Rising wheat & milk prices, high core inflation: Why RBI's rate hike cycle is unlikely to pause

Markets were expecting pause in rate hike cycle after 25 basis points hike but RBI gave no such assurance. Globally, too, central banks have continued to tighten monetary conditions.

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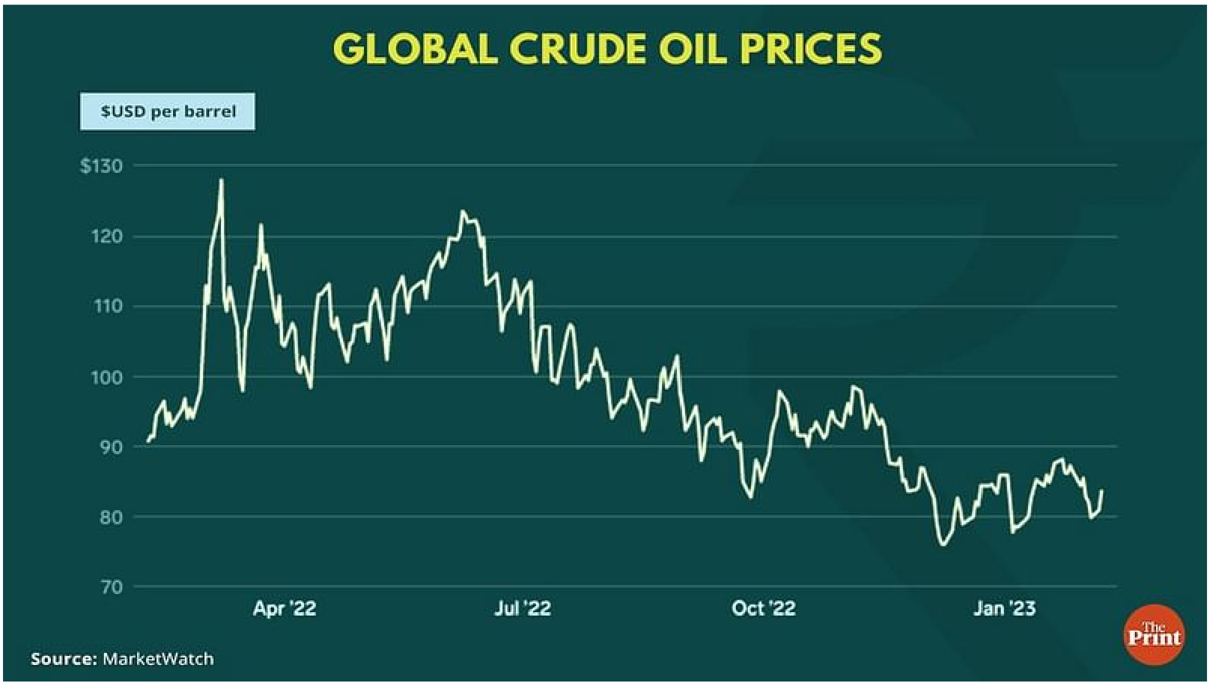


The Reserve Bank of India's Monetary Policy Committee (MPC) decided to raise the policy repo rate by 25 basis points to 6.5 per cent in its February meeting. With this, the policy rate has been hiked by 250 basis points since May last year to contain inflation. The Committee announced that its policy stance would continue to focus on the withdrawal of accommodation to ensure that inflation remains within the target. The decisions on both the rate and the stance were split, with four out of six members voting in favour of the resolution.

The policy statement continues to maintain a cautious view on inflation. This is understandable. While the headline inflation has fallen below the upper threshold of 6 per cent in the past two months, the decline is primarily driven by vegetables and edible oils, the prices of wider basket of food items are still elevated. Core inflation continues to remain sticky.

While markets were expecting a pause in the rate hike cycle after the 25 basis points rate hike, the RBI's MPC refrained from giving such an assurance. To anchor inflation expectations and to break the persistence of the core inflation, the RBI indicated that this may not be end of the rate hike cycle.

Globally central banks have continued to tighten monetary conditions, albeit at a slower pace suggesting that there is a consensus towards higher interest rates. In addition, easing of Covid-related restrictions and sharp rebound in growth in China are likely to exert upward pressure on commodity prices.

Central banks globally are not done with rate hikes

In its recent meeting on 1 February, the Federal Open Markets Committee raised the Federal Funds rate by 25 basis points to 4.75 per cent. This was in line with market expectations. In the statement accompanying the decision, Governor Jerome Powell noted that despite inflation having eased somewhat, it still remained elevated, and well above the Federal Reserve's target of 2 per cent.

The strong labour market stands at odds with the US Fed's efforts to lower inflation. The recent jobs report showed that the economy added 517,000 jobs in January. The strong labour market indicates that the central bank would have to do more work to bring down inflation, rates would remain higher and that terminal rate could be higher than expected.

Bank of Canada, while raising its policy rate by 25 basis points, signalled a conditional pause in rate hikes. The central bank's governor indicated that they wanted to pause to assess the impact of rapid rate hikes on demand and labour markets.

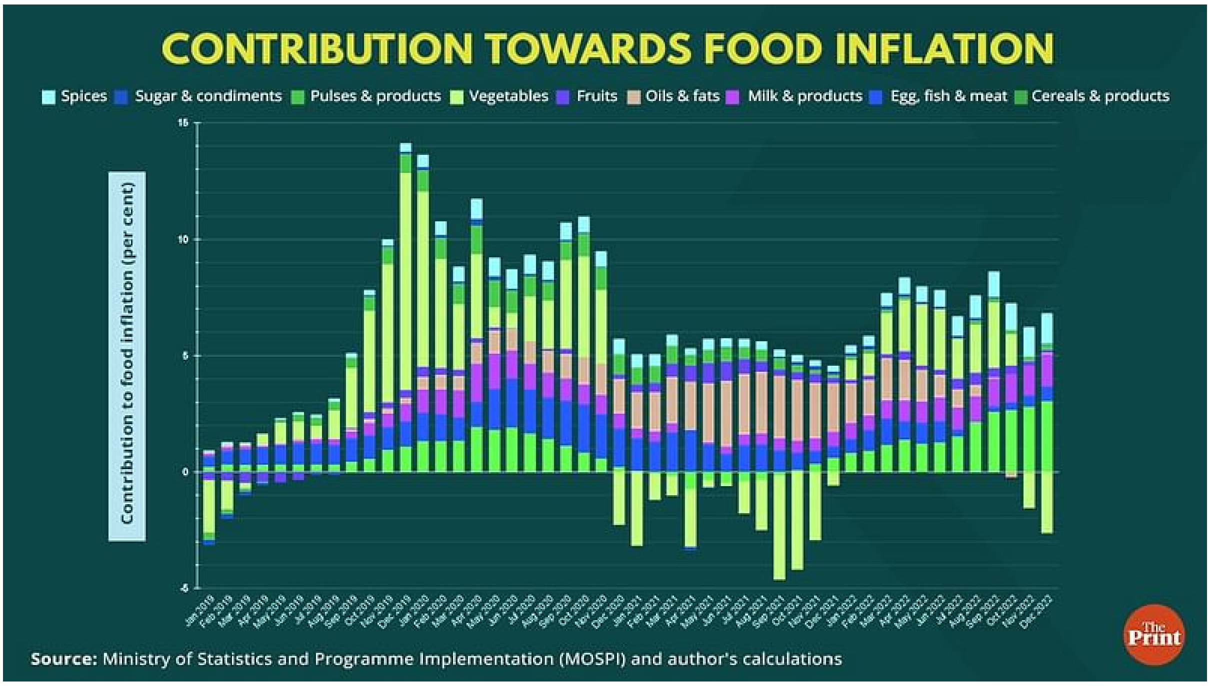
The Bank of Canada's January announcement has meant that the Bank has now become the first major central bank globally to indicate a pause in hiking rates (unlike the US Fed which has only indicated it could slow down the pace of rate hikes).

The European Central Bank (ECB) has raised rates by 50 basis points and pledged to stay the course in raising interest rates significantly at a steady pace. The Bank's statement indicated the possibility of another 50 basis points rate hike in March. The Bank of England also announced a 50 basis points rate hike in its recent MPC meeting and indicated that smaller rate hikes may be expected in the coming meetings.

Moderation in retail inflation driven by small section of food basket

Retail food inflation declined to 4.2 per cent in December from 4.7 per cent in November. But the decline in food inflation is not broad-based. It is driven by a 15 per cent contraction in vegetable prices and moderation in prices of edible oils. Inflation in cereals inched up to touch almost 14 per cent in December. The record high prices of wheat may prompt the government to extend the ban on wheat exports to preserve local supplies.

Inflation in milk, spices and egg, fish and meat also remained elevated. Cereals, milk and spices have been the key contributors to the 4.2 per cent food inflation in January.

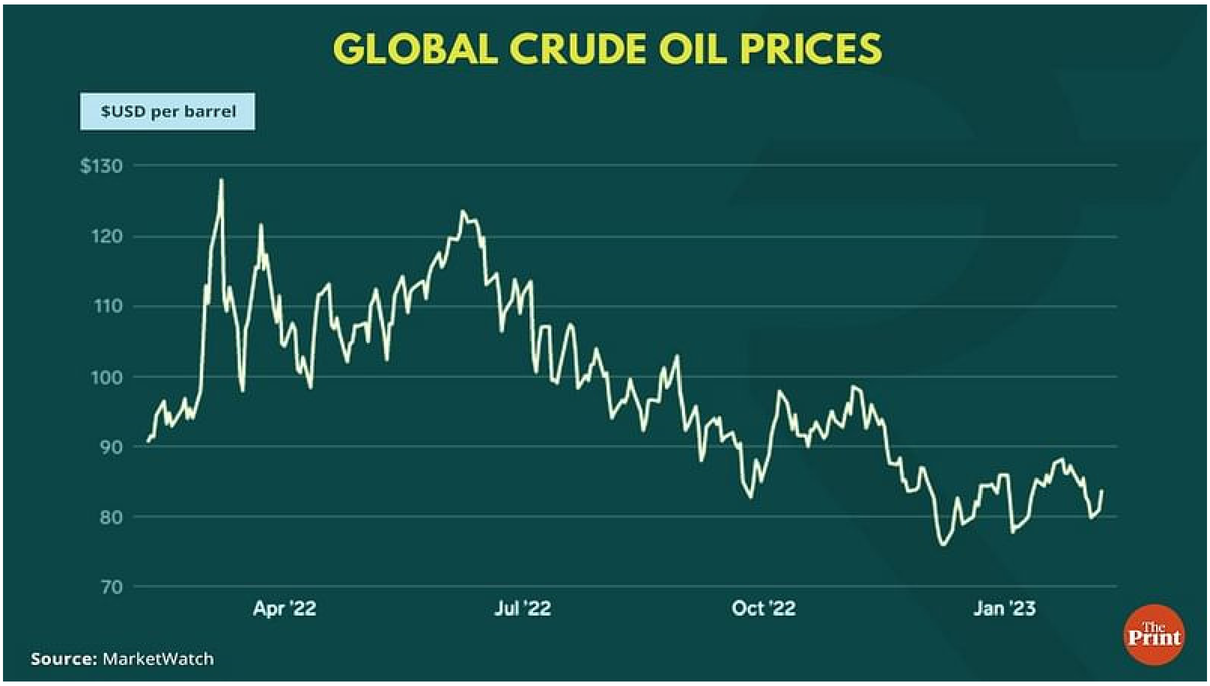


Core inflation inched from 6 per cent in November to 6.17 per cent in December. Categories such as health, education and personal care and effects registered sustained price rise. The pass-through of input costs to output prices would continue to exert upward pressure on core inflation.

Commodity prices could see volatility on China's re-opening

China's re-opening could pose pressure on commodity prices, though the final impact will be known only in the coming months. The optimism about China's economy boosted demand for industrial metals. As an example, the price of copper saw a sharp rebound in the first half of January before slumping in the second half.

Global crude oil prices would also be supported by potentially healthy demand coming from China, however higher interest rates could slow the global economy and weaken demand.



To pause or not to pause

While the MPC voted for a 25 basis points rate hike this week, the decision was not based on consensus. Two members voted against the rate hike. While the reasons will be known when the minutes of the meeting will be out, the dissent may be possibly owing to the concern that aggressive monetary tightening may imperil the growth outlook. On the stance also, the two members were possibly in favour of movement towards a neutral stance.

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Views are personal.