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RBI Monetary Policy: Status quo on rates, focus on liquidity management

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 fourth policy in a row, citing the need to maintain vigilance amid rising global food and energy prices. Further, the impact of past rate hikes is yet to be fully seen in the economy. Headline inflation is expected to come off over the next two quarters, benefiting from correction in vegetable inflation and the recent cut in LPG prices, with the full-year forecast retained at 5.4%. That said, the MPC noted that the persistence of headline inflation above the tolerance band necessitates the monetary policy to remain disinflationary, particularly in the light of upside risks emanating from volatile global energy and food prices and unfavourable weather conditions back home. The growth outlook, however, remains strong, with GDP growth estimate for FY24 retained at 6.5%, rising modestly to 6.6% in Q1 FY25. Liquidity conditions, that tightened meaningfully last month, should ease now following the release of remaining incremental cash reserve ratio (I-CRR) funds and pick-up in Government spending, partly offset by rise in festival-led currency demand. This may lead to RBI undertaking OMO (open market operations) sales to manage liquidity, in line with the objective of ensuring price and financial stability.

The MPC's decision on maintaining status quo on rates and stance is in line with expectations. The commentary, however, is incrementally hawkish, given the Committee's explicit and strong emphasis on liquidity management, in addition to its undeterred commitment to aligning inflation to the 4% target. This is likely to weigh on bond markets, which otherwise have stayed afloat until now despite a global sell-off, thanks to expected foreign capital inflows following India's inclusion in the JP Morgan Emerging Market Bond Index. Yields across the curve moved up after the policy, with the 10-year yield rising by ~14bps to 7.36%—the highest level since Mar'23, marking the highest one-day jump in over 14 months. We continue to expect a prolonged pause, with a rate cut possibility to emerge only in the next financial year. Until then, liquidity management is likely to remain at the centre stage.

- **Status quo on rates and stance:** In line with expectations, the RBI's MPC unanimously decided to retain the policy repo rate at 6.5%, citing the need for maintaining vigilance amid volatile global energy and food prices and persistence of inflation above the tolerance band. Moreover, it continues to monitor the impact of past rate hikes on the economy[1]. 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 eighth time in a row.

The RBI expectedly kept the policy repo rate unchanged at 6.5%, retaining the "withdrawal of accommodation" stance for the fourth time in a row.

- **Inflation forecase for FY24 retained at 5.4%:** Inflation conditions are expected to improve in the near-term with vegetable prices coming off and cut in LPG prices. That said, volatile energy and food prices on the global front and decline in sowing in major crops including pulses and oilseeds and lower reservoir levels on the domestic front pose upside risks to the outlook. Further, recurrence of such food price shocks could result in second-order effects in the form of generalisation and persistence of inflation. Keeping these risks in mind, the RBI has maintained its inflation forecast for FY24 at 5.4%, expecting Q2 inflation at 5.6% (up 20bps from earlier estimate), Q3 at 5.6% (-10bps) and Q4 at 5.2%. For Q1 FY25, headline inflation estimate has been pegged at a steady 5.2%.

inflation and growth forecasts for FY24 have been retained at 5.4% and 6.5% respectively.

- **Growth outlook unchanged:** Even as global economy is slowing, domestic growth outlook has remained resilient, thanks to steady urban consumption demand and strong Government spending. The RBI has retained its growth forecast for FY24 at

[1] WADTDR (Weighted Average Domestic Term Deposit Rate) and WALR (weighted average lending rate) on fresh deposits and rupee loan increased by 233 and 196bps respectively while outstanding term deposit rates and lending rates rose by much lower 157 and 112bps respectively in the current tightening cycle.

6.5%, estimating a marginal uptick to 6.6% in for Q1FY25. This is on the back of (i) a sustained buoyancy in services, (ii) robust industrial activity as reflected in PMI and IIP data and business optimism, (iii) revival in the capex cycle, thanks to strong government capex and healthy corporate and bank balance sheets, and (iii) revival in rural demand supported by recovery in overall *Kharif* sowing acreage (0.2% up YoY as on Sept 29th) despite uneven monsoon. Festive season is expected to provide further support to private consumption and investment activity. Downside risks to the outlook emerge from weak external demand, financial market volatility and continued geopolitical uncertainty.

- **OMO sales to keep liquidity in check:** The incremental CRR (I-CRR), a temporary measure which was announced in the August policy in order to deal with the excess liquidity overhang, had absorbed about Rs 1.1trn in liquidity from the system. This is being discontinued in a phased manner, with 50% of the funds parked in I-CRR to be released on October 7th, 2023. As such, liquidity conditions, that tightened meaningfully last month, further impacted by advance tax outflows, is expected to ease with release of I-CRR funds and higher Government spending, partly offset by an increase in festival-led currency demand. This may lead to RBI undertaking OMO sales to keep liquidity in check, in line with the objective of ensuring price and financial stability. Further, the RBI highlighted the skewed liquidity distribution in the banking system, with banks parking sizeable amounts under the overnight SDF (Rs 760bn on average in Sep'23), leading to deficit banks borrowing heavily under the Marginal Standing Facility (MSF borrowings shot up from Rs 67bn in Jul'23 to Rs 946bn in Sep'23).

- **Prolonged pause; liquidity management key:** While the pause on rates and stance was widely expected, the commentary has turned incrementally hawkish, given the Committee's explicit and strong emphasis on liquidity management, in addition to its undeterred commitment to aligning inflation to the 4% target. This is likely to weigh on bond markets, which otherwise have stayed afloat until now despite a sharp sell-off in global bond markets, thanks to a steady macro environment and expected active and passive foreign capital inflows following India's inclusion in the JP Morgan Emerging Market Bond Index. Yields across the curve moved up after the policy, with the 10-year yield rising by ~14bps to 7.36%—the highest level since Mar'23, marking the highest one-day jump in over 14 months. With inflation expected to remain well above the 4% target in the medium-term, we continue to expect a prolonged pause, with a rate cut possibility to emerge only in the next financial year. Until then, liquidity management is likely to remain at the centre stage.

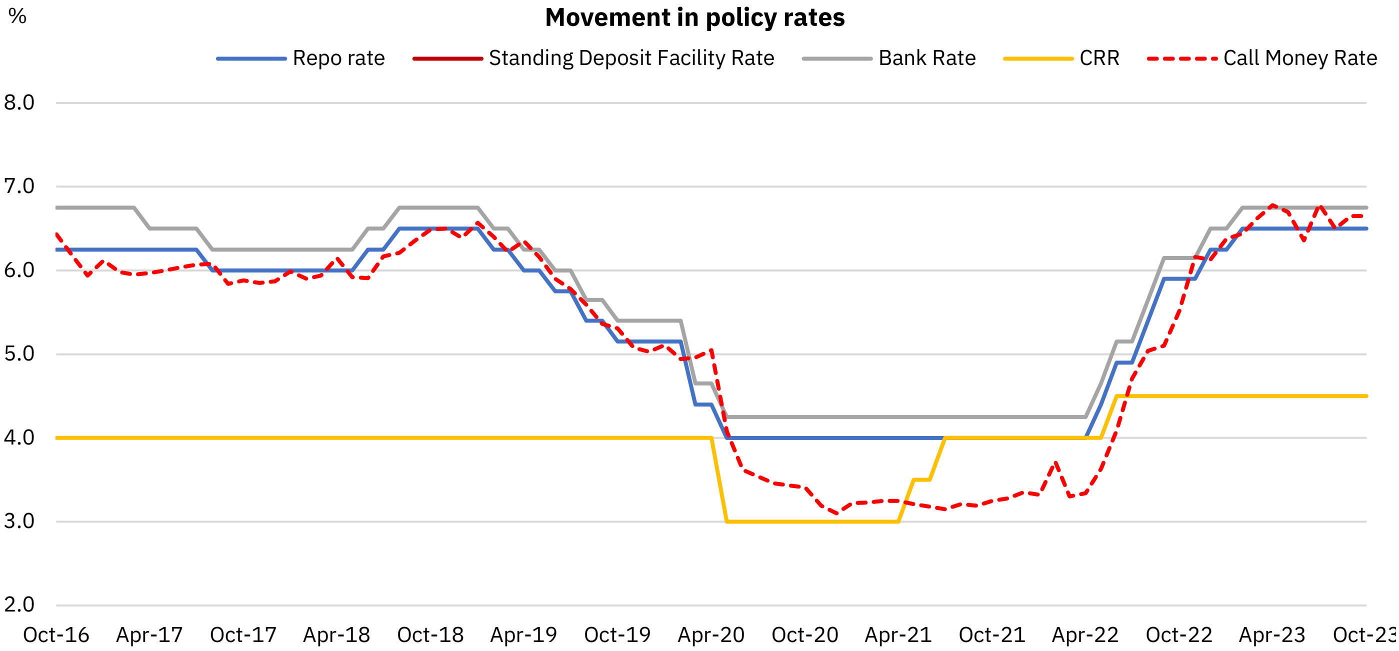
Table 1: Current policy rates

Key rates	Apr 2023	Jun 2023	Aug 2023	Oct 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

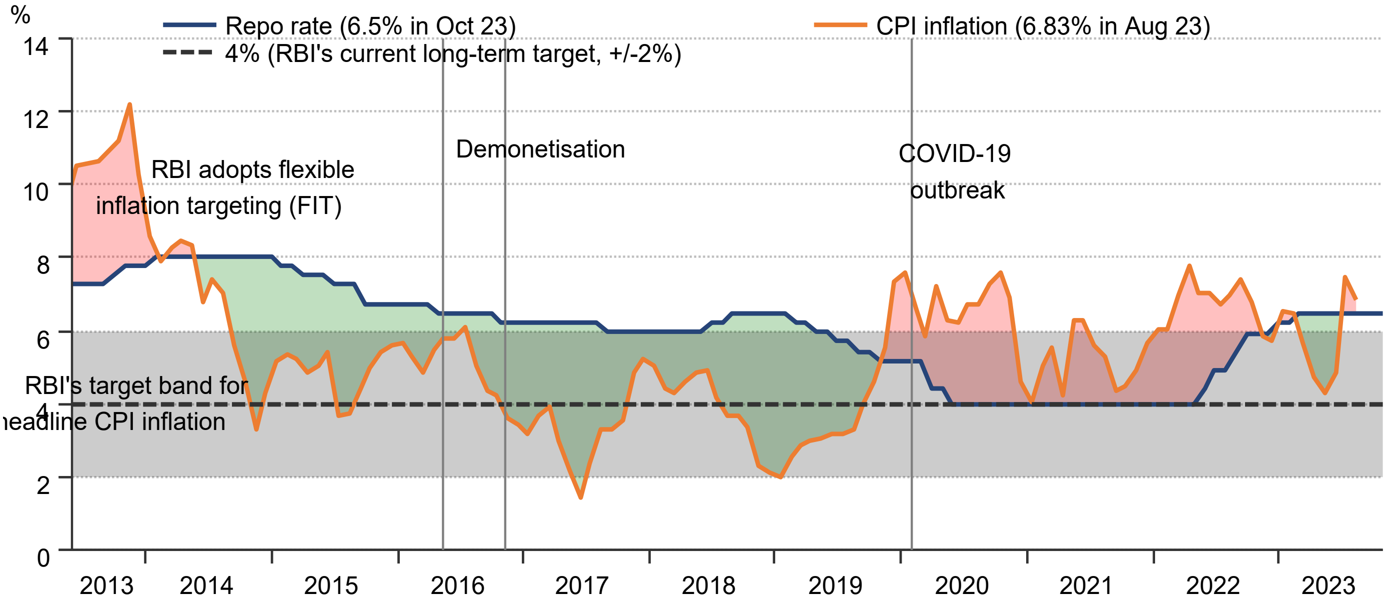
The repo rate was retained at 6.5% in the October policy, accompanied with continuation of “withdrawal of accommodation” stance. Call money rate exceeded the repo rate on several days over the last couple of months, suggesting skewed liquidity distribution.



Source: Refinitiv Datastream, NSE EPR.

Figure 2: Real interest rates

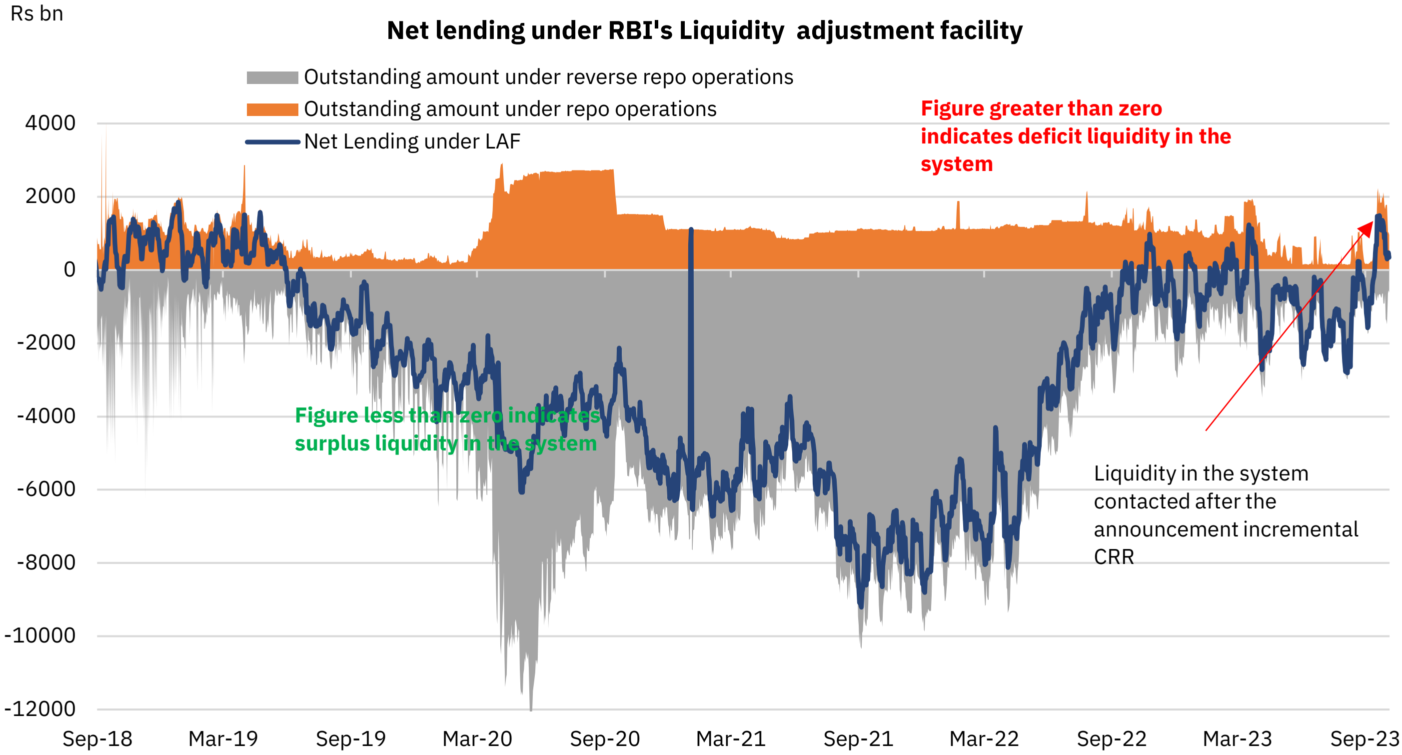
Real interest rates turned negative after turning positive momentarily in FY24.



Source: Refinitiv Datastream, NSE EPR.

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

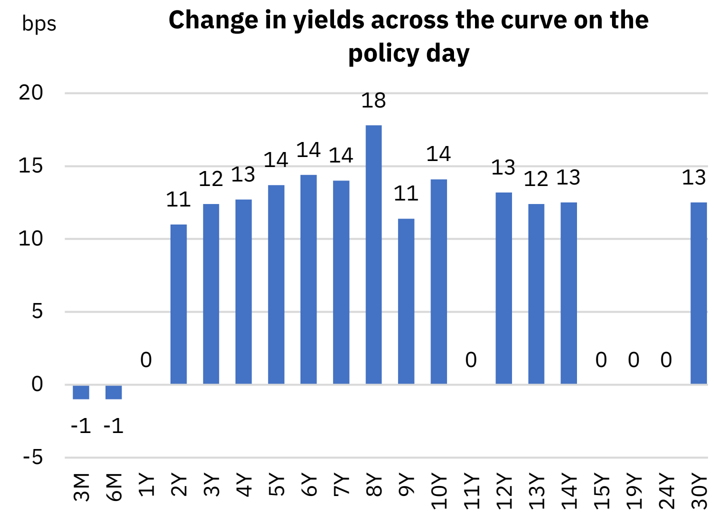
Net systemic liquidity turned into deficit in September after the temporary implementation of I-CRR and Q2 advance tax ouflows.

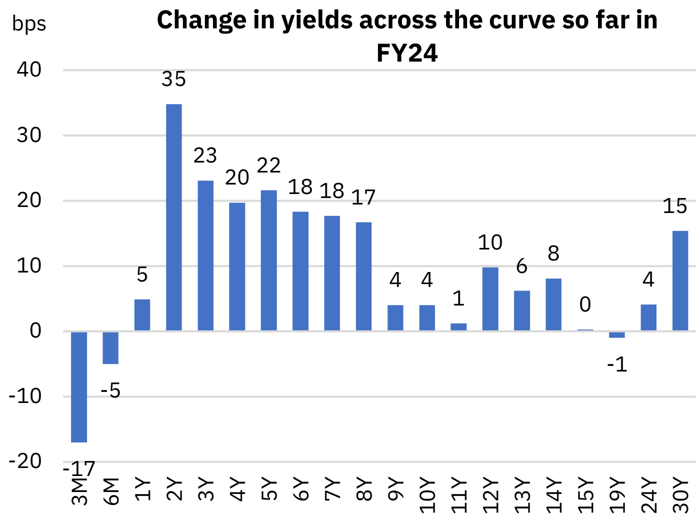


Source: CMIE Economic Outlook, Refinitiv Datastream, NSE EPR.

Figure 4: Change in yield curve on the policy day and in FY24 thus far (As on October 6th, 2023)

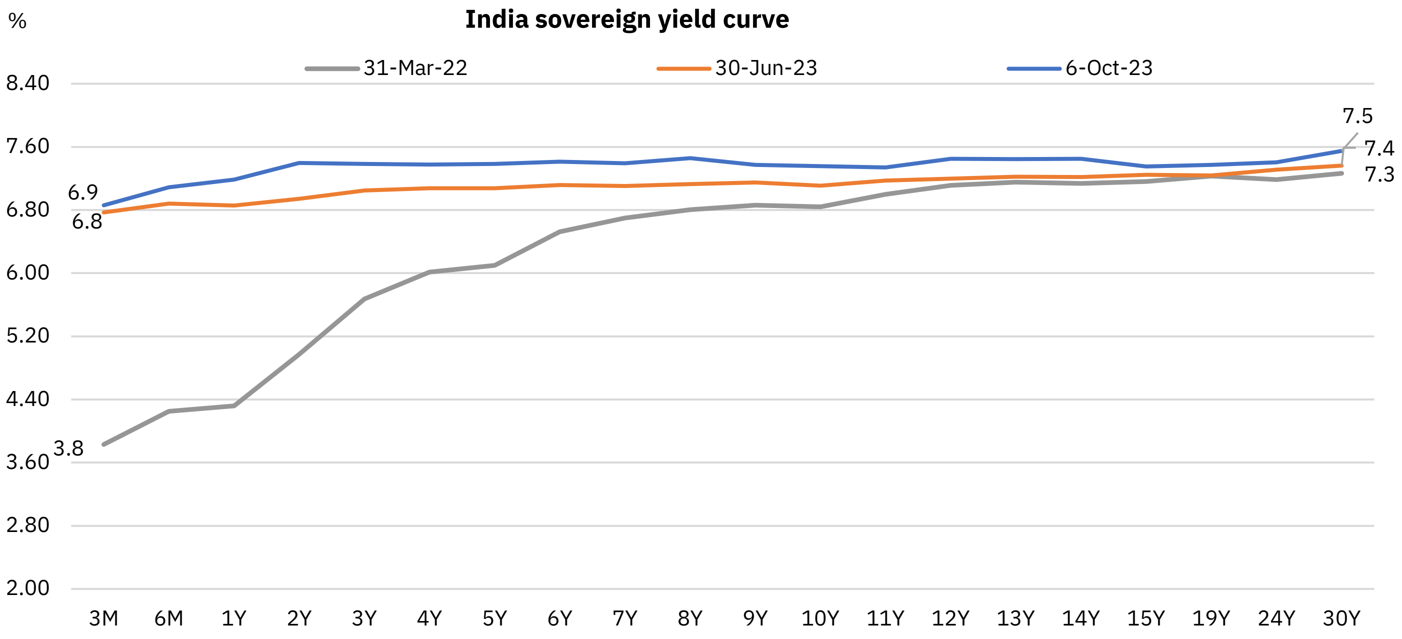
The RBI mentioned the need of OMO sales to manage liquidity as the balance funds parked as I-CRR are released, and Government spending rises. This led to bond yields rising across the board. The 10-year G-sec yield ended the day 14bps higher to 7.36%—the highest since March 2023, marking the steepest single day hike in over 14 months.





Source: Refinitiv Datastream, NSE EPR.

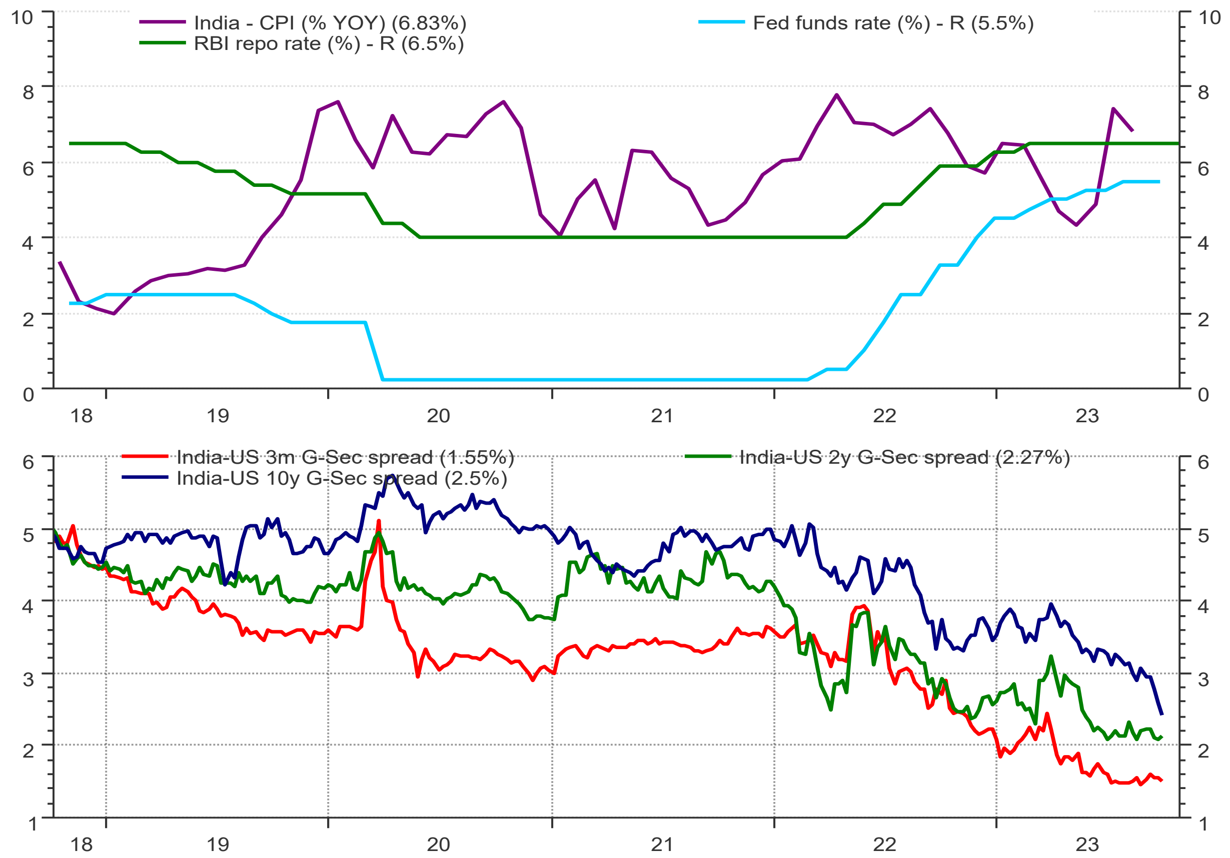
Figure 5: India sovereign yield curve



Source: Refinitiv Datastream, NSE EPR.

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

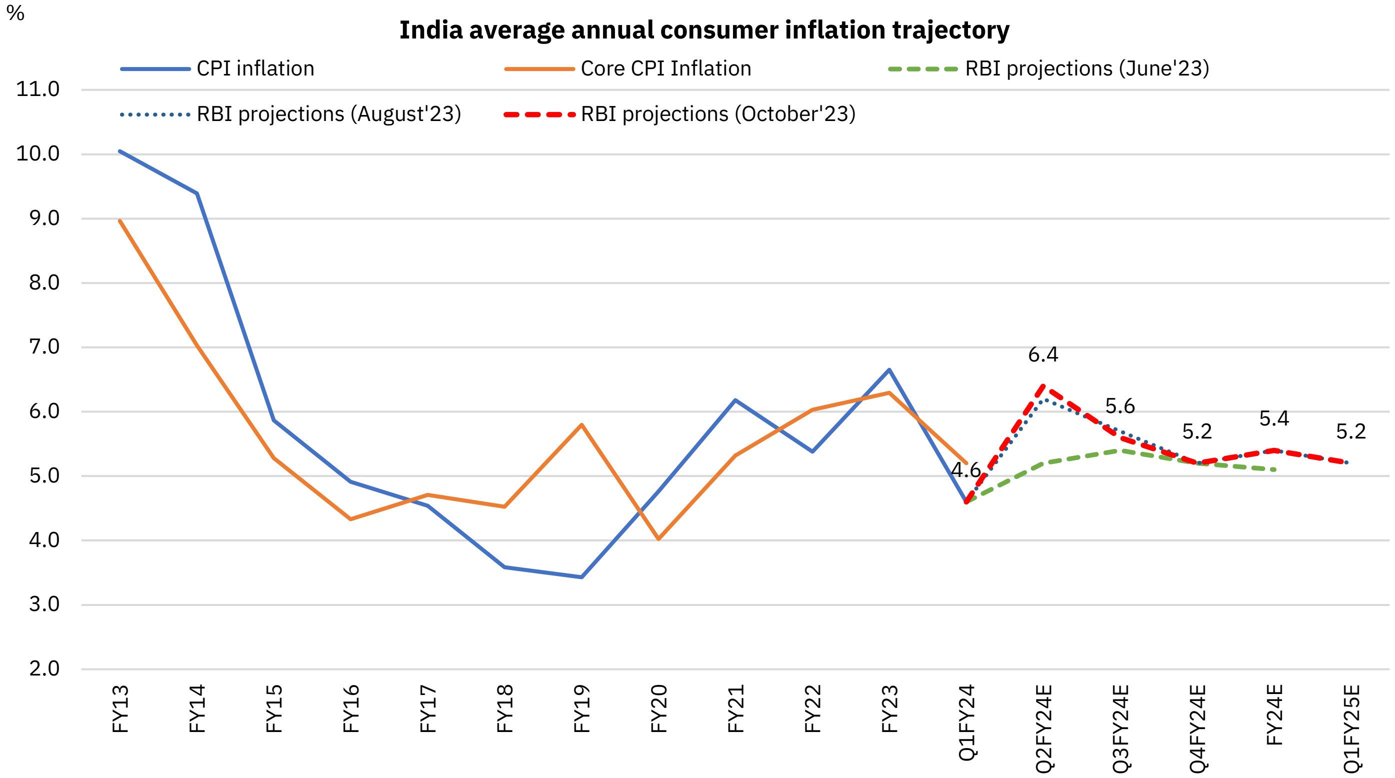
Spreads between India and US 10Y G-sec has been coming off, thanks to a sharp rise in US bond yields, while Indian bond yields have remained fairly steady.



Source: Refinitiv Datastream, NSE EPR.

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

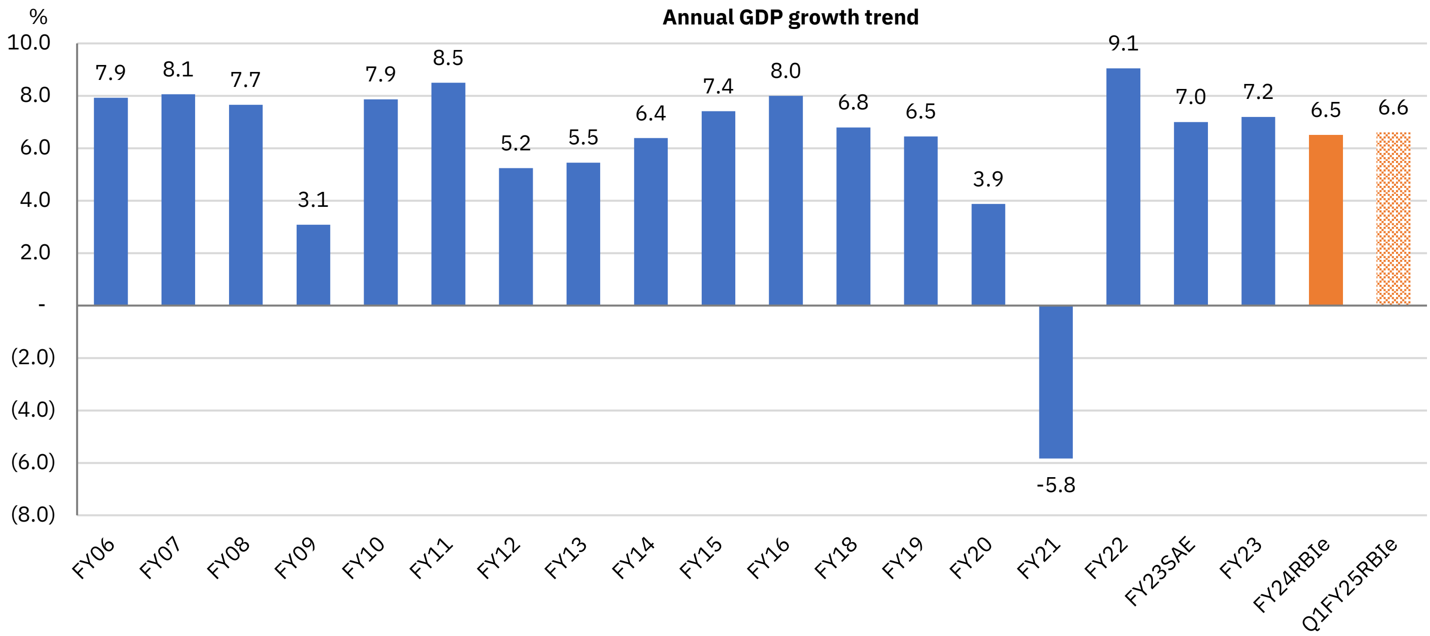
The RBI maintained the headline CPI inflation forecast for FY24 at 5.4% while revising the Q2 forecast upwards by 20bps and Q3 forecast downwards by 10bps.



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, pick up in rural demand and an uptick in industrial activity.



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

Figure 9: Transmission in lending rates

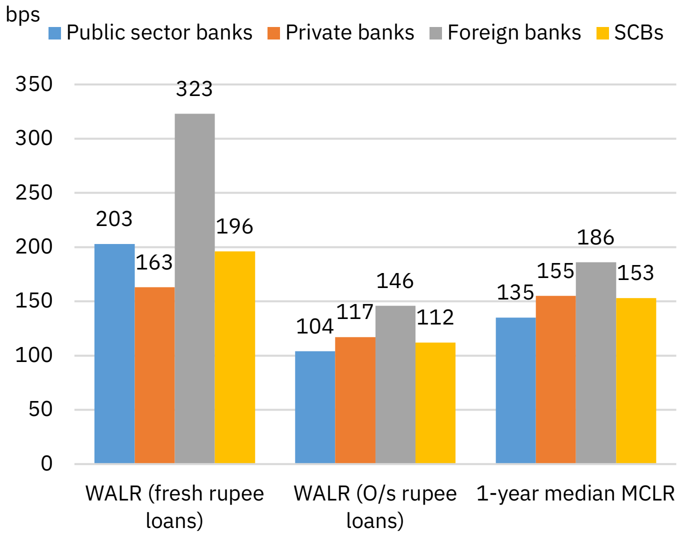
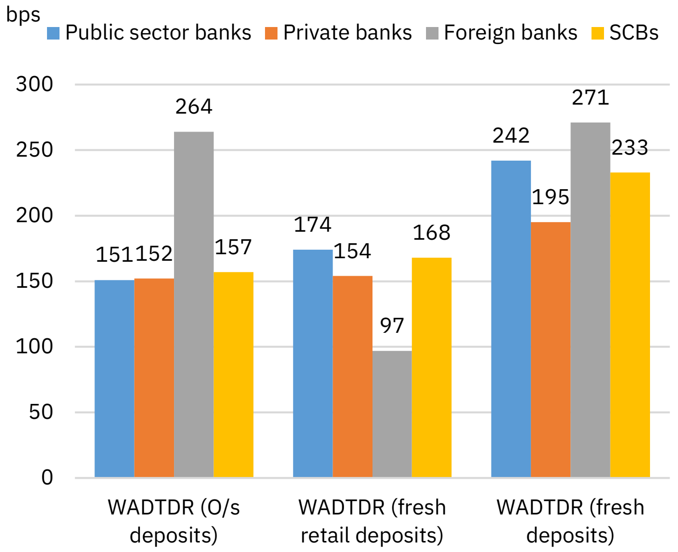


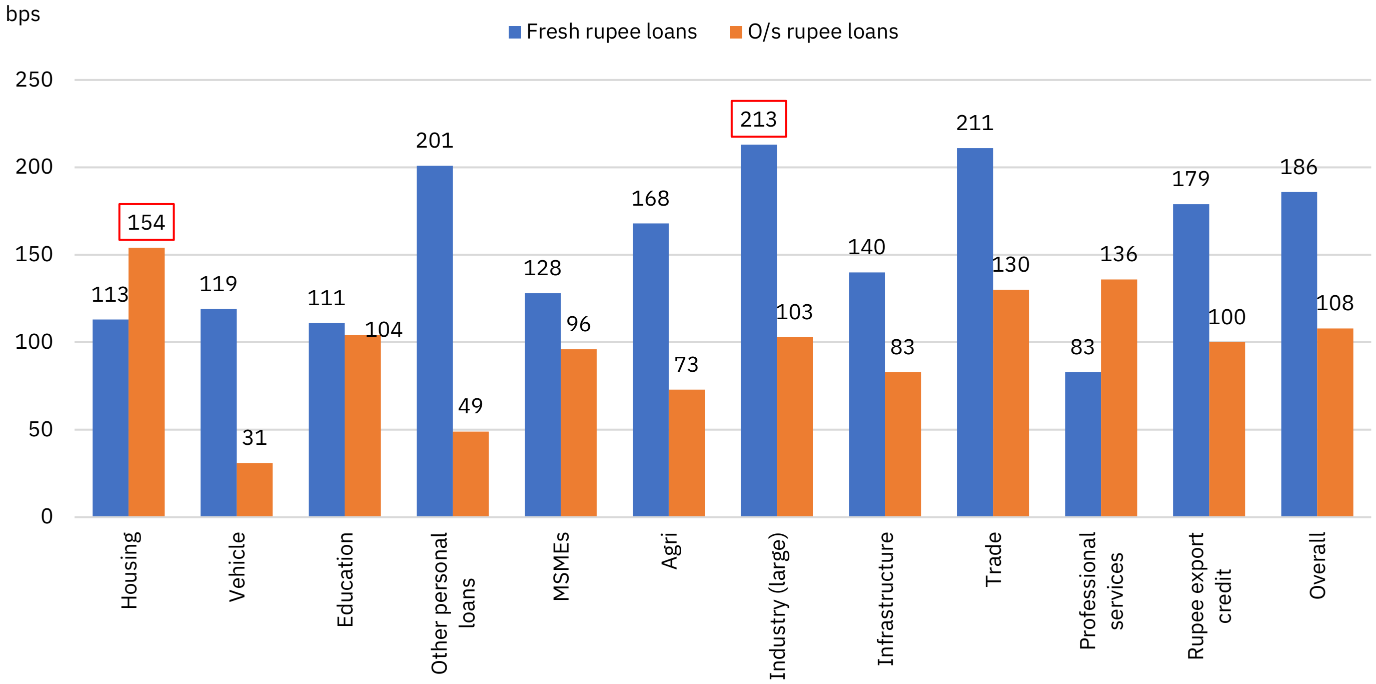
Figure 10: Transmission in deposit rates



Source: RBI's Monetary Policy Report, NSE EPR.

Figure 11: Transmission in lending rates across sectors

Housing sector witnessed the highest transmission on outstanding rupee loans, while industry sector saw the highest increase in fresh rupee loans.



Source: RBI's Monetary Policy Report, NSE EPR.

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