosen to continue with front-loading, and hiked the repo rate by 50 bps — in line with expectations. The RBI has preferred to err on the side of caution given that the CPI inflation is still above RBI's target band. The central bank has emphasised that the CPI inflation has become broad-based, core inflation is still high, and there is threat of persistent high inflation destabilising the household inflationary expectations. With inflation still high and domestic growth indicators showing signs of improvement, the RBI has taken this opportunity to move towards a positive real rate of interest.

The other factor influencing the bank's decision to hike the rate has been the external environment. As the US Federal Reserve has hiked policy rates, the RBI would not like the interest rate differential to widen further. While the dollar index has retreated in the last few days, the RBI would like to remain cautious given the widening of India's trade deficit. We expect India's CAD to widen to 3.1 percent of GDP and Balance of Payment deficit of around $65-70 billion in FY23, implying that the RBI would remain cautious on the external front

The RBI has maintained the inflation projection at 6.7 percent for FY23, with expectations of inflation falling below 6 percent in Q4 FY23, and further to 5 percent in Q1 FY24. The recent fall in global commodity prices and inflation controlling measures announced by the Government of India, should enable the central bank to achieve its inflation projection. In fact, we feel that the CPI inflation could even turn out to be marginally lower than the RBI's projection at ~6.5 percent. The upside risk to this projection would be any sharp reversal in energy prices during the winter.

As for growth, the RBI has maintained its GDP projection at 7.2 percent for FY23. The economy is showing gradual improvement as reflected by high frequency indicators such as GST collection, credit demand, PMI, and auto sales. Importantly, the RBI has highlighted that the manufacturing sector capacity utilisation level has improved to 75.3 percent in Q4 FY22, above its long-run average.

While urban demand is showing improvement, the monsoon will play a critical role in improving rural demand. The overall monsoon is above normal so far, but sowing of paddy has got adversely impacted by lower rainfall in some regions. The other critical aspect would be the global growth dynamics that will have a bearing on India's growth prospects.

Overall liquidity surplus in the system has reduced to Rs 2 lakh-crore from Rs 3 lakh-crore in July, and Rs 7 lakh-crore in the beginning of 2022. The RBI would be doing a fine balancing act in liquidity management. While the central bank wants to remove excess liquidity to increase the effectiveness of policy rate hikes, it would at the same time like to ensure sufficient liquidity to take care of growing credit demand and the government's huge borrowing programme.

After the current hike, the critical question is what next? As the RBI has reiterated, its future course of action would be data dependent. Apart from domestic factors, it would also be closely watching the global growth dynamics, and the trend in global commodity prices to chart its future course of action.

If the domestic growth indicators show sustained improvement, the central bank could hike the repo rate by a further 50 bps in FY23. With the terminal repo rate at 5.90 percent, the RBI would be moving towards a positive real rate of interest.

Rajani Sinha is Chief Economist, CareEdge Group. Views are personal, and do not represent the stand of this publication.