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RBI Monetary Policy: Rates on hold, inflation revised up, liquidity tightened

The RBI's Monetary Policy Committee (MPC) unanimously decided to keep the policy repo rate unchanged at 6.5% and retain the *'withdrawal of accommodation'* stance on a 5:1 majority, for the third policy in a row, citing rising inflationary pressures amidst a sanguine growth environment. Inflation is likely to remain a concern in the near-term, with the estimate for FY24 seeing a 30bps increase to 5.4%, thanks to a steep 100bps jump for the current quarter to 6.2% owing to higher vegetable prices. The MPC, however, chose to look through this spike given its transient nature but remains committed to taking further policy actions if required to align inflation to the target and anchor inflation expectations. In a surprise move, the RBI has tightened liquidity by announcing an incremental cash reserve ratio (I-CRR) of 10% for banks on their overall deposit accretion between May 19th, 2023 and July 28th, 2023. The move, while temporary (To be reviewed on September 8th), was a consequence of banks' lukewarm response to RBIs' 14-day variable rate reverse repo (VRRR) auctions and is likely to result in liquidity withdrawal to the tune of Rs 1trn, reducing the excess banking system liquidity to about Rs 1.5trn.

The positive impact of an unchanged policy tone and the MPC's decision to look through the inflation spike was partly offset by the RBI's surprise I-CRR announcement. The money market and short-term rates, as a result, are expected to harden further which were already reeling under pressure due to inflation concerns. Moreover, a significant increase in inflation projections for the next few quarters has pushed rate cut expectations into FY25.

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

- **Status quo on rates and stance:** The RBI's MPC unanimously decided to retain the policy repo rate at 6.5%, citing the temporary surge in vegetable prices (led by tomatoes), expected supply disruptions due to adverse weather conditions and persistence of inflation above the target level. Moreover, it continues to monitor the impact of past rate hikes on the economy. 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 members also voted, with a 5:1 majority, in favor of keeping the *"withdrawal of accomodation"* stance intact, with Prof. J. R. Varma expressing reservations for the third time in a row. While the MPC chose to look through the transient spike in inflation, its focus resolutely remains on keeping a close vigil on these shocks, aligning headline inflation to the target and containing inflation expectations.

Headline inflation for FY24 is revised upward by 30bps to 5.4% vs. 5.1% estimated in June owing to surge in food inflation, with forecast for Q2 revised up by a steep 100bps.

- **Inflation forecast revised upwards; growth outlook steady:** Inflation is likely to remain a concern in the near-term, thanks to higher vegetable prices, weather-related disruptions, rising crude oil prices and higher global food prices due to an adverse geopolitical environment. As such, the RBI has revised its inflation forecast for FY24 upwards by 30bps to 5.4%, thanks to a steep 100bps/30bps jump in Q2 and Q3 projections to 6.2%/5.7%, while estimate for Q4 has been retained at 5.2%. For Q1 FY25, headline inflation estimate has been pegged at a steady 5.2%. On the other hand, growth outlook remains steady, with the RBI retaining its growth forecast for FY24 at 6.5% and estimating 6.6% growth for Q1FY25 citing (i) A pick-up in *Kharif* sowing, (ii) robust industrial activity as reflected in IIP and PMI data, and (iii) buoyant demand conditions as urban demand recorded sustained growth and rural demand picking up. Festive season is expected to provide further support to private consumption and investment activity.
- **ICRR introduced to temporarily withdraw excess liquidity:** Recent months have seen a jump in surplus liquidity, thanks to withdrawal of Rs 2000 notes, pick-up in Government spending and huge foreign capital inflows. Notwithstanding this, market response to longer tenor VRRRs has remained lukewarm. With an aim to absorb this excess liquidity, the RBI announced an incremental CRR of 10% on the

increase in net demand and time liabilities (NDTL) between May 19th, 2023 and July 28th, 2023. This is likely to result in liquidity withdrawal to the tune of Rs 1trn, reducing the excess banking system liquidity to about Rs 1.5trn. This move, while temporary, will be reviewed on September 8th.

- **Rate cut expectations pushed to FY25:** The positive impact of an unchanged policy tone and the MPC's decision to look through the recent and expected inflation spike was partly offset by the RBI's surprise I-CRR announcement. While this is a temporary measure, it is likely to result in push the money market and short-term rates higher, as a result, are expected to harden further which were already reeling under pressure due to inflation concerns. Moreover, a significant increase in inflation projections for the next few quarters has pushed rate cut expectations into FY25.

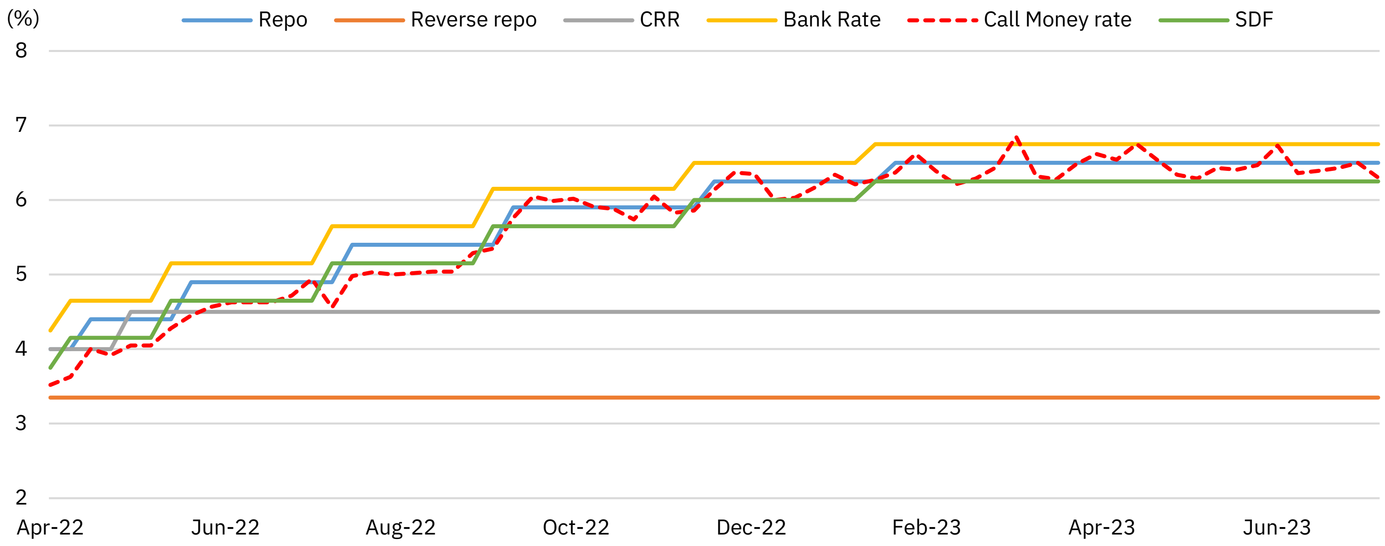
Table 1: Current policy rates

Key rates	Feb 2023	Apr 2023	Jun 2023	Aug 2023
Repo Rate	6.50%	6.50%	6.50%	6.50%
Standing Deposit Facility (SDF)*	6.25%	6.25%	6.25%	6.25%
Marginal Standing Facility (MSF)	6.75%	6.75%	6.75%	6.75%
Bank Rate	6.75%	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

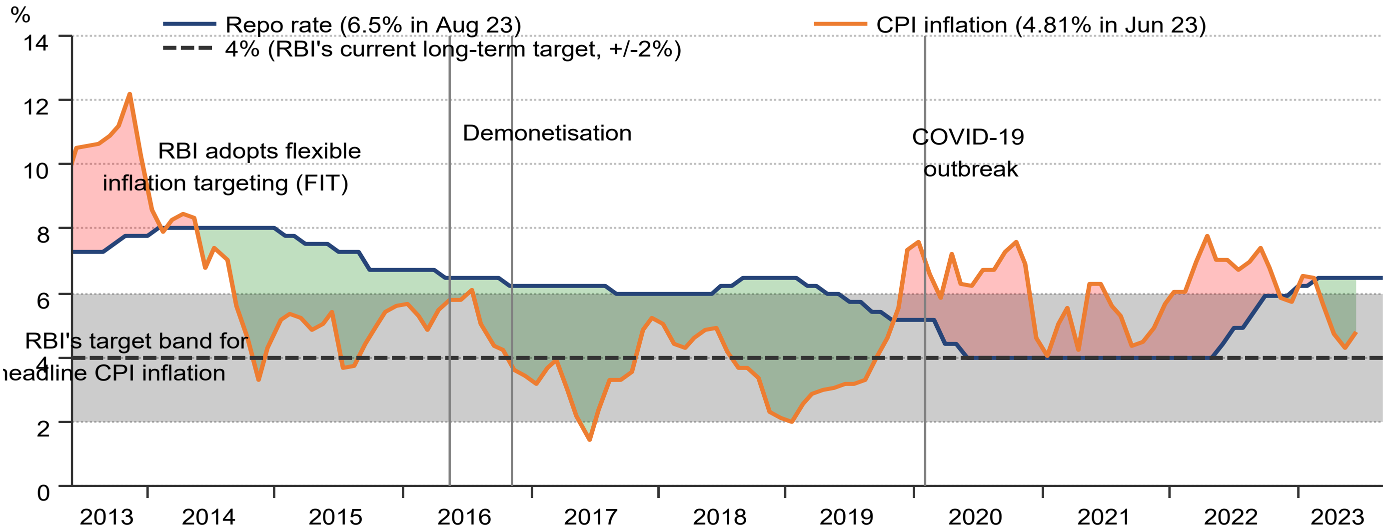
Policy repo rate was retained at 6.5% in the August policy, accompanied with continuation of "withdrawal of accommodation stance. Call money rate has exceeded repo rate on several days over the last couple of months, suggesting skewed liquidity distribution.



Source: Refinitiv Datastream, NSE EPR.

Figure 2: Real interest rates

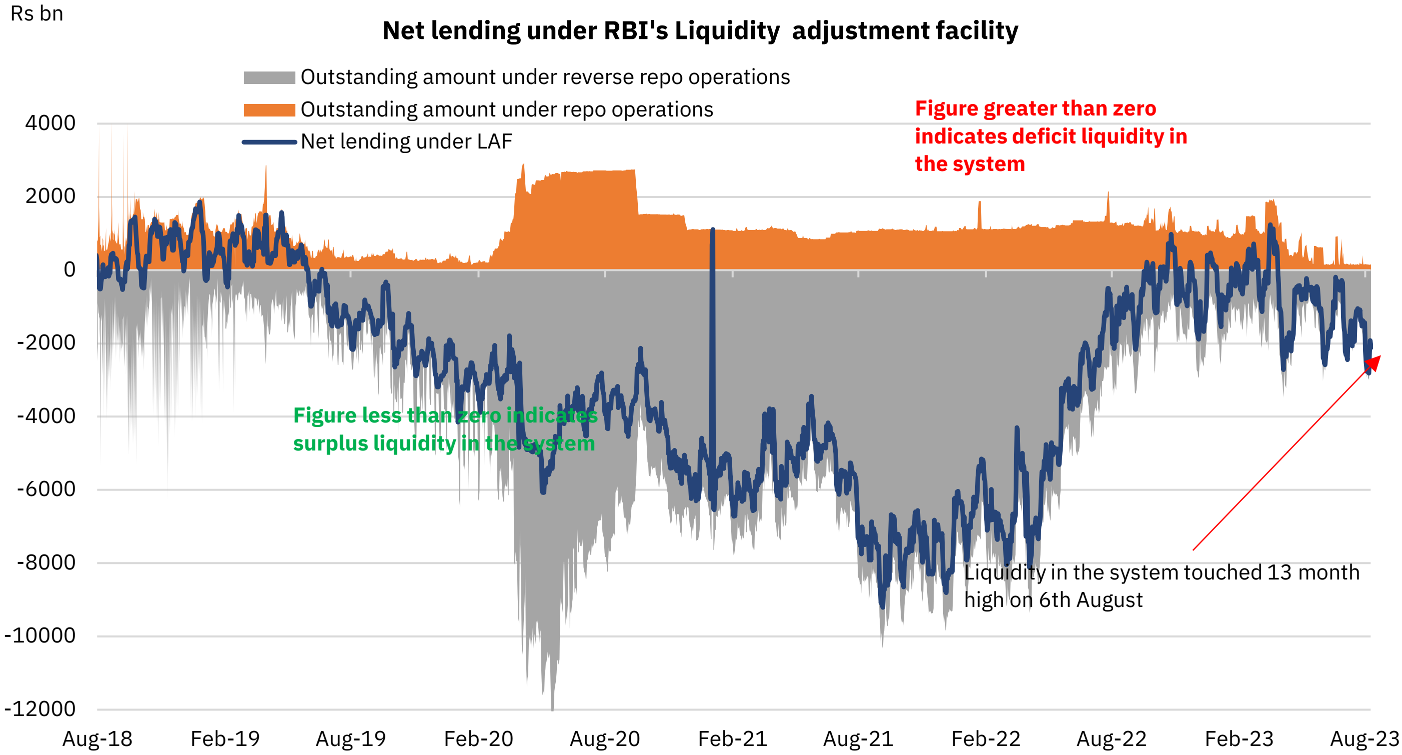
Real interest rates turned positive this year after remaining in the negative territory over the previous three years.



Source: Refinitiv Datastream, NSE EPR.

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

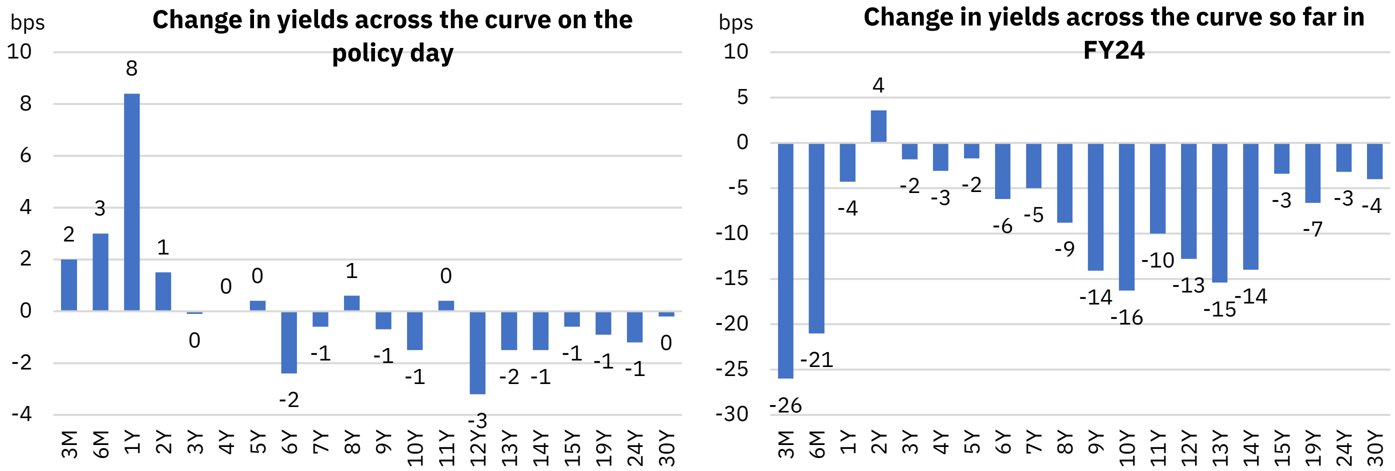
Liqudity surplus in the banking system is evidenced by high levels of net lending under LAF, which recorded a 13 month high on 6th August.



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

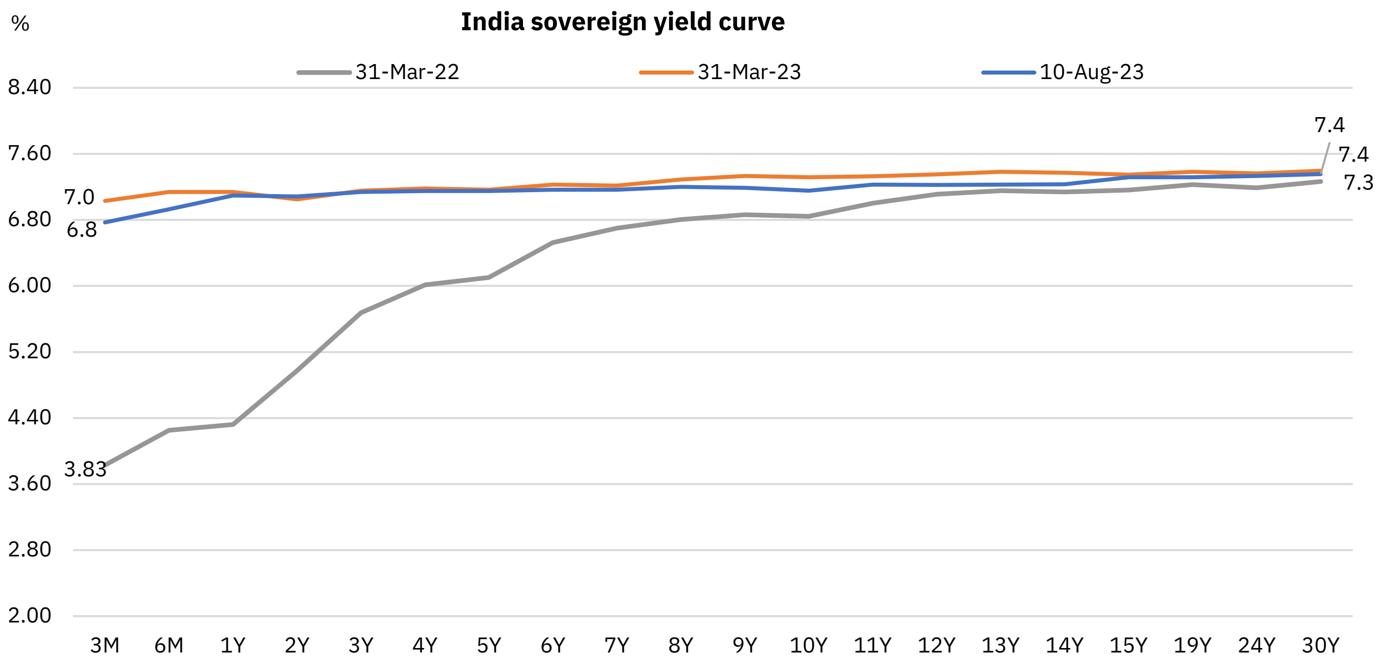
Figure 4: Change in yield curve on the policy day and in FY24 thus far (As on August 10th, 2023)

The announcement of a temporary 10% CRR on banks for incremental deposits between May 19th, 2023 and July 28th, 2023 led to a marginal increase in yields at the short-end, while long-end yields drew comfort from the MPC's view on the recent inflation spike being transitory in nature.



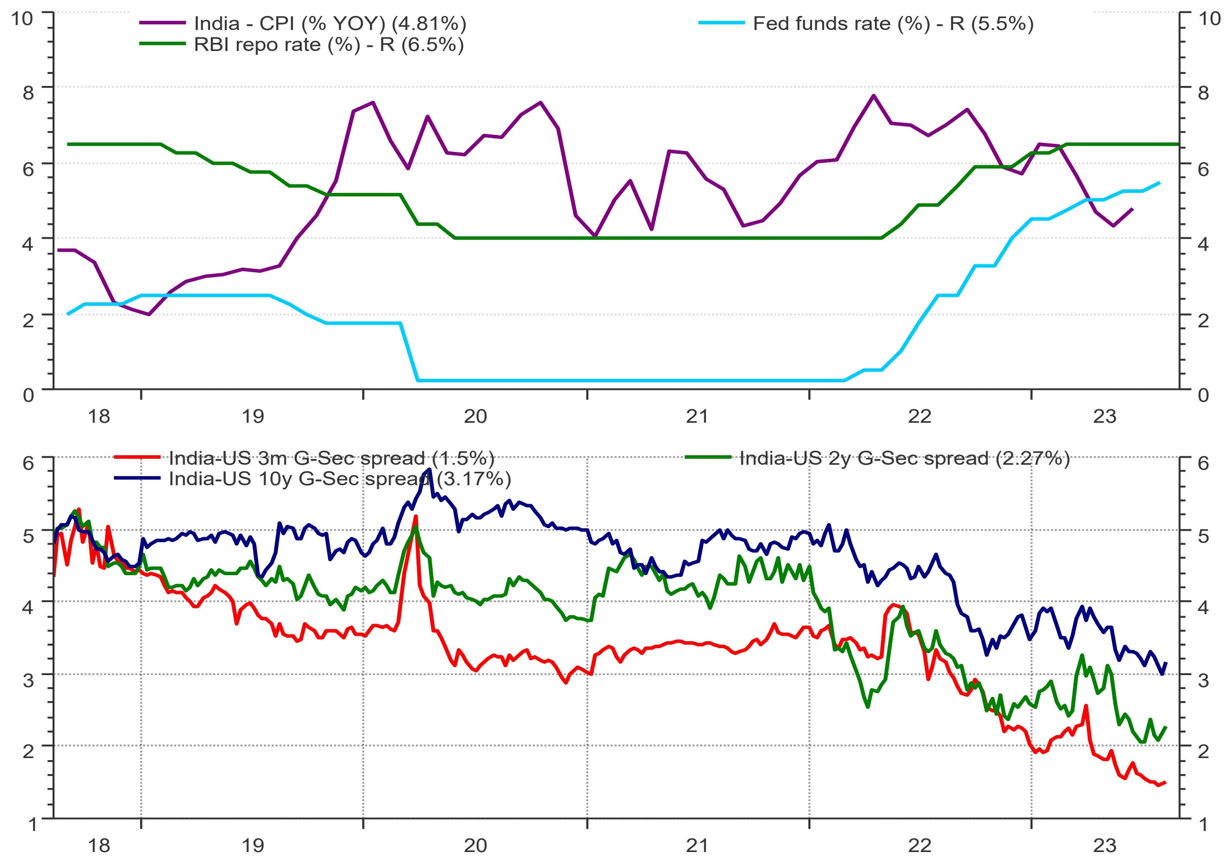
Source: Refinitiv Datastream, NSE EPR.

Figure 5: India sovereign yield curve



Source: Refinitiv Datastream, NSE EPR.

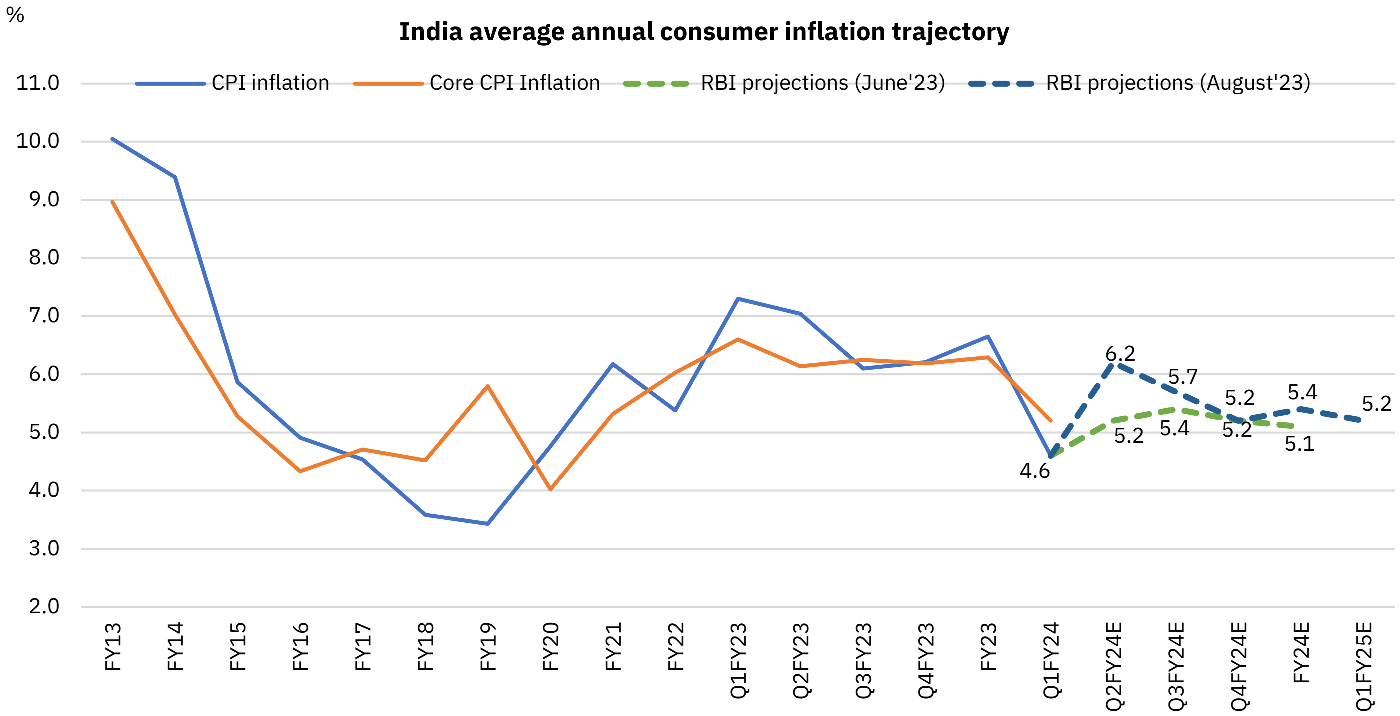
Figure 6: India vs. US policy rates and yield differential



Source: Refinitiv Datastream, NSE EPR.

Figure 7: India's consumer inflation trajectory and RBI's forecasts

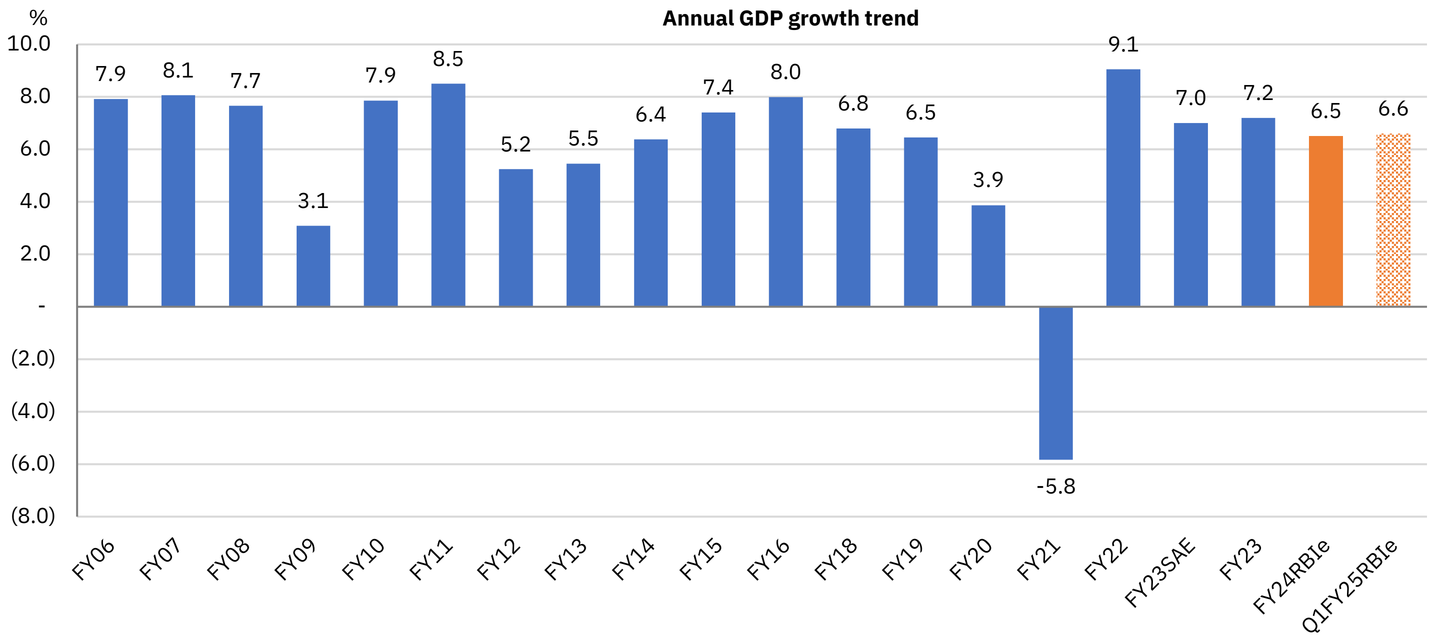
The RBI revised the headline CPI inflation forecast for FY24 upwards by 30bps to 5.4%.



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

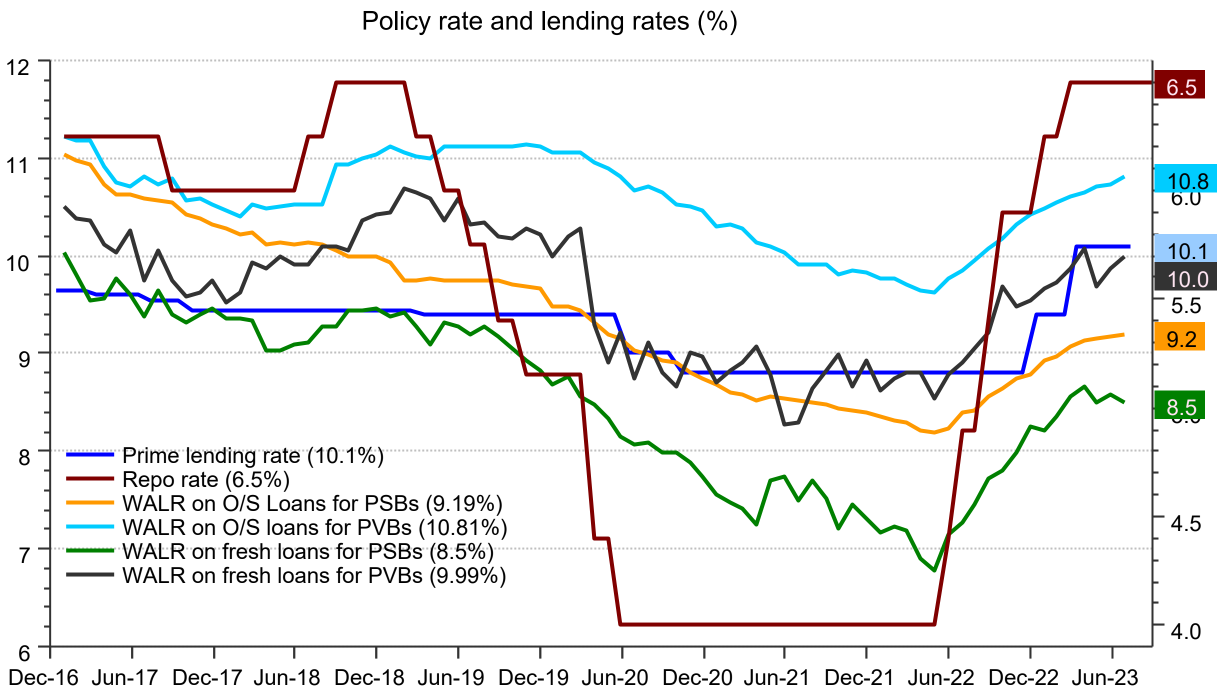
Figure 8: GDP growth trend and estimate for FY24

The RBI kept the GDP growth forecast for FY24 unchanged at 6.5%, supported by strong urban demand and pick up in rural demand coupled with uptick in industrial activity.



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

Figure 9: Policy transmission in credit markets



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

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