Monetary policy | First cut

This cycle's last hike?

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Improved inflation outlook leads to slower pace of rate increase

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) raised the repo rate today by 25 basis points (bps), taking it to 6.50%. The decision to slow its pace of hike (from the previous instances of 35 bps and 50 bps) is in line with the improving inflation outlook. Yet, a calibrated monetary policy action of a smaller quantum was warranted to 'break the persistence of sticky core inflation' and anchor inflation expectations. Indeed, the moderation seen in headline inflation in the past two months was largely driven by sharp correction in vegetable prices (the most volatile in the inflation basket), even as core inflation remains sticky at 6%.

The governor's statement underlined that while inflation has come within the central bank's tolerance range of 2-6%, it remains above its medium-term target of 4%. Hence, the MPC's actions can also be seen through the prism of ensuring inflation eventually aligns to this target. That said, the RBI's current forecast does not foresee inflation below 5% in any quarter of the next fiscal. But the average inflation forecast of 5.3% for the next fiscal (compared with 6.5% this fiscal), puts it on a declining glide path.

The smaller quantum of rate hike by the central bank is a nod to moderating inflation and improved inflation outlook, while recognising the risks arising from core inflation. We expect this to be a terminal hike in the current cycle, and the MPC to pause thereafter to assess the impact of rate hikes so far. Sticky core inflation could mean that the repo rate could remain at 6.5% for longer. The latest decision is also in alignment with actions of a few central banks that have slowed or paused rate hikes in the past few months, as inflation is now on a descent globally.

Highlights of the February meeting

- The MPC voted with a 4-2 majority to raise the policy rate by 25 bps, taking the repo rate to 6.5%, standing deposit facility rate to 6.25% and marginal standing facility rate to 6.75%
- The monetary policy stance was maintained at 'withdrawal of accommodation', again with a 4-2 majority
- The MPC maintained its downwardly revised forecast for Consumer Price Index (CPI) inflation at 6.5% for this fiscal (from 6.7% earlier)

What factors influenced the MPC's decision?

Inflation has climbed down faster than expected, largely due to seasonal factors. But core inflation remains sticky owing to passthrough of input costs. Economic activity indicators show that the domestic economy remains resilient. Liquidity conditions are in surplus, and hence, focus remains on absorption of liquidity to facilitate transmission of rate hikes.

- **Inflation has eased faster than expected, and food inflation outlook has improved:** Consumer price inflation eased for two consecutive months, and printed at 5.72% on-year in December, led by sharp deflation in vegetables. However, excluding vegetables, CPI inflation increased to 7.2% from 7% in November. The governor's statement acknowledged this idiosyncrasy, highlighting the risks to inflation are still clear and present in the form of persistent core inflation (which has remained ~6% since May 2022).

Thus, another rate hike, of a smaller quantum, was considered appropriate to target the second-round effects of inflation.

Going ahead, likely robust rabi crop harvest and uptick in kharif procurement support further moderation in food inflation. Low volatility of the rupee means imported inflation pressures will be limited. The MPC, accordingly, revised downwards its forecast of CPI inflation to 6.5% for this fiscal, with the last quarter at 5.7%. It has forecast 5.3% inflation next fiscal.

- **Liquidity conditions in surplus:** The MPC voted to remain focused on 'withdrawal of accommodation' as its monetary policy stance. The governor's statement stated that surplus liquidity is expected to remain going ahead as well, with likely return of foreign portfolio investment flows, and higher government spending (moderated to some extent by redemption of low-cost funds provided during the pandemic). Further, the real interest rate, while turning positive, remains below the pre-pandemic levels.

  The MPC, in maintaining its policy stance, has signalled that the central bank has still not taken its foot off the pedal and is keeping options open: as in a tightening phase, rate rises are restricted in the presence of higher availability of surplus liquidity in the system (the RBI, August 2022). Thus, absorption of excess liquidity remains in focus to facilitate transmission of the policy rate hikes.

- **Economic activity shows resilience**: The governor's statement struck an optimistic note on economic growth going by its continued resilience, both in terms of urban consumption (passenger vehicle sales and air passenger traffic) and rural demand (expansion of tractor and two-wheeler sales). Credit growth is also robust, and firms' capacity utilisation is inching up.
  Further, the Union budget adopting fiscal consolidation while supporting growth through a capital expenditure push would have provided some comfort to the MPC.

  The MPC forecasts gross domestic product (GDP) growth at 6.4% for the next fiscal, with risks evenly balanced. However, continued uncertainty on geopolitical tensions and tightening financial conditions will bear watching.

Our view

Today's rate action was largely as per market consensus. The governor's statement, while highlighting the moderation in inflation and improved food inflation outlook, also reiterated the risks from core inflation. Hence, the need for a rate hike, albeit of a smaller quantum.

We expect today's rate hike will likely be a terminal one in the current monetary tightening cycle, based on three factors: first, inflation outlook has improved with positive developments from rabi crop harvest and lower international commodity prices; second, the RBI would now want to assess the impact of cumulative hikes of 250 bps effected so far in the fiscal (since May) on inflation; and third, central banks globally, too, have started slowing their pace of rate hikes (US) or signalled a pause (Brazil and Chile). Such synchronised monetary policy actions augur well for global financial stability.

We maintain our forecasts for GDP growth and CPI inflation for the next fiscal at 6% and 5%, respectively.

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