MPC Preview- Commencement of Policy Normalisation

- **RBI to signal commencement of policy normalisation cycle with a 20bps hike each in reverse repo rate in February and April meetings**
- **RBI to revise FY22 growth estimate to 9.2%, in-line with CSO. RBI to retain FY23 growth estimate at 7.8%, our estimate stands at 8.2%**
- **RBI to retain the CPI forecast for FY22 at 5.3%. However, Q1FY23 and Q2FY23 forecast likely to be revised upwards, given backdrop of higher oil and commodity prices**

Our Expectations:

GDP growth now at 9.2% versus earlier estimate of 9.5%: The first advance estimates released by CSO have projected GDP growth at 9.2% versus RBI's estimate of 9.5%. CSO has also revised FY21 growth upwards from -7.3% to -6.6%. At the same time, FY20 growth has been revised lower to 3.7%. Economic activity will also take a hit from Omicron wave in January as seen in dip in ICICI Bank's weekly UFI index, which dipped to 108.7 from a high of 119.2 in early-January. However, it has since recovered again to 116.6 in end-January and will improve further. States are now increasingly removing restrictions and with fall in infections, economic activity is expected to normalise in coming months. However, revision in base and impact of restrictions imply RBI is likely to revise its growth forecasts FY22 to 9.2%, in-line with government and our estimates.

Inflation risks building up: Global inflationary concerns have risen sharply on the back of a significant increase seen in oil prices and Bloomberg metal index, which have increased by 23% and 10%, respectively, since the last policy meeting. Retail fuel prices have not been impacted on the back of excise and VAT duty cuts put in place by Centre and States. With oil prices now above USD 90/barrel, under-recovery by Oil Marketing Companies imply a sharp INR 4-5 increase in petrol prices in coming months, unless there is another duty reduction by Centre. Pass-through of higher energy prices will also have indirect impact, which will feed into inflation. Increase in telecom tariffs is yet to see a complete pass-through. At current oil prices, CPI inflation is likely to average 5.4% in FY23 instead of current projection of 5%. We expect RBI to flag upside risk to inflation and revise inflation trajectory upwards.

Liquidity absorption and way forward: RBI has been absorbing liquidity through OMO sales as well as VRRR auctions. RBI had net sold INR 111.3bn via OMO sales in December 2021, which dropped to INR 78.9bn in January 2022. The funds parked with RBI through VRRR auctions was at INR 6.26tn as on 4 February 2022. As tool of liquidity absorption, share of fixed rate segment has fallen from 30% in October policy to 17% now. VRRR cutoffs are consistently closer to repo rate now. In the overnight segment, the average WACR has also inched up to 3.40% in January 2022 vs. 3.32% in December 2021. Going forward, RBI will continue to use VRRR window to absorb liquidity.

Fiscal math for FY23: Fiscal deficit for FY22 has been revised up to 6.9% of GDP. Even with fiscal consolidation (deficit at 6.4% of GDP in FY23), gross and net market borrowings have seen a sharp increase in FY23 to INR 14.3tn and INR 11.2tn respectively. The higher than estimated borrowing along with no movement on global bond inclusion have led to sharp jump in yields. Cancellation of recent auction has led to some reversal in bond yields. However, RBI's intervention will be critical to ensure balance in demand supply dynamics next year.

Global central banks turning hawkish as inflation pressures mount: BoE has gone ahead and raised rates twice, first since 2004. It has also proceeded with quantitative tightening. FOMC too has given a more hawkish guidance. Markets are pricing in more than 100bps increase in Fed rate in 2022. ECB President also highlighted concerns about high inflation in the post policy statement and press conference. Global backdrop shows yields will continue to inch up.

What to expect in February policy?: Given the limited impact from Omicron variant, incipient inflation pressures which continue to build up and global backdrop of rising oil and commodity prices along with yields gives RBI room to normalise LAF corridor from current level of 65bps to 25bps in two steps of 20bps increase each in February and April. Union Budget is also growth inducive by pushing capex higher. Revenue number are conservative and there is room to overachieve revenue estimates and thus gives government room for demand and supply side responses. Higher government borrowings imply RBI's intervention is more important in managing the demand supply dynamics at the long-end. At the short-end, policy normalisation is the way forward. For this to happen we believe RBI is likely to change its stance in June to neutral from accommodative. However, we do not rule out the possibility of the same happening as early as April.

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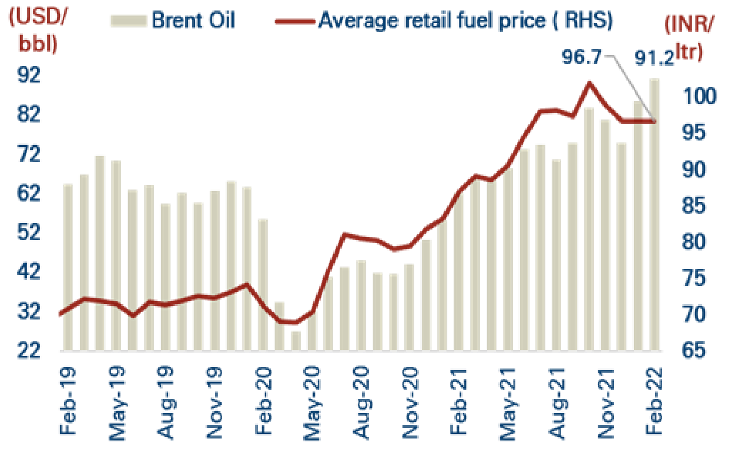
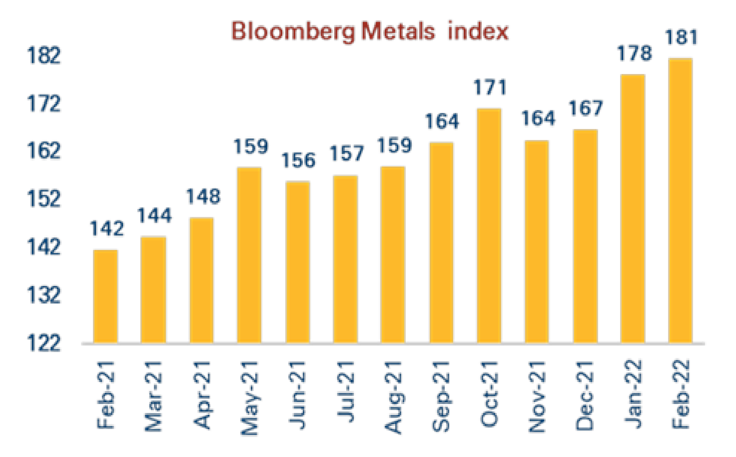
Global oil prices have increased, retail prices remained muted	Metal prices are also on the rise

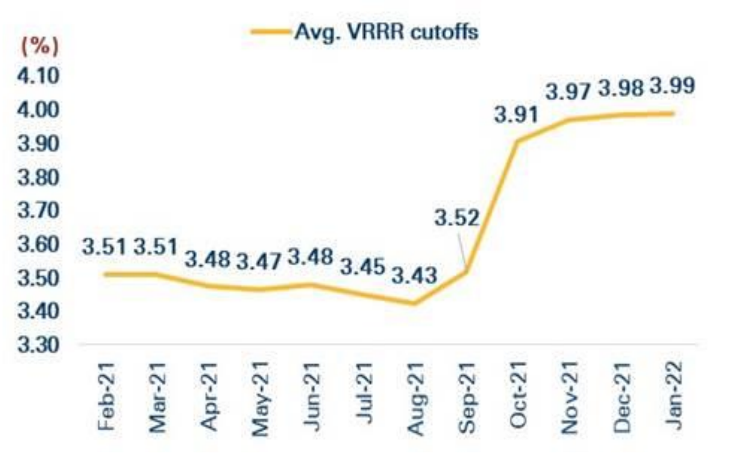


Source: CEIC, Reuters, ICICI bank Research



Source: Bloomberg, ICICI Bank Research

VRRR inching towards Repo	Fixed rate absorption is falling



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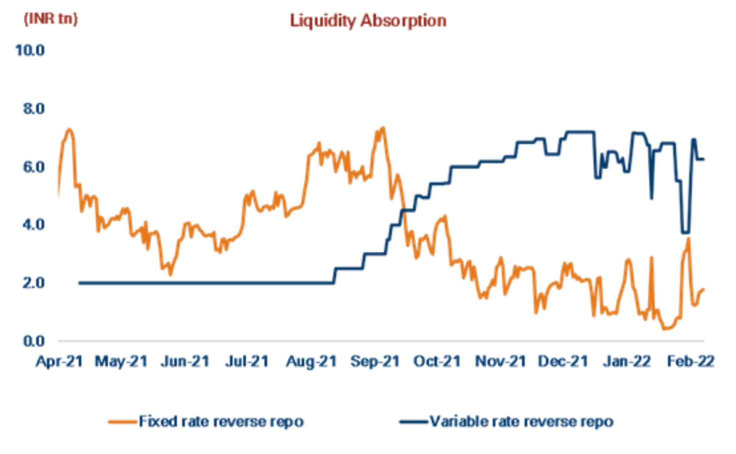

Source: RBI, ICICI Bank Research

Growth Estimates

Yearly Growth estimates (% YoY)	FY19	FY20	FY21	FY22 ICICI Exp	FY23 ICICI Exp
Agriculture	2.1	5.5	3.3	3.5	3.2
Industry	5.3	-1.4	-3.3	8.2	7.3
Services	7.2	6.3	-7.8	9.0	9.3
GVA	5.8	3.8	-4.8	8.6	7.8
GDP	6.5	3.7	-6.6	9.2	8.2

Source: MoSPI, ICICI Bank Research

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