To achieve positive real rate, MPC needs to take repo rate closer to 6%

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A rate hike in the upcoming Monetary Policy Committee (MPC) meeting on August 3-5 is a broad-based view. The debate is on the size of a likely rate hike and the MPC's tone amid latest developments since the June MPC meeting. Will the recent correction in global commodity prices and softer economic activity data in the western world lead to a smaller rate hike? Or will an inflation print 100 basis points (bps) higher than the upper bound of the mandated MPC's band of 2-6 per cent keep it squarely focused on inflation?

In our view, the MPC is likely to deliver a 50 bps increase in the repo rate (currently at 4.9 per cent), for both global and domestic reasons. On the global front, while the recent correction in commodity prices is encouraging, their trading levels remain elevated. Energy prices (crude oil and coal), freight charges, semiconductor prices, wheat prices etc., are still up in double and triple digits on a year-on-year (YoY) basis. While they are clearly off the recent peaks, their future path is uncertain given the likelihood of increased demand from China as it reopens on a firmer footing, the underlying tightness of supply dynamics in commodities, and uncertainty about the intensity of a recession (we expect a technical recession in the US and euro area). The recent agreement between Russia and Ukraine on grain trade (wheat, corn, etc.) — mediated by Turkey — is a clear positive. That said, the impact on grain supply will need to be monitored, especially on issues related to logistics, a likely increase in insurance costs and efficacy of enforcement mechanisms.

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On the domestic front, monsoon-related uncertainty is an important monitorable. As of July 15, paddy sowing was 20 per cent lower than the same period last year. While monsoon distribution has improved recently (northwest rainfall deficiency improved from – 8 per cent to -1 per cent in the week ended July 24), states that are important for paddy crop remain in large rainfall deficits (Bihar, Uttar Pradesh, and West Bengal, etc). With rice stocks likely to reach the threshold for buffer targets by the end of September on the ongoing free rice distribution scheme, a good paddy crop is essential to keep food prices contained over next year.

To clarify, we are not building in a scenario of a smaller crop size for rice or other crops' or further shocks to global commodity prices. However, uncertainty on the future path of prices requires a more cautious stance, in our view. With economic activity holding up well in India and near-term and headline CPI likely to stay above the 6 per cent mark until February 2023, we think the MPC should use the available window to ensure containment of price pressures from a medium-term perspective. Such an approach is required in an environment where central banks are hiking rates to put the inflation genie back in the bottle.

Lastly, with the aim to achieve and maintain a positive real rate from a 2-3-year perspective, we believe the MPC will need to take the repo rate closer to 6 per cent. Assuming inflation cools to 5 per cent in FY24 from 6.6 per cent in FY23, a 6 per cent repo rate would ensure a 100 bps of positive real rates for the economy. This is needed for external-sector resilience and to ensure adequate returns to savers. If the MPC has a terminal repo rate of 5.5-6 per cent in their mind, it's important to front load it in our view given the growth uncertainties over next 6-9 months.

Overall, while the recent correction in global commodity prices and softer PMIs in the developed economies provide the MPC more space to slow the pace of rate increases, we think these can be best exercised at the September meeting rather than in August.

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