Inflationary challenges mount; RBI expected to hike policy rates by 50 basis points in June 2022 MPC meeting

Brickwork Ratings, Bengaluru, 07 June 2022: Consumer Price Index (CPI) inflation reached a high of 7.79%, surging above the upper tolerance level of 6% of the Monetary Policy Committee (MPC) for the fourth consecutive month in April 2022. Increases in global commodity prices, serious supply-side disruptions in essential inputs due to the ongoing Russia-Ukraine war and accompanying sanctions and unfavourable weather conditions affecting supply of food items have adversely impacted both the output and prices. The escalation has also brought in considerable economic uncertainty. With surging inflationary pressures, we expect the RBI to increase the key policy rate by 50 bps in its upcoming policy announcement.

No additional space on both fiscal and monetary fronts

Since March 2020 following the outbreak of Covid-19, the RBI's MPC has reduced the key policy rates by 115 points to support broad-based economic recovery. After maintaining the repo rate at a record low of 4% for two years since May 2020, along with supportive liquidity measures to aid the recovery process, the RBI on 4 May 2022, hiked the repo rate by 40 bps and CRR by 50 basis points to 4.5% (effective from the midnight of 21 May 2022) in an unscheduled off-cycle MPC meeting.

The government also stepped in to cool down the surging price pressures in May by announcing a series of measures such as the excise duty cut on petrol and diesel, and import duty cut on the key raw materials and inputs for the steel and plastic industry. The government has also levied an export duty on some steel products and has raised the same on iron ore and concentrates, along with permitting the duty-free imports of 20 lakh tonnes of crude soyabean and crude sunflower oil. In addition, to maintain food security and bring down the prices, it announced a ban on wheat exports, regulated sugar exports and announced the provision of additional fertiliser subsidy of Rs 1.1 lakh crore to farmers over and above the Rs 1 lakh crore budgeted for the current fiscal. Additionally, it granted a Rs 200 per-cylinder subsidy under the Ujjwala Yojana.

All these measures are likely to help bring down price pressures to some extent in the coming months, but the current level of inflation is uncomfortably higher. The RBI is left with no choice other than raising the policy rates to anchor inflation expectations and maintain macroeconomic stability.

Inflation and Growth Outlook

Continued supply-side bottlenecks, along with a shortage in critical items such as semiconductor chips, which are essential for manufacturing, and rising commodity prices on the back of the Russia-Ukraine war that has been ongoing for more than 100 days, has trimmed the growth outlook. As per the latest provisional estimates by the MOSPI, the GDP is estimated to grow by 8.7% y-o-y in FY22 on the back of a low base (6.6% contraction in FY21). Although the economy has been progressing well after the lifting of the lockdown, both domestic and global developments undermine the earlier forecasts on the growth outlook, and the outlook for FY23 does not look very promising. ***We expect the RBI to revise downwards the GDP outlook for FY23 to 7% from 7.2% projected in the April meeting***.

Continued monetary support to sustain economic recovery is necessary since the economy has still not fully recovered from the pandemic shock and adverse geopolitical developments impeding the recovery process. The government also has limited space on the fiscal front as there are major challenges to maintain the budgeted fiscal deficit target at 6.4% in FY23 owing to the estimated shortfall of Rs 1 lakh crore due to the excise duty cut on petrol and diesel announced in May. The shortage in revenue may lead to a reduction in the budgeted capital expenditure or result in higher borrowings. With the already elevated level of budgeted borrowings for FY23 and excess liquidity floating in the system, the pressure on inflation is intensifying. ***We expect the RBI to revise its inflation forecast upwards to above 6% for FY23 from 5.7% estimated in the April policy meeting***.

Says Dr M Govinda Rao, Chief Economic Advisor, Brickwork Ratings, "Going by the price pressures, the MPC has been left with little scope to continue with an accommodative stance. Inflation surging at elevated levels and continuing to remain above the upper target range of the RBI makes it challenging on the monetary front. Continuing war-led supply and trade disruptions, and sanctions and a sharp rise in the international crude oil and other input prices are likely to have a significant adverse impact on both inflation and economic growth. CPI inflation will remain elevated above the upper limit of the target at least in the first two quarters of FY23. ***We expect the RBI to revise both inflation and the GDP outlook, and raise the repo rate by 50 basis points in the June announcement***".

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