Oct-Dec inflation 50 bps below RBI forecast, but Feb rate hike still likely

Siddharth Upasani / January 13, 2023

India's headline retail inflation rate fell for the third month in a row in December, coming in at 5.72 percent – 18 basis points below the consensus estimate of 5.9 percent – the statistics ministry has said.

More importantly, Consumer Price Index (CPI) inflation averaged 6.1 percent in October-December, well below the Reserve Bank of India's (RBI) forecast of 6.6 percent.

In any other quarter, inflation undershooting the central bank's forecasts by such a large margin would send the market's hopes soaring. However, these are extraordinary times.

"Despite two months of below 6 percent headline inflation, we think the RBI is unlikely to feel very comfortable with the details, given demand-driven price pressures remain elevated," noted Rahul Bajoria, chief India economist at Barclays.

"We expect the central bank to maintain a broadly hawkish policy stance going into the February monetary policy meeting and deliver a 25-basis-point hike, taking the repo rate to 6.5 percent," Bajoria added.

Bajoria is not alone in thinking the RBI's Monetary Policy Committee (MPC) is set to deliver another rate hike a week after the Budget for 2023-24 is presented, with Shilan Shah of Capital Economics and Sunil Sinha of India Ratings also pencilling in a rate hike next month.

Nikhil Gupta, a chief economist at Motilal Oswal Financial Services, also expects a 25-basis-point increase in the repo rate on February 8. According to Gupta, concerns remain: excluding vegetables, retail inflation rose to 7.2 percent in December, while core inflation remained above 6 percent.

On the other hand, services inflation of 5.2 percent and the fraction of items in the CPI basket which registered an inflation rate of more than 5 percent in December were, both, the lowest in five months.

"Overall, the fall was not broad-based, but the ease in services is welcome," Gupta added.

Case for pause

The rate hike call is not an unopposed one.

According to Rajani Sinha, chief economist at CareEdge, the February interest rate decision "will be a close call", given that core inflation remains sticky.

In December, the MPC had surprised central bank watchers with the emphasis it placed on core inflation when it said the repo rate had to be increased to "break the core inflation persistence".

Aditi Nayar, ICRA's chief economist, is a step further in the dovish direction and expects the rate-setting panel to pause on rates next month.

"While the average CPI inflation in October-December 2022 has come in significantly below the MPC's projection of 6.6 percent, we foresee a flattish print in January-March 2023, before a considerable correction sets in during April-June 2023," Nayar said.

"Taking into account today's lower-than-expected CPI inflation print, and the muted average IIP (Index of Industrial Production) growth of 1.3 percent during October-November 2022, we anticipate that the MPC may choose to pause in February," she added.

Soumya Kanti Ghosh, State Bank of India's group chief economic adviser is in agreement.

"Against the evolving landscape, we see little incentive for a further rate hike, with synchronised past actions on the rate front yet to show the full impact."

Ghosh expects CPI inflation to average 4.7 percent in April-June, 30 basis points lower than what the RBI is forecasting.

Industrial pain

The statistics ministry also released industrial growth data for November on January 12, which exceeded all expectations by coming in at 7.1 percent – well above the consensus estimate of 3.2 percent – thanks to a favourable base effect.

However, this followed a particularly dire October, when industrial output had contracted by 4 percent, which has now been revised to 4.2 percent.

As ICRA's Nayar pointed out, the average IIP growth for the two months is just over 1 percent.

But even the seemingly-impressive November IIP growth number has left people unconvinced. According to Sunil Sinha of India Ratings, the recovery in factory output has a "long way to go".

"At the used-based classification, even now the output levels of two segments that is intermediate goods and consumer durables are less than the pre-COVID (February 2020) output levels. Therefore, India Ratings believes the ongoing industrial recovery will continue to need more policy support," Sinha said.

However, Dharmakirti Joshi, CRISIL's chief economist, thinks there are tough days ahead as the policy screw has already tightened.

"…transmission of rate hikes has been picking up. In December, key loan rates such as housing loans and auto loans reached the pre-pandemic five-year average. Further rise in lending rates will test the resilience of domestic demand in the coming year," Joshi said.