

# Inflation Remains Centre-Stage



**Ramnath Krishnan**

As expected, RBI's Monetary Policy Committee (MPC) delivered a stepped-down 35-basis-point (bps) rate hike in the December 2022 policy review, and kept consumer price index (CPI) inflation projection for FY2023 unchanged at 6.7%. But MPC further pared the baseline forecast for FY2023 growth to 6.8% from September 2022's 7% and the previous 7.2%.

One is somewhat circumspect about reading too much into the slowdown in various high-frequency indicators in October 2022, which saw a year-on-year jump during the festive season. Regardless, the timing and intensity of the impact of the global slowdown on Indian exports remains the predominant concern.

Inflation was characterised as well above target and expected to moderate, but print above 4% over the next 12 months. Seen in the context of cut in growth projection, the comment that further calibrated monetary policy action is warranted to keep inflation expectations anchored, break the core inflation persistence and contain second-round effects, appears decidedly hawkish.

Shaktikanta Das added that adjusted for inflation, the policy rate remains accommodative, and that there

has been a rise in the system liquidity surplus in early December 2022. So, MPC maintained its stance of remaining focused on withdrawal of accommodation.

Since May, MPC has now cumulatively hiked the repo rate by 225 bps. As per analysis of portfolio entities in interest rate-sensitive sectors like roads and power, the credit profiles of most entities are seen to have the tolerance to accommodate the level of interest rate hikes seen so far. They either have the pricing power that emanates from their contractual agreements or have the backing of strong sponsors.

Despite the rate hikes, bank credit growth has been exuberant at a decadal-high 17.5% year-on-year as on November 18, 2022. This reflects a combination of factors such as the recovery in economic activity, higher working capital requirements, a shift from external commercial borrowings (ECBs) to local financing as well as from the bond/commercial paper

(CP) market to bank credit.

While the increase in the repo rate in H1 FY2023 was largely passed on to the borrowers linked to external benchmarks, the transmission to other borrowers was incomplete, as the median increase in the 1-year marginal cost of funds-based lending rate (MCLR) has been lower.

Despite the transmission of policy rate hikes to home loan interest rates, the residential real estate sector maintained its growth trajectory in H1 FY2023 and the sale volumes in the top seven cities grew by 49% on a year-on-year basis, supported by continued end-user demand and good affordability. Even after today's hike, the interest rates would remain lower than the peak interest rates, and demand for residential real estate should remain firm, primarily driven by aspiration and healthy affordability that is expected to keep pace with the increase in EMI burden.

The deposit growth for the banking system stood at a relatively moderate 9.6% as on November 18, amid an incomplete pass-through of the repo hikes to deposit rates. Das added that a close watch is being kept on such transmission.

With a strong base effect coming up, bank credit growth is expected to settle 15-16% by end FY2023, and to moderate further to 11-12% in FY2024. Deposit growth should be at 8-9% each in FY2023 and FY2024. The competition for deposit mobilisation is likely to push up the overall deposit rates further and, eventually, the overall cost of funds for banks, leading to moderation in the interest margins in

coming quarters.

On liquidity, the governor said that conditions are expected to improve even as sporadic episodes of tightness may re-emerge. He cautioned market participants to wean themselves away from the overhang of liquidity surpluses. Upon durable signs of a turn in the liquidity cycle when banks draw down large part of standing deposit facility (SDF) and variable rate reverse repo (VRRR) balances, liquidity injection operations may be forthcoming.

What do the rate hikes mean for the nascent capex revival? The recovery in domestic investment activity was tentative in Q2 FY2023, owing to geopolitical tensions, weakening external demand and clarity around the sustainability of domestic demand. With multiple states holding investor meets in Q3 FY2023, the new project announcements are expected to spike in this quarter, although the intent to invest may not be immediate.

The sustenance of consumer demand after the festive season will crucially influence the capacity utilisation levels, and guide the pace of capacity expansion in the coming quarters. Also, a step-up in the state governments' own capex would help support investment demand, amid the ample fiscal space available with them.

MPC has signalled that inflation remains centre-stage, with growth concerns being somewhat secondary. So, it is unlikely to shy away from more rate hikes if headline and/or core inflation remain stubborn.

*The writer is managing director-group CEO, Iera*



**It still lingers**