Emerging Insight

India: RBI preview – One more hike, followed by extended pause

05 April 2023

GEM Fixed Income Strategy & Economics
Global

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RBI – Reserve Bank of India

MPC – Monetary Policy Committee

INR – Indian Rupee

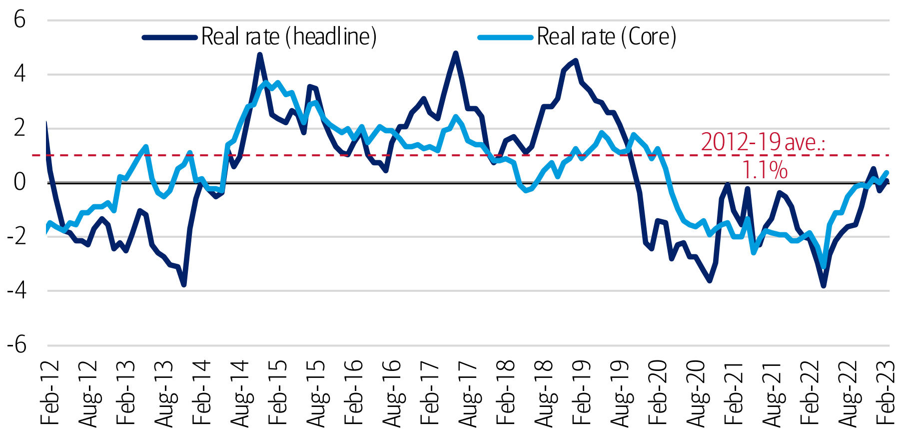
C/A – current account

Key takeaways

- We expect RBI to hike by 25bp on 6th April & shift policy stance to neutral to signal end of the current tightening cycle.
- Sticky core inflation remains a policy concern. Holding policy rate steady at 6.75% will help raise real rates to above-1%.
- We turn more constructive on INR (end-23 forecast 80/USD) on improving trade balance, higher FX reserves and valuation.

By Faiz Nagutha & Abhay Gupta

Exhibit 1: RBI real policy rates (%)
Real policy rate has averaged 1.1% over 2012-19, on an ex-post basis



Source: BofA Global Research estimates, Haver

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India in Focus

We expect a final 25bp hike from RBI on 6th Apr, following the 250bp of increases since May last year. RBI's hawkishness in the last policy has been vindicated by elevated headline and core inflation. We also expect a change in stance to neutral, signaling the end of the current tightening cycle. With inflation likely to stay sticky and MPC's 4% target still some distance away, we see policy rate staying at 6.75% through 2023 and bringing real rates close to its historical 1.1% average. India's trade deficits have started to narrow on lower imports and steady exports, which could keep current account deficit below the -2.5% threshold over 2023. We turn more constructive on INR (USD/INR to 80 by end-23) on improving trade balance, higher FX reserves and favorable valuation.

India: Last hike from RBI, followed by an extended pause

RBI MPC's first policy of the new fiscal year will be announced today (6th April) at 9am India time. While much has changed externally since the last RBI policy in early Feb (see our review here), including concerns around global financial/banking stability, domestic policy considerations has remained pretty much the same with inflation staying elevated over Jan-Feb and growth continuing to moderate. We review the key data (GDP, inflation, trade) and the minutes of the last policy meeting in this report and conclude the following:

(i) We expect a final 25bp hike to 6.75% and a change in stance to neutral;

(ii) The bar for rate cuts remains rather high in our view; and

(iii) We hold a bullish INR view on smaller trade deficit, carry & hawkish RBI.

Growth: FY'23 likely close to 7.0%; Expect moderation to 6.0% in FY'24

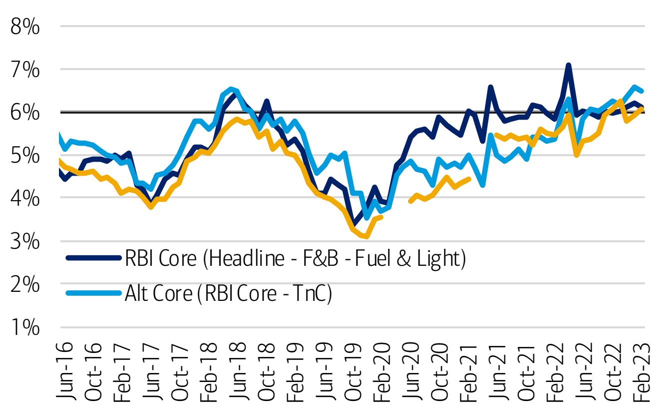
India's GDP growth eased to 4.4% year on year (yoy) in 4Q'CY22, down from 6.3% in the previous quarter. Private consumption growth slowed sharply from 8.8% in 3Q to 2.1% in 4Q, while the contraction in government consumption eased from -4.1% to -0.8%. Growth in investments remained resilient with gross fixed capital formation staying strong at 8.3% yoy, only slightly softer than the 9.8% previously. While the outturn was slightly softer than consensus expectations at 4.7%, it was in-line with RBI's estimates and higher than our 4% forecast. Given the GDP data and resilient high-frequency indicators, FY 22/23 growth appears likely to come close to 7%. We project a growth slowdown towards 6.0% in FY 23/24, which point to downside risks to RBI's 6.4%.

Jan-Feb CPI still 6.4-6.5%; All core measures sticky above 6%

CPI inflation remained elevated at 6.4% yoy in Feb, after surging to 6.5% in Jan (see Jan CPI report). The slight moderation was due to softer fuel & light inflation (Feb: 9.9% yoy; Jan: 10.8%) which offset slightly higher food (Feb: 6.3% yoy; Jan: 6.2%) and housing (Feb: 4.8% yoy; Jan: 4.6%) inflation. On a month-on-month basis, CPI rose by 0.17%, with sequential increases in most categories except food (-0.1%). Core inflation was above 6% in Feb, further highlighting the highly sticky nature of inflation (Exhibit 2).

The Jan/Feb combined data continues to push up upside risks to our inflation forecasts, although lower oil/commodity prices through the rest of the year could provide some relief. RBI's forecast of 6.5% average inflation for FY22/23 will likely be pushed higher to 6.7% in the April policy meeting due to the higher Jan/Feb outturn. Meanwhile, the FY23/24 forecast at 5.3% (BofAe: 5.4%) will most likely be kept unchanged as concerns about sticky core inflation could be offset by lower oil prices. Quarterly projections, however, are likely to be shifted around slightly due to the much higher base for March

Exhibit 2: Various measures of core inflation (% yoy)
All measures of Core reached above-6% in Feb



Source: BofA Global Research estimates, CEIC

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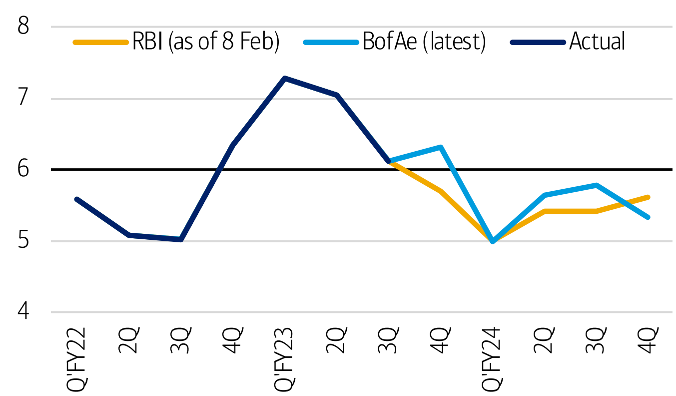
Exhibit 3: CPI Inflation – RBI & BofA projections (% yoy)
We see slight upside to RBI's quarterly inflation projections



Source: BofA Global Research estimates, RBI, CEIC

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quarter (4Q'FY) and any changes to oil price forecasts (Exhibit 3).

RBI: 25bp hike + neutral stance; high bar for rate cuts

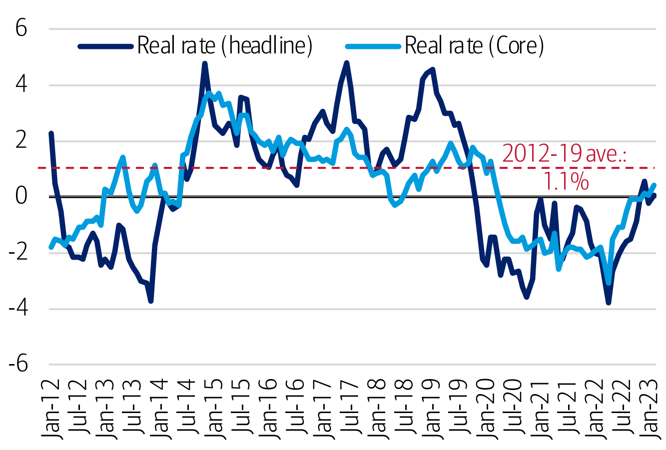
Alongside global markets pricing in a lower Fed terminal rates and rates cuts potentially from Jul, Indian markets too have moved and are pricing a last hike on 6th April followed by cuts from end-2023. With the recent stress events in global banking systems, we no longer see an upside risk to our terminal rate forecast of 6.75% - which will be reached if the RBI hikes by 25bp in the April meeting as we expect. However, given India's relatively more resilient growth outlook, stickiness of inflation and RBI's 4% target, it appears unlikely to us that the central bank will lower policy rates over 2023-early 2024.

The minutes for the Feb meeting further confirmed the divide within the MPC, with four members (three of whom are internal members – Governor, Deputy Governor & Head of Economic and Policy Research) appearing firmly in the hawkish corner, with the remaining two (both external) voicing concerns over the hit to growth from excessive tightening. We expect the hawks to continue to dominate, with data also confirming their views that "disinflation towards the target rate is likely to be protracted" (Governor Das) and that "a deep dive into CPI inflation indicates little evidence of a decisive and durable disinflation process" (ED Rajiv Ranjan). DG Patra summarized it best when he noted that "the MPC has to remain committed to its primary mandate" and that "it is important to at least contain inflation within the tolerance band in 2023-24 as the first milestone to be passed in aligning inflation with the (4%) target". Another 25bp hike to 6.75% will help take real rates (on a forward-looking basis) firmly above unity, in line with the pre-pandemic average of 1.1% (Exhibit 4).

We also expect RBI MPC to shift to a "neutral" policy stance in the upcoming meeting. Despite hiking rates by a cumulative 250bp since last May, the MPC remained "focused on withdrawal of accommodation" in the Feb 2023 decision as (a) real policy rate was still below pre-pandemic levels; and (b) liquidity was in surplus. Both anchors no longer point to policy accommodation, with real rates moving firmly above unity on a forward-looking basis with another 25bp hike and RBI undertaking liquidity injection operations. However, should the MPC focus on current inflation, real rates will still be below 1% (6.75% policy rate & 4Q'FY23 inflation of 6.3%). As such, there is a risk that the MPC makes no change to the stance, which would be interpreted as hawkish surprise relative to expectations.

Exhibit 4: Real policy rates (%)

Real policy rate has averaged 1.1% over 2012-19, on an ex-post basis



Source: BofA Global Research estimates, Haver

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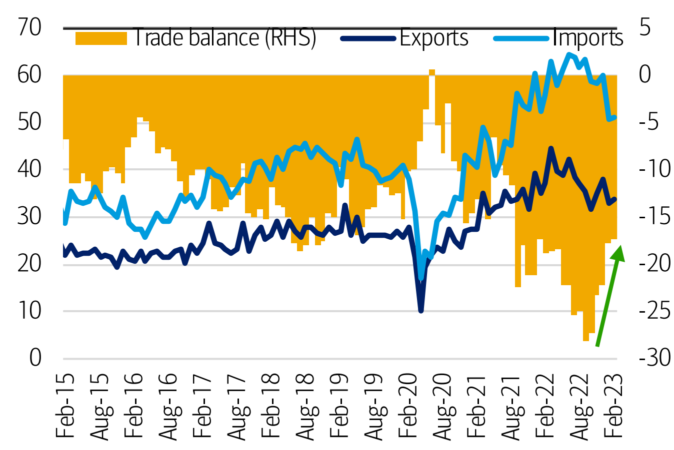
Exhibit 5: Monthly trade data ($bn)

Trade deficit has narrowed recently, mainly on lower imports



Source: BofA Global Research estimates, Haver

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Trade deficit narrowing; C/A deficit likely to be below 2.5% levels

India's trade deficit continues to narrow, improving substantially from a peak monthly deficit of $28bn in Sep'22 to around $17-18bn in Jan-Feb'23 (Exhibit 5). The improvement is primarily on the back of continuing decline in imports in recent months, while exports have been broadly steady. Imports have declined by over $10bn/month off the peak, due to lower vegetable oils, fertilizer, chemicals, petroleum, and vegetable oils imports. Lower global oil and commodity prices in recent months have clearly boosted India's terms-of-trade, which could sustain if these prices move lower on rising US recession risks. Overall current account deficit averaged -2.4% of GDP in 2022 (although quarterly variations were wide with a low of -1.5% in 1Q and -3.7% in 3Q) and could remain below the -2.5% threshold over 2023. The sensitivity to global oil prices, which are again on the rise, has weakened due to increased crude imports from Russia.

INR: More constructive on better trade balance, higher reserves & valuation

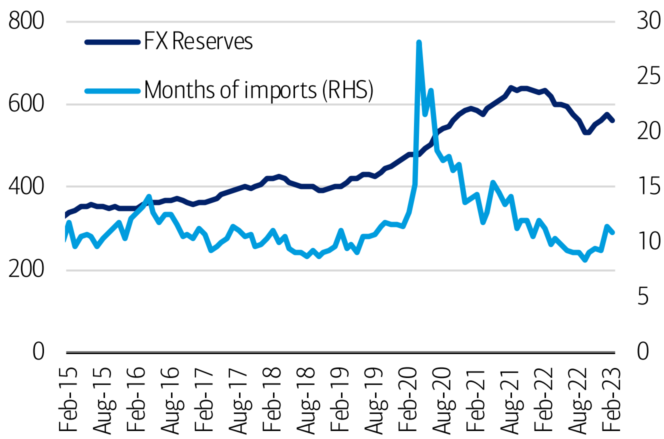
INR has been trading in a tight range over the last few months, exhibiting low beta to USD moves. Trade balance has narrowed substantially over the last few months due to usual seasonality and lower commodity prices. Portfolio outflows in equities stabilized in March with $1.4bn inflows but outflows re-started after global banking turmoil. RBI would take comfort in the sharp increase in FX reserves over the last few months (Exhibit 6) and reduced concerns in over-valuation (Exhibit 7). That would allow RBI to take a softer approach in accumulating further reserves and open some room for INR to appreciate in the near-term. On the top-side of USD/INR, we expect RBI resistance against a break of 83/USD unless broader USD strength picks-up.

We revised our forecast for INR to appreciate gradually to 80/USD by end-2023

Low volatility and skewed return profile has improved INR's carry appeal on risk-adjusted basis. India may begin to get more debt inflows for carry exposure and via corporate debt fund raising. Hawkish turn by RBI and further rate-hike in the upcoming meeting would also be supportive of INR as real rates turn further positive. We have revised our forecast for INR to appreciate gradually to 80/USD by end-2023. The risk to this view could come from a global hard landing scenario which could result in larger equity outflows and offset any benefit from lower commodity prices.

Exhibit 6: RBI FX reserves ($bn)

FX reserves have rebounded, after bottoming in Oct 2022



Source: BofA Global Research estimates, Haver

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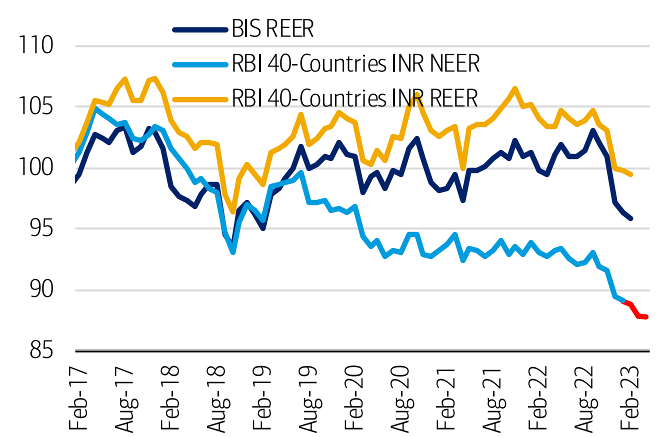
Exhibit 7: INR nominal (NEER) and Real effective exchange rates (REER)

INR REER / NEER indicate room to appreciate



Source: BofA Global Research estimates, BIS, RBI

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