MPC minutes: Front-loading to anchor inflation expectations

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MPC minutes show members emphasized the need to anchor inflation expectations. Though inflation is led by supply side factors, members were worried about the widespread buildup. At the same time, growth is holding up. Since the policy, metal and energy prices have seen a decline. Global yields are also responding to increasing risk of slowdown. While the above backdrop is positive, most members feel India should move towards positive real rate defined as policy rate less 1-year ahead inflation. In addition, the revised trajectory of US Fed looking at raising Fed Funds rate to 3.8% (2.8% earlier), we believe even MPC would have to raise terminal repo rate to 6.5% instead of our base case of 6%. This may call for front-loading rate hikes with a 50bps rate hike in next policy instead of our base case of 35bps.

Anchoring inflation expectation: Members emphasized on the need to anchor inflation expectations which can become unanchored. While inflation is driven by supply side factors, members acknowledged that it is more broad-based now. Dr Ranjan pointed out that CPI diffusion indices and core inflation measures—exclusion based and trimmed means—show inflation pressures are widening. Dr Goyal believes that inflation in India is not likely to see the same re-run as seen in early 2010s as India has a flexible inflation targeting regime, labour market is not tight, credit growth is lower and firms don't have pricing power. Dr Patra said that endeavour should be to bring down inflation into the tolerance band by Q4FY23 or Q1FY24. We expect inflation at 6.8% in FY23 and at around 6% in Q4FY23.

Growth sustaining: Members acknowledged that growth is holding up. Dr Ranjan stated that 51 High Frequency Indicators (HFIs) out of more than 70 have crossed their pre-pandemic (FY20) levels. While 37 HFIs have exceeded their pre-pandemic levels by more than 10 per cent, 30 HFIs have surpassed it by over 20 per cent. Overall, growth drivers seem to be holding up despite higher inflation and tightening monetary conditions. Governor, Shri Das, also pointed out that revival of economic activity remains steady and is gaining traction. Normal monsoon, rising labour force participation rate, higher capacity utilization, and improving non-food credit augurs well for growth outlook. We expect growth at 7% in FY23 as against RBI's estimate of 7.2%.

Real rates and guidance: Dr Goyal said at this stage of the recovery one-year ahead real rate must not be more negative than -1%. Given the Q4FY23 inflation forecast of 5.8%, in her opinion a 50-60bps increase in repo rate should achieve this. At the same time, Prof Varma pointed out that RBI's inflation projection has increased by 100bps over April policy and repo rate by 90bps. Thus, real policy rate is where it was in April. He believes, more needs to be done in future meetings to bring real policy rate to a modestly positive level. In a TV interview after the release of minutes he indicated a real policy range of 0.5-1%. He also is in favour of giving guidance on extent of tightening in this cycle. Dr Patra noted that policy rate same should be atleast above 4-quarter ahead inflation.

Rate trajectory: Dr Ranjan pointed out that one needs to be aware that pace of policy transmission has quickened after introduction of external benchmark lending rate regime and this would strengthen the monetary transmission in the current cycle. Prof Varma was in favour of increasing repo rate by 60bps. Dr Patra believes if headline inflation starts moving down in H2, the objective of taking the policy rate above the level of future inflation will be achieved sooner than later, providing space to pause and reconfigure. While minutes emphasise on fiscal and monetary co-ordination and each country will be influenced by domestic dynamics, the US Fed dot plots show another 225bps of rate hikes. While our base case has been that RBI may have to raise repo rate to a terminal rate of 6%, the Fed trajectory makes us believe that terminal repo rate is most likely to land at 6.5%. This also makes a case for perhaps front-loading with a rate hike of as much as 50bps in the next policy rather than the base case of 35bps. The recent fall in global oil and commodity prices is a positive.

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