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Hawkishly data-dependent

The MPC's February 2023 repo rate decision should be driven by the domestic inflation-growth dynamics

WITH INFLATION STUBBORNLY entrenched above the MPC's 6% upper threshold for 10 consecutive months, another rate hike in the December 2022 review was a given. The MPC raised the repo rate but stepped down its quantum to 35 bps from the 'new normal' of 50 bps, with a welcome softening in the latest inflation reading. This takes the repo rate to 6.25%, last seen in March 2019. The MPC maintained its CPI inflation forecast for FY23 at 6.7% while marginally raising the Q3 and Q4 FY23 projections to 6.6% and 5.9%, respectively. Thereafter, it expects a headline print to average 5% in Q1 FY24 (unchanged from its September 2022 projection) before rising to 5.4% in Q2 FY24. The MPC highlighted concerns around the inflation outlook owing to elevated uncertainty on the food and energy outlook and expectations of a continued stickiness in core inflation. ICRA expects headline and core CPI inflation to average ~5.2% and 5.4%, respectively, in FY24.

The MPC's commentary on domestic growth factors was optimistic, even as it highlighted risks owing to global factors, including tightening financial conditions and slowing external demand. It cut the FY23 GDP growth projections to 6.8% from 7%, revising the Q3 and Q4 estimates to 4.4% and 4.2%, respectively, from the 4.6% it projected for the two in September. It also reduced the Q1 FY24 GDP growth projection marginally to 7.1% from 7.2% and issued a fresh projection of 5.9% for Q2 FY24. GDP growth is expected to be around 6-6.2% in FY24; a gloomy global outlook poses a key downside risk to the baseline forecast. A higher GDP growth of ~7.5% in H1 FY24 is foreseen, followed by a modest 5% rise in H2 FY24.

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The repo hike saw an expectedly non-unanimous vote of 5:1, whereas the policy stance was kept unchanged with a 4:2 vote. The increased focus of core inflation in the MPC's statement, the Governor's speech, as well as the clear guidance on the need for 'further calibrated monetary policy action to keep inflation expectations anchored and break the core inflation persistence' lend a hawkish tone to the policy. This is particularly surprising as one would have presumed that a non-unanimous vote on rates and policy stance would be accompanied by a dovish tilt. Moreover, the systemic liquidity moved back into a surplus in early December 2022. The Governor highlighted that RBI would look for a durable sign of a turn in the liquidity cycle when banks draw down large parts of their SDF and VRRR balances before it injects liquidity via LAF operations.

On the external front, the Governor remarked that while the terminal interest rate for the US Fed is anybody's guess, their monetary policy can't be tightened endlessly and reiterated that RBI has been striving to ensure that the rupee is allowed to find its market-determined level. From the low of $524 billion in September 2022, India's forex reserves rebounded to $561 billion in December. This predominantly reflects a combination of fortuitous factors such as a decline in US bond yields and concurrent rise in asset prices, and a sharp retracement of the Dollar Index. FII equity inflows have also resumed, standing at $4.4 billion in November 2022 as global risk sentiment turned.

After considerable strengthening of the rupee, which mirrored the DXY fall, the Indian currency has weakened in recent sessions. Looking ahead, if expectations surrounding the pace of additional rate hikes from the Fed harden, then the DXY could jump to an extent from the prevailing level of 105.7, although it is unlikely to test the recent highs of 114-115. In that case, the rupee would likely weaken further and may breach our current expected range of 80-83/$ in the remainder of FY23. Going forward, the MPC has signalled that rate decisions will be data-dependent. Notwithstanding how many more hikes are in store from the Fed, the MPC's decision on the repo rate in February 2023 should be driven by the domestic inflation-growth dynamics, including the contours of the FY24 Union Budget.