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RBI Monetary Policy: Hawkish pause again; inflation fight on

In a widely expected move, the RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy repo rate unchanged at 6.5%, along with maintaining the *'withdrawal of accommodation'* stance with continued dissent from Prof. J. R. Varma, citing persistence of inflation above the target level. The headline inflation projection for FY24 has been curtailed by a modest 10bps to 5.1%, with the progress of Southwest monsoon amidst the El Nino effect, movement in crude oil prices and global financial market volatility imparting uncertainty to the outlook. The MPC finds domestic economic activity to be resilient, with GDP growth estimate for FY24 retained at 6.5%. While an expected normal monsoon, and sustained demand for services is expected to aid private consumption, investment activity should get fillip from strong Government capex, declining commodity prices and healthier balance sheets of banks and corporates. Muted external demand and protracted geopolitical tensions, however, pose downside risks to the outlook.

The MPC's commitment to keeping inflation expectations anchored and bringing down headline inflation closer to the 4% target is reflected in its decision of keeping the stance unchanged, thereby retaining flexibility on future policy actions. This seems prudent amidst an uncertain global environment. Governor Das's remarks on headline inflation within the tolerance band being not enough underlines the Committee's determined focus on achieving its goal. This points to an extended pause, at least through this year, without ruling out a possibility of a hike if inflation surprises on the negative.

- **Status quo on rates:** In line with market expecations, the RBI's MPC unanimously decided to retain the policy rate at 6.5%. Maintaining wait and watch on the transmission of earlier policy rate hikes, the MPC cited persistence of inflation above the 4% target level as the major reason behind the status quo, and highlighted that progress of southwest monsoon will remain critical in the coming months. With this, the Standing Deposit Facility (SDF) and the Marginal Standing Facility (MSF) rates—the upper and lower bounds of the Liquidity Adjustment Facility (LAF) corridor—remain unchanged at 6.25%, and 6.75% respectively. The MPC's focus resolutely remains on keeping a close vigil on evolving inflation and growth outlook, aligning headline inflation to the target and containing inflation expectations. The members also voted, with a 5:1 majority, in favor of keeping the *"withdrawal of accomodation"* stance intact, with Prof. J. R. Varma expressing reservation yet again.

The RBI expectedly kept the policy repo rate unchanged at 6.5%, retaining the "withdrawal of accommodation" stance.

- **Inflation forecast trimmed marginally; growth forecast kept unchanged:** The RBI further revised its forecast for inflation by another 10bps to 5.1% for FY24 citing (i) a sharp decline in CPI print in Apr to 4.7%, (ii) resilient rabi harvest and (iii) forecast of a normal Southwest monsoon. However, uncertainties around spatial and temporal distribution of monsoon, global financial market volatility, uncertain crude oil price outlook and lagged pass-through of input costs are likely to impart upside pressures. Inflation forecast for FY25 is pegged at 4.5%—closer to the RBI's mid-point target. The RBI has remained positive on growth outlook, retaining its growth forecast for FY24 at 6.5%. While an expected normal monsoon, and sustained demand for services is expected to aid private consumption, investment activity should get fillip from strong Government capex, declining commodity prices and healthier balance sheets of banks and corporates. Muted external demand and protracted geopolitical tensions, however, pose downside risks.

Headline inflation for FY24 is projected at 5.1% vs. 5.3% estimated in February; FY25 inflation estimated pegged at 4.5%.

- **Liquidity surplus jumped, RBI to remain nimble:** Daily liquidity absorption under LAF moderated Rs 1.7trn in Apr-May from Rs. 2.9trn for FY23, thanks to maturing TLTROs and build-up of Government cash balances. Liquidity surplus, however, widened in later part of May and further in June post the announcement of discontinuation of 2000 denomination notes. Despite surplus liquidity in the overall banking system during the last two months, surge in MSF borrowings during this period and overshooting of call money rates beyond the repo rate suggest skewed liquidity distribution within the banking system. As long-term rates have remained broadly stable, RBI will remain nimble in liquidity management, while ensuring adequate resources are available for productive purposes.

- **Regulatory measures:** To ease the implementation challenges faced by Primary (Urban) Cooperative Banks (UCBs), the Priority sector lending (PSL) target of 75% that was to be achieved by Mar'24 has now been extended by two years. The PSL targets for UCBs were revised in 2020 and a glide path was formulated to expand the UCBs PSL portfolio from 40% of advances in 2020 to 60% in Mar'23 to eventually 75% in Mar'24. In addition, the RBI has i) announced increasing the scope and reach of e-RUPI vouchers; ii) allowed issuance of RuPay Prepaid Forex Cards by banks in India to expand payment options for Indian travellers abroad; and iii) allowed issuance of RuPay debit, credit, and prepaid cards in foreign jurisdiction that could be used internationally, and in India to expand the reach of RuPay cards globally.
- **Emphasis on 4% inflation target:** Notwithstanding some easing in FY24, headline inflation is expected to remain well above the RBI's 4% target. Additionally, the Governor's remarks on inflation hovering within the target band being not enough and that prompt and appropriate policy actions should be taken to ensure headline inflation falls to the 4% target level shows the Committee's undeterred focus on its inflation goal. By keeping the stance unchanged, the MPC has retained flexibility on future policy actions, which seems prudent amidst an uncertain global environment. This points to an extended pause, at least through this year, without ruling out a possibility of a hike if inflation surprises on the negative.

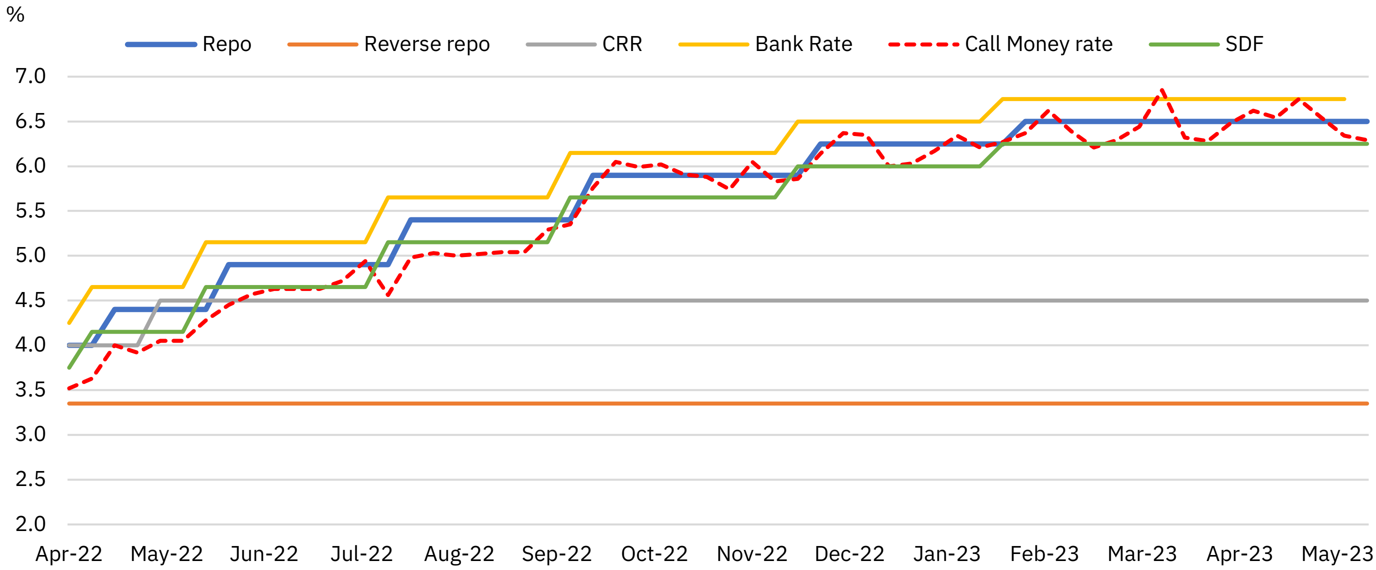
Table 1: Current policy rates

Key rates	Dec 2022	Feb 2023	Apr 2023	Jun 2023
Repo Rate	6.25%	6.50%	6.50%	6.50%
Standing Deposit Facility (SDF)*	6.00%	6.25%	6.25%	6.25%
Marginal Standing Facility (MSF)	6.50%	6.75%	6.75%	6.75%
Bank Rate	6.50%	6.75%	6.75%	6.75%
Cash Reserve Ratio (CRR)	4.50%	4.50%	4.50%	4.50%

Source: RBI, NSE EPR. * Introduced in April 2022 policy as the new floor of the LAF corridor.

Figure 1: Movement in key policy rates

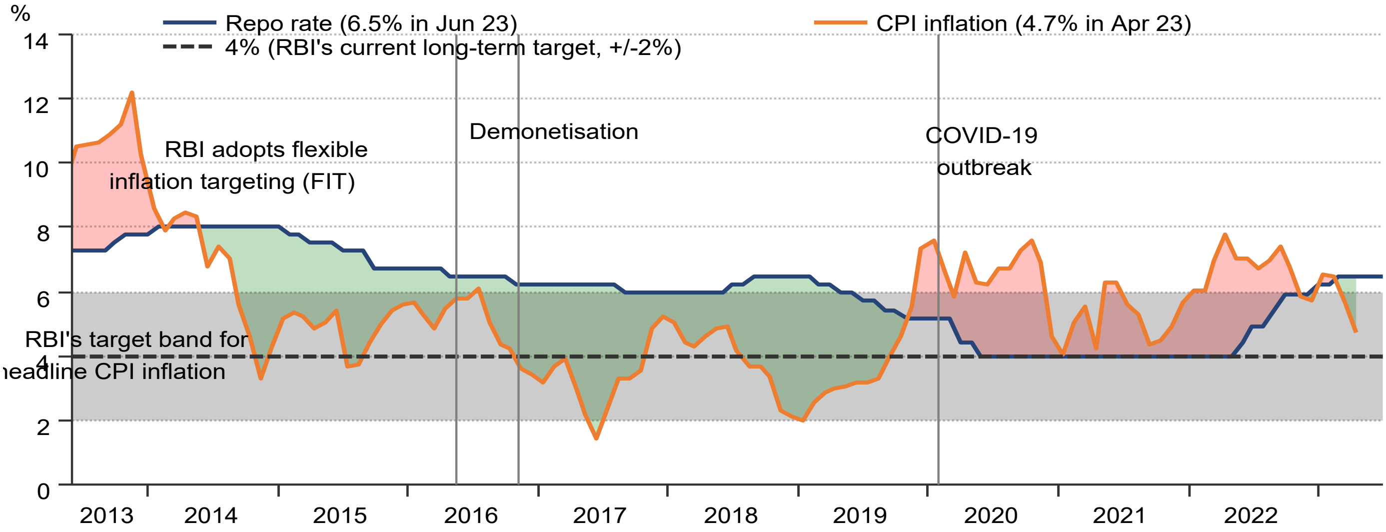
Policy repo rate was retained at 6.5% in the June policy, accompanied with continuation of "withdrawal of accommodation stance. Call money rate exceeded repo rate on several days prior to May 18th suggesting skewed liquidity distribution.



Source: Refinitiv Datastream, NSE EPR.

Figure 2: Real interest rates

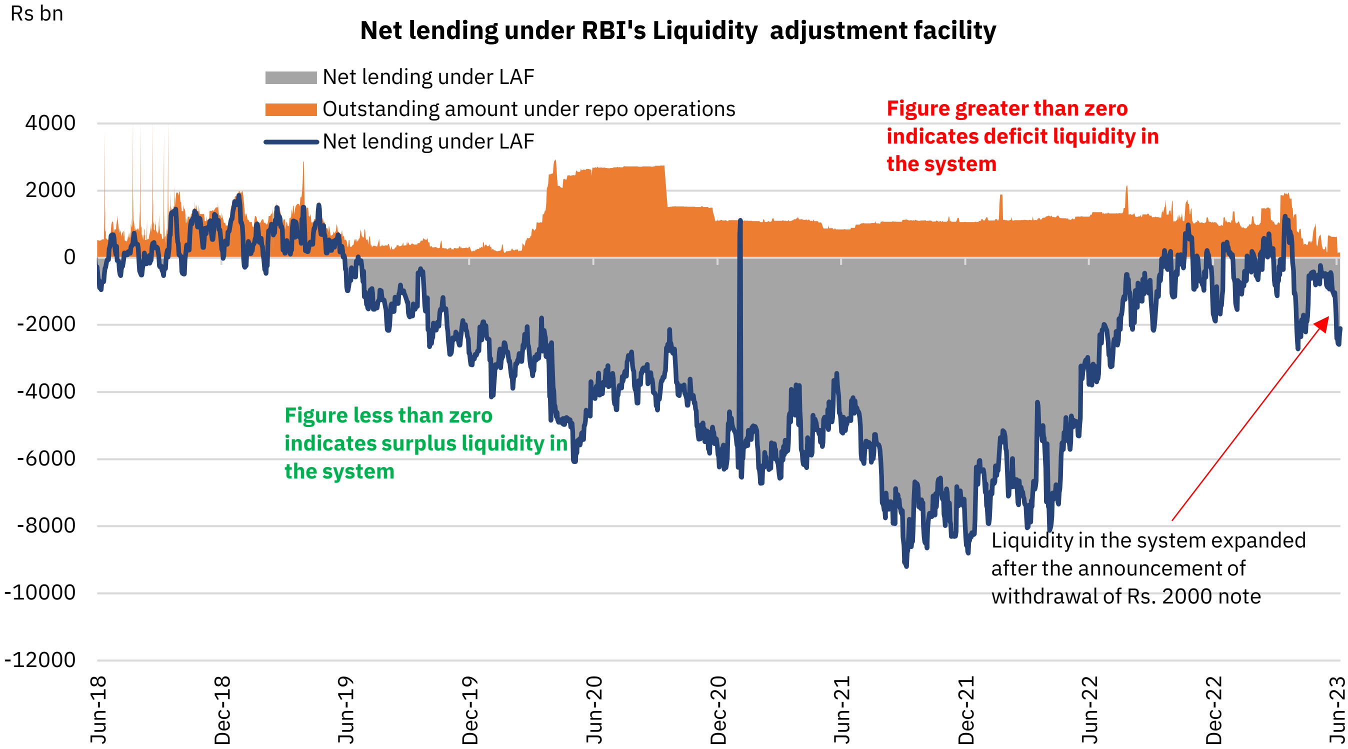
Real interest rates turned positive after remaining in the negative territory for over three years.



Source: Refinitiv Datastream, NSE EPR.

Figure 3: Net lending under RBI's Liquidity Adjustment Facility

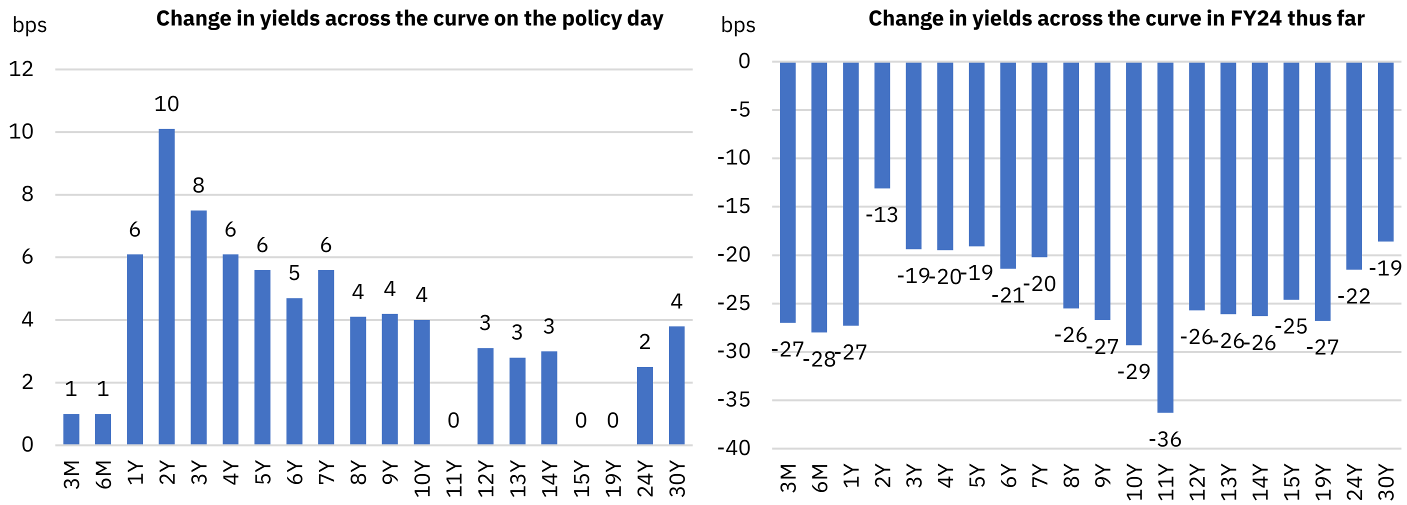
Liqudity surplus in the banking system expanded meaningfully (3x as on June 6th vs. that of May 19th) after the announcement of withdrawal of Rs 2000 note on May 19th.



Source: CMIE Economic Outlook, Refinitiv Datastream, NSE EPR.

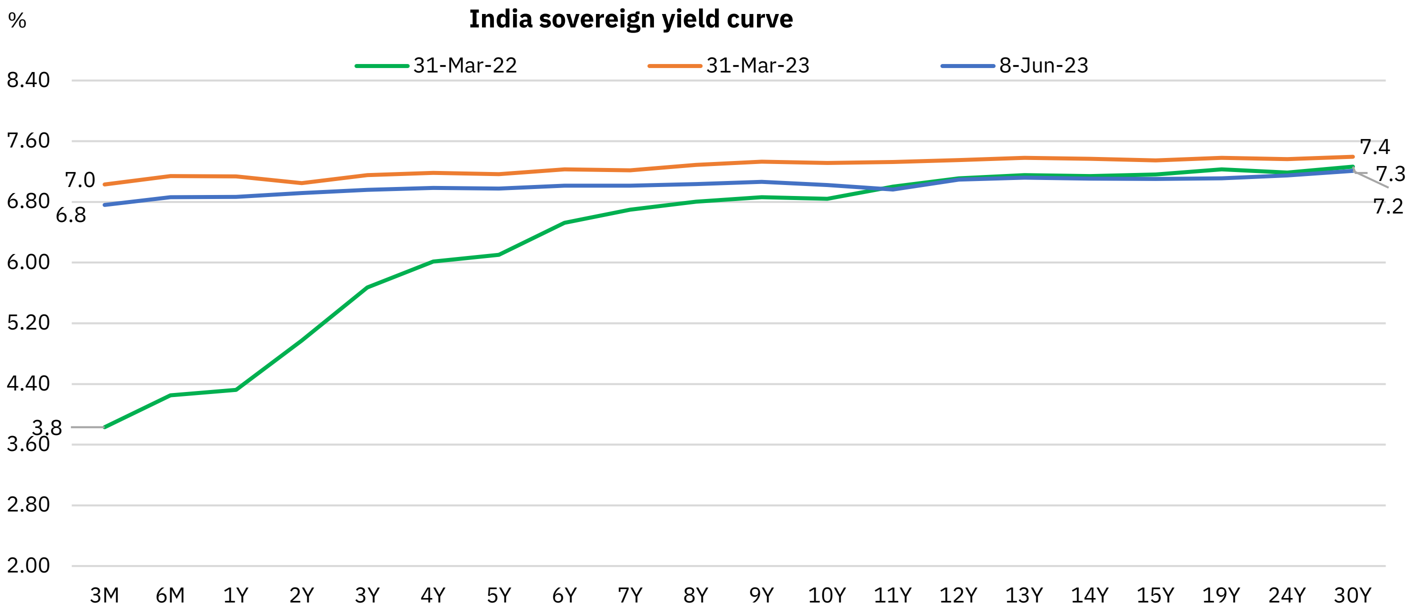
Figure 4: Change in yield curve on the policy day and in FY24 thus far (As on June 8th, 2023)

A hawkish pause today, with the MPC's firm commitment on bringing down inflation to the 4% target, has negatively surprised the markets and resulted in an increase in yields across the board, more so at the short end and belly of the curve.



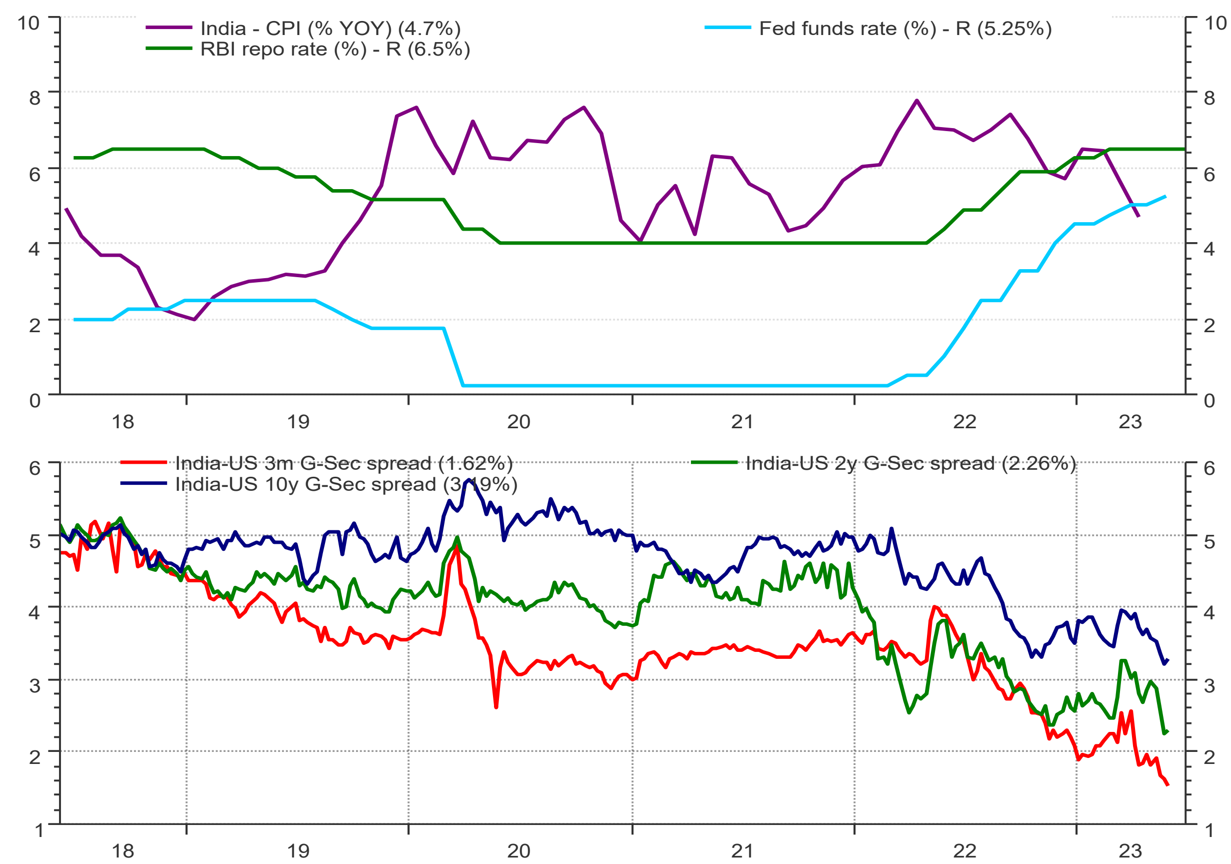
Source: Refinitiv Datastream, NSE EPR.

Figure 5: India sovereign yield curve



Source: Refinitiv Datastream, NSE EPR.

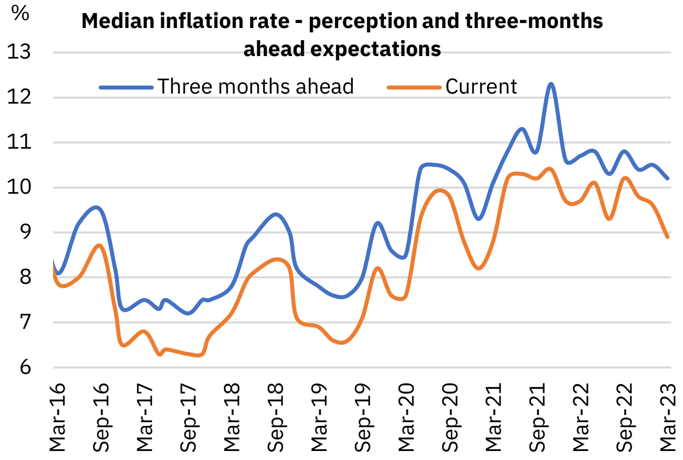
Figure 6: India vs. US policy rates and yield differential

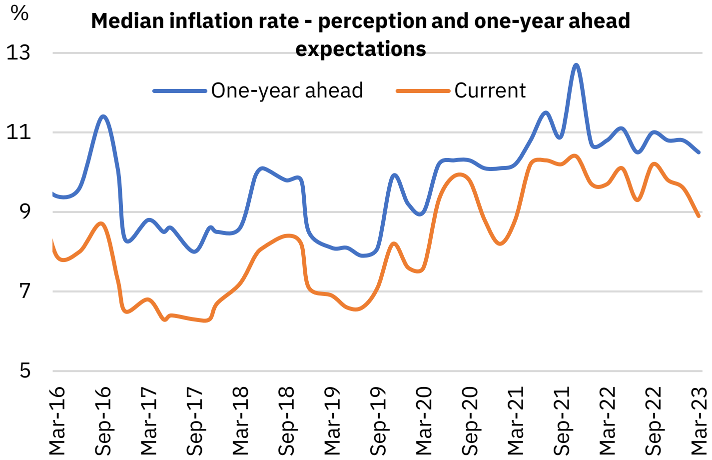


Source: Refinitiv Datastream, NSE EPR.

Figure 7: Household inflation expectation: Three-months and one-year ahead

Household inflation expectations–both for the three-month and one-year ahead periods–have been tapering off, signalling anchored inflation expectations.

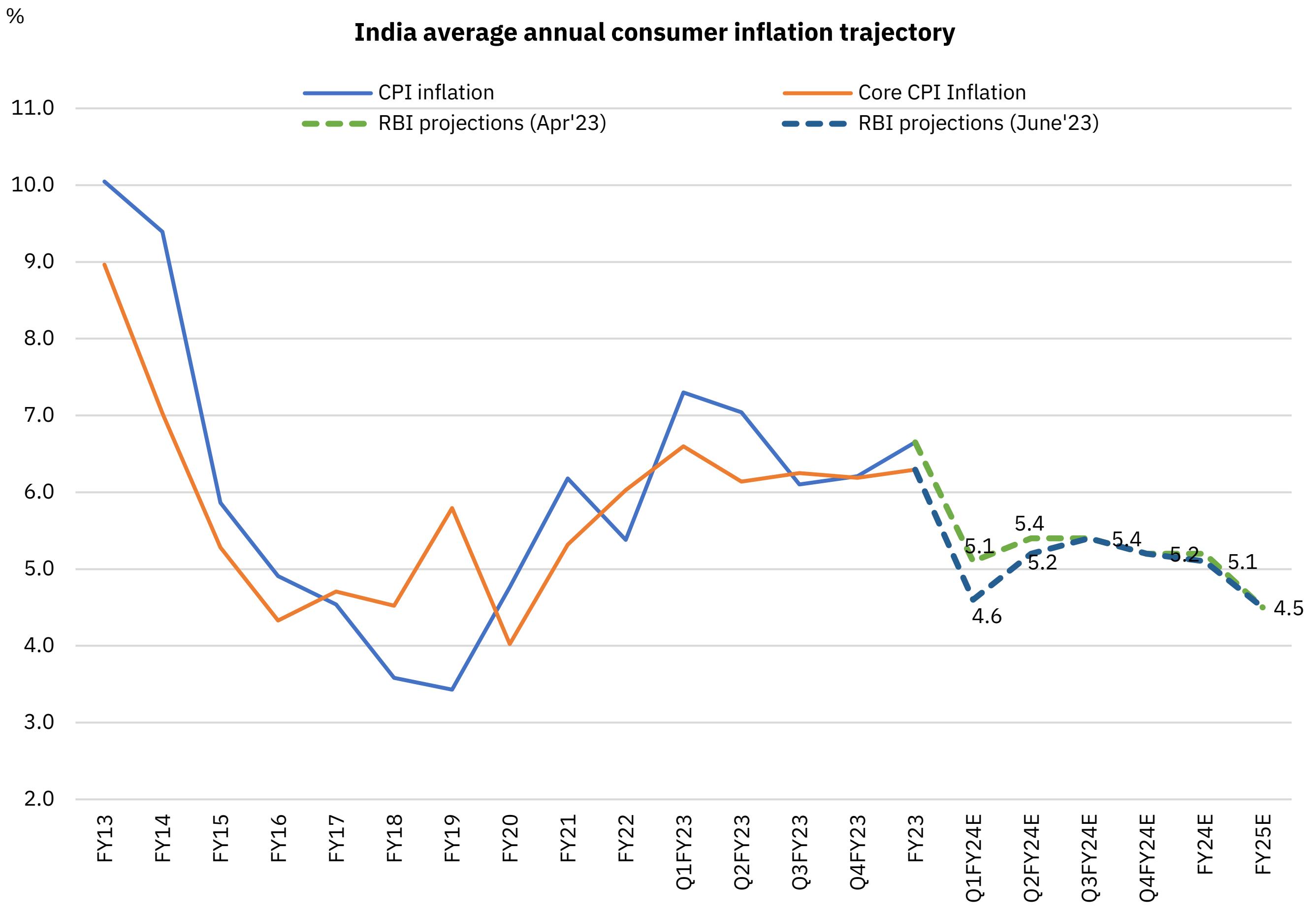




Source: RBI, NSE EPR.

Figure 8: India's consumer inflation trajectory and RBI's forecasts

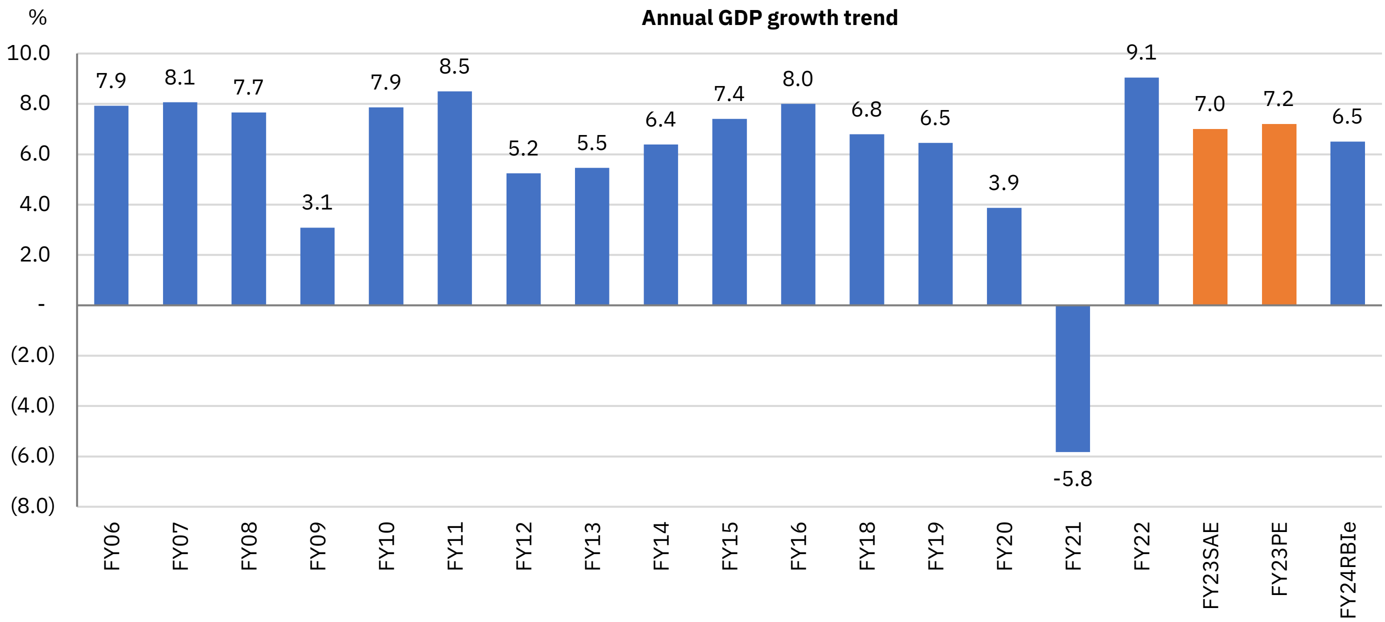
The RBI trimmed its headline CPI inflation forecast for FY24 downwards by a modest 10bps to 5.1% on the backdrop of an unharmed rabi harvest and expectations of a normal monsoon.



Source: CMIE Economic Outlook, RBI EPR. Core inflation is calculated as CPI inflation excluding food, pan, tobacco & intoxicants and fuel & light.

Figure 9: GDP growth trend and estimate for FY24

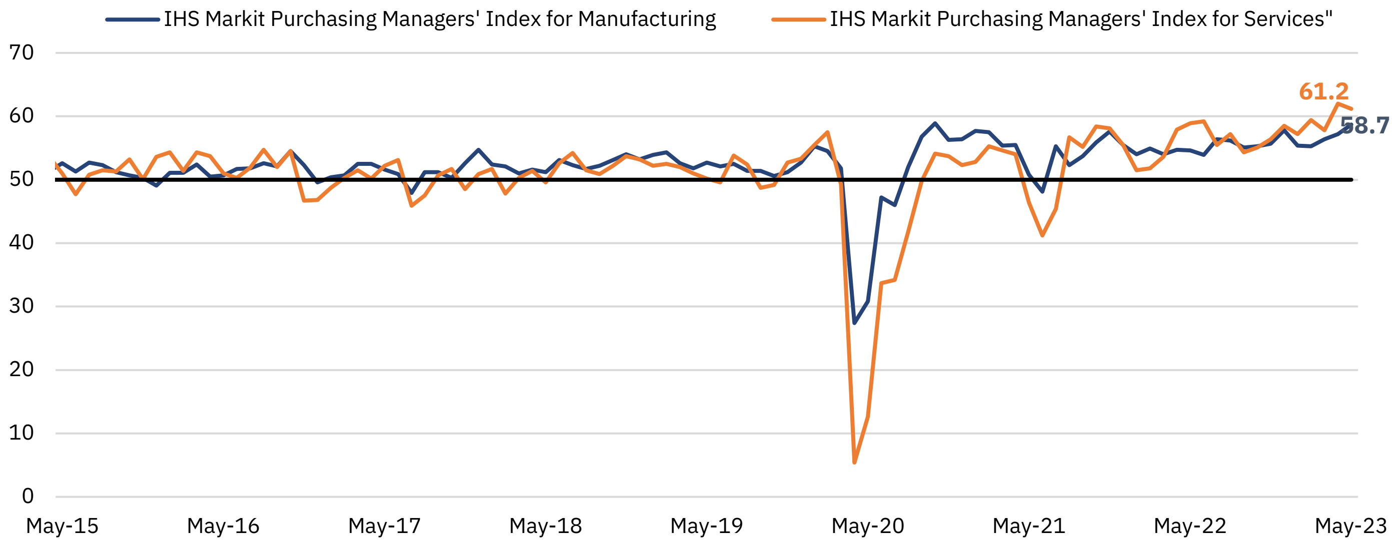
The RBI kept the GDP growth forecast for FY24 unchanged at 6.5%, supported by strong urban demand, capex thrust by the government and reviving manufacturing activity.



Source: CMIE Economic Outlook, RBI, NSE EPR. RBIe = RBI estimate, FAE = First Advance Estimate, PE = Preliminary Estimate.

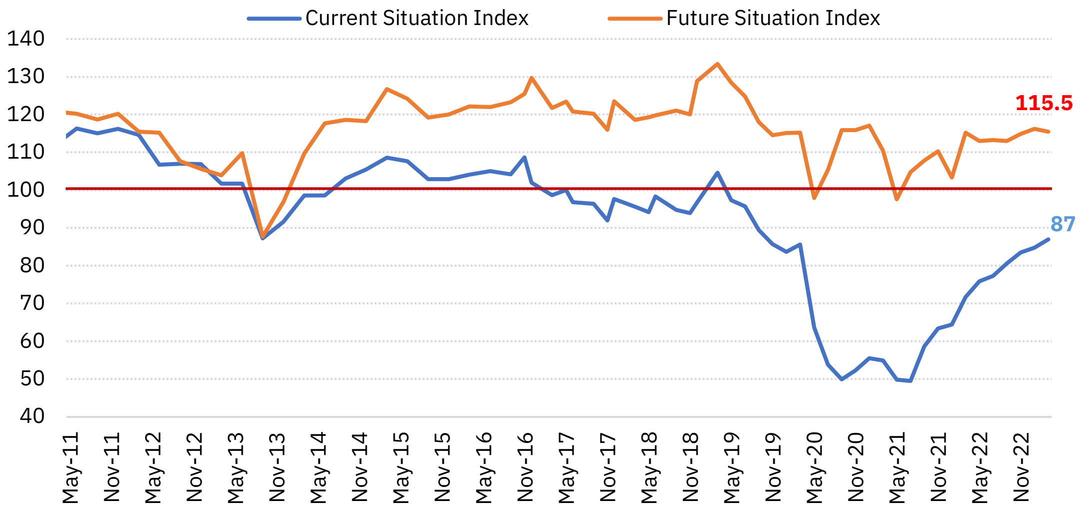
Figure 10: India's manufacturing and services PMI trend

Capex thrust by the Centre, increasing capacity utilization in manufacturing and easing commodity prices are likely to boost manufacturing and investment activities, thereby supporting growth in FY24.



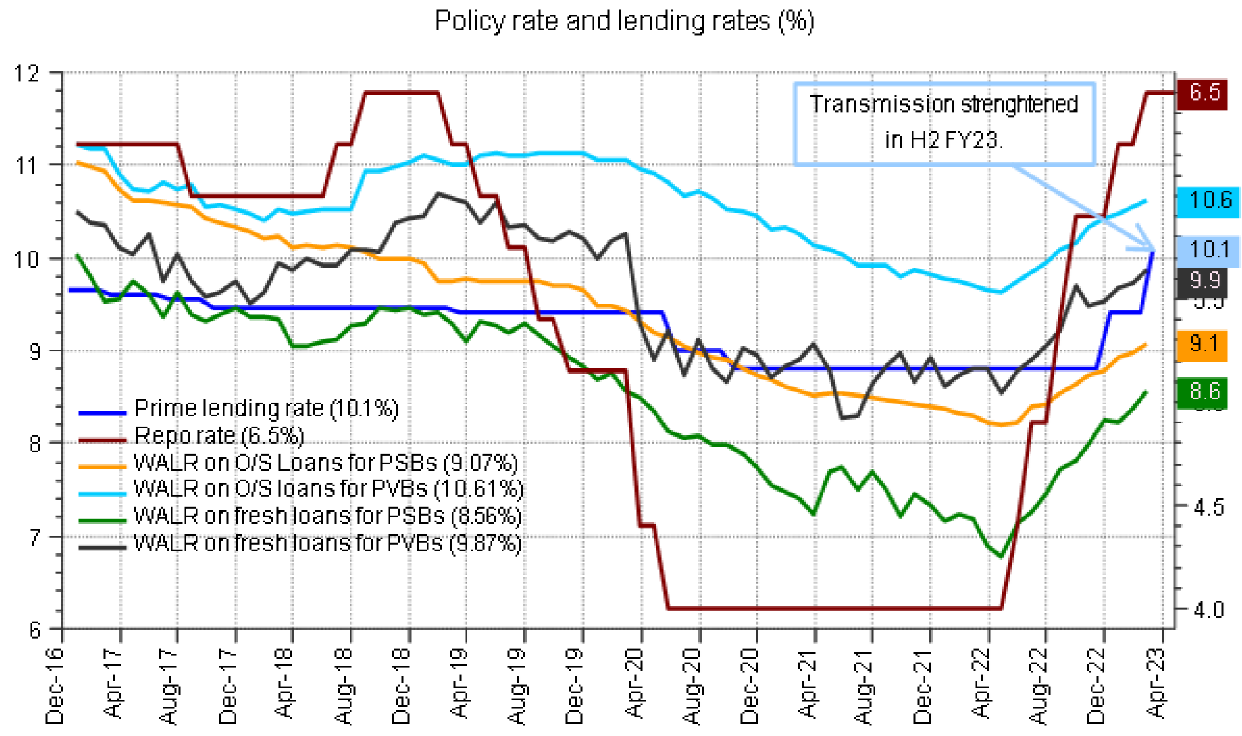
Source: CMIE Economic Outlook, NSE EPR.

Figure 11: Consumer Confidence Indices



Source: CMIE Economic Outlook, NSE EPR.

Figure 12: Policy transmission in credit markets



Source: CMIE Economic Outlook, Refinitiv Datastream, NSE EPR.

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