THE ECONOMIC TIMES

A cautious RBI will have to look inside and beyond the border for next policy action

Dec 08, 2022

RBI has moderated the pace of policy rate hike to 35 bps, taking cue from expected moderation in CPI inflation (supported by base effect) and easing of global commodity prices. Expectations of US Federal Reserve going slow with Fed fund rate hike and consequently lesser weakening pressure on Rupee also provided RBI the scope for moderation. However, the important aspect to note is that RBI has emphasized on the need to "keep inflationary expectations anchored, break core inflation and ccore inflation and contain the second-round effect" of inflation.

Core inflation has remained sticky around 6% for the last one year or so. While supply related inflationary pressure are quick to reverse as the bottlenecks are eased, core inflation becomes difficult to reverse as it gets entrenched in the system. Moreover, food inflation in the economy is still high at around 7%, with high cereal inflation at 12%.

This runs the risk of putting further upward pressure on inflationary expectations.

As per the latest data, household inflationary expectations have inched up to more than 10%, touching the highest level in the current year. With global uncertainties looming high and domestic inflationary concerns persisting, the RBI would remain vigilant on inflation front. It is important to note that while CPI inflation is likely to move below 6% by the end of FY23, it will be a challenge for the Central Bank to achieve the 4% target (mid of the 2-6% band) even in FY24.

With external headwinds accentuating, RBI has lowered the GDP growth projection for FY23 to 6.8%. While there is no denying that India is a bright spot currently in midst of the global turmoil, it cannot remain unscathed from the global slowdown. India's exports have contracted by 17% in October 2022, with widening of net exports being a critical factor shaving off from India's GDP in the first two quarters of FY23.

Domestic demand indicators are showing resilience, with bounce back in sectors like travel, tourism and hospitality supported by pent up demand. Other high frequency indicators like GST collection, PMI (Manufacturing and Services), passenger vehicles sales, bank credit offtake are also indicating healthy domestic demand recovery. However, external demand is likely to weaken further, and domestic demand could also see some moderation as pent-up demand fizzles out and financing conditions tighten.

As per the minutes of the September MPC meeting, some of the MPC members were concerned about rate hikes overshooting the requirement and hence denting growth. Even in the December meeting, there is divergence in view among the MPC members, with five out of six members voting in favour of a rate hike, while the decision to maintain stance at 'focus on withdrawal of accommodation' was supported by only four MPC members.

Going forward, the Central Bank will not just be watching the domestic data but will also be closely monitoring global developments like US fed rate decisions, movement of global commodity prices and global currency movements. The RBI would also like to evaluate the impact of policy 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). However, the WADTDR (weighted average domestic term deposit rate) on outstanding deposit has increased by only 46 in the fiscal year so far in contrast to 225 bps rate hike in the repo rate (including the latest hike). With surplus liquidity in the system reducing and bank credit-deposit ratio increasing, the transmission through higher deposit rate is likely to pick up.

This would improve effectiveness of the monetary policy tightening so far. With policy rate moving in the positive territory, RBI would be very cautious of further rate hikes. However, given the global uncertainties and persisting inflationary concerns, there are chances of another 25 bps rate hike in the February meeting, taking the terminal repo rate to 6.5%.