NSE

Macro Review

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RBI Monetary Policy: Unchanged rates, fluid on liquidity

The RBI's Monetary Policy Committee (MPC) decided to keep the policy repo rate unchanged at 6.5% and retain the *'withdrawal of accommodation'* stance on a 5:1 majority, as the past rate hikes continue to work their way through the economy. With headline inflation expected to moderate in the near-term, weather (rabi sowing) and geo-political risks may impart upward pressure. With core at sub-4% level, Governor's statement pointed the need to remain vigilant during the on-going process of disinflation. Forecast for headline CPI for FY24 is maintained at 5.4% while this is expected to decline to 4.5% in FY25. FAE[1] projects the FY24 at 7.3%--marking the third successive year of 7%+ real GDP growth rate. With robust manufacturing activity, healthy balance sheets of banks and corporates, and continued focus on capital expenditure keeps the growth outlook intact with RBI projecting the real GDP growth at 7% for FY25. RBI has been keeping a close eye on the liquidity tap with its recent VRRR and VRR auctions as liquidity conditions remain tight. While exogenous factors like government spending in the coming months will have implications on the systemic liquidity, RBI will use the appropriate instrument to maintain the money market rates (that saw some volatility over the last one week) closer to the policy repo rate of 6.5%.

While the MPC's decision on maintaining status quo on rates and stance is in line with expectations, accompanied commentary remains hawkish. MPC reiterated its commitment to aligning inflation to the target and repeatedly highlighted the need to remain vigilant on the process of last mile of disinflation. Moreover, RBI maintained the "nimble and flexible" approach to manage liquidity such that the money market rate is maintained around the policy repo rate of 6%. In the light of MPC's comfortable outlook on growth and undeterred focus on the 4% inflation target, we continue to expect a prolonged pause. Until then, RBI is likely to continue to focus on liquidity management to ensure liquidity conditions remain aligned with the monetary policy stance.

- **Status quo on rates and stance:** In line with expectations, the RBI's MPC decided to retain the policy repo rate at 6.5% with a 5:1 majority, citing the need to maintain vigilance on the volatile food price which could interrupt the on-going disinflationary process. Moreover, the transmission of past rate hikes is still underway.[2] 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 to ensure that inflation progrssively align with the RBI's target of 4%.

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

- **Inflation forecast for FY24 retained, and FY25 projected at 4.5%:** Moderating inflation conditions are expected to sustain in the near-term with correction in vegetable prices. However, adversities from weather events on rabi sowing and increasing supply-chain disruptions from geo-political tensions pose upside risk to the headline outlook. Core inflation (excluding food and fuel) moderated to four-year low of 3.8% in December on account of cummulative impact of monetary poliicy actions and significant sofetning in commodity prices. Taking these risks into consideration, the RBI has maintained its inflation forecast for FY24 at 5.4%, revising downwards its Q4 forecast by 20 bps to 5%. Further, assuming a normal monsoon, CPI inflation is projected at 4.5% in FY25 with marginal downward revisions in Q1FY25 (20 bps) and Q3FY25 (10bps).

Inflation retained at 5.4% for FY24 and projected at 4.5% in FY25, whereas GDP growth for FY25 is pegged at 7%.

- **GDP growth for FY25 at 7%:** Even as global economy remains turbulent, domestic growth outlook has exhibited resilience with real GDP growth expected to be over

[1] First Advanced Estimates

[2] WADTDR (Weighted Average Domestic Term Deposit Rate) and WALR (weighted average lending rate) on fresh deposits and rupee loan increased by 246 and 181bps respectively while outstanding term deposit rates and lending rates rose by much lower 180 and 112bps respectively in the current tightening cycle.

7% for the third year in a row, thanks to Government's strong capex push. Robust manufacturing activity amidst higher profit margins, revival in construction activity on the back of buoyant residential housing demand and strong capex bodes well for the overall consumption demand. Further, strengthening farm-level activity and extension of PMGKAY should support rural demand. Healthy balance sheets of banks and financial institutions, improving financial parameters of NBFCs and govt's strong intent to remain on the fiscal consolidation path provides a conducive environment for a steady recovery in private investment cycle. Thereby, the growth momentum is expected to sustain and is pegged at 7% for FY25, with Q1, Q2 and Q3 figures revised up to 7.2% (+50bps), 6.8% (+30bps) and 7%(+60bps) respectively. Key downside risks to the growth outlook may emanate from a weaker-than-expected external demand, heightened geopolitical tensions. The high levels of public debt amidst an environment of high interest rates and low growth pose additional risk.

- **Flexibility maintained on the liquidity front:** Systemic liquidity remained in deficit throughout December and January, with the magnitude of deficit increasing to an average of Rs 1.6 lakh crore in these two months compared to Rs 0.5 lakh crore in the September-November period. However, when adjusted for government cash balances, potential liquidity is actually in surplus, as a result of which the RBI has undertaken multiple Variable Reverse Repo Rate (VRRR) auctions over the last two months. There is a continued emphasis on liquidity management with the goal of keeping the interbank call rate close to the repo rate of 6.5% (currently at 6.48% vs. 6.81% on 26th Dec'23) in order to facilitate complete transmission of the policy hikes. Going forward, the RBI is likely to practice flexible and nimble management of liquidity in order to deal with exogenous shocks to the systemic liquidity like lower levels of government cash balances in the coming months as a result of increased expenditure.

- **Regulatory measures:** RBI has now permitted resident entities to engage in over the counter (OTC) gold price hedging within the IFSC to address the need for more hedging options and flexibility. This move aims to provide access to a variety of derivative products for managing gold price risk, thereby increasing the liquidity in the gold segment. In addition, RBI has (i) mandated all regulated entities (REs) to provide the borrowers of all retail and MSME loans with the "Key Fact Statement", providing critical information on the terms of the loan; (ii) proposed streamlining AePS onboarding and implementing fraud risk management to foster financial inclusion; (iii) announced a principle-based "framework for authentication of digital payment transactions" with an alternative authentication mechanism to enhance digital security ; (iv) announced introduction of programmability to ensure defined benefits and offline functionality in rural areas in CBDC-R pilots.

- **Hawkish tone, higher for longer cues:** Unlike last time, when the Governor highlighted the "risk of overtightening", today's statement became more hawkish with Governor repeatedly pointing to continuing the last mile of disinflationary process clarifying the stance "withdrawal of accommodation" is to bring inflation back to the 4% target. Further, he highlighted the risks pertaining from high levels of global debt (Our report: A deep dive into global indebtedness: A 100-year history) which can result in higher global yields can become new source of stress. Moreover, RBI is expected to remain flexible with liquidity management by deploying the "appropriate mix of instruments" such that the money market rates (that witnessed some volatility over the last few days) remain close to the policy rate, managing both frictional and durable liquidity. The credit policy points to a prolonged status quo on rates with RBI keeping a close eye on systemic liquidity enhancing transmission.

Table 1: Current policy rates

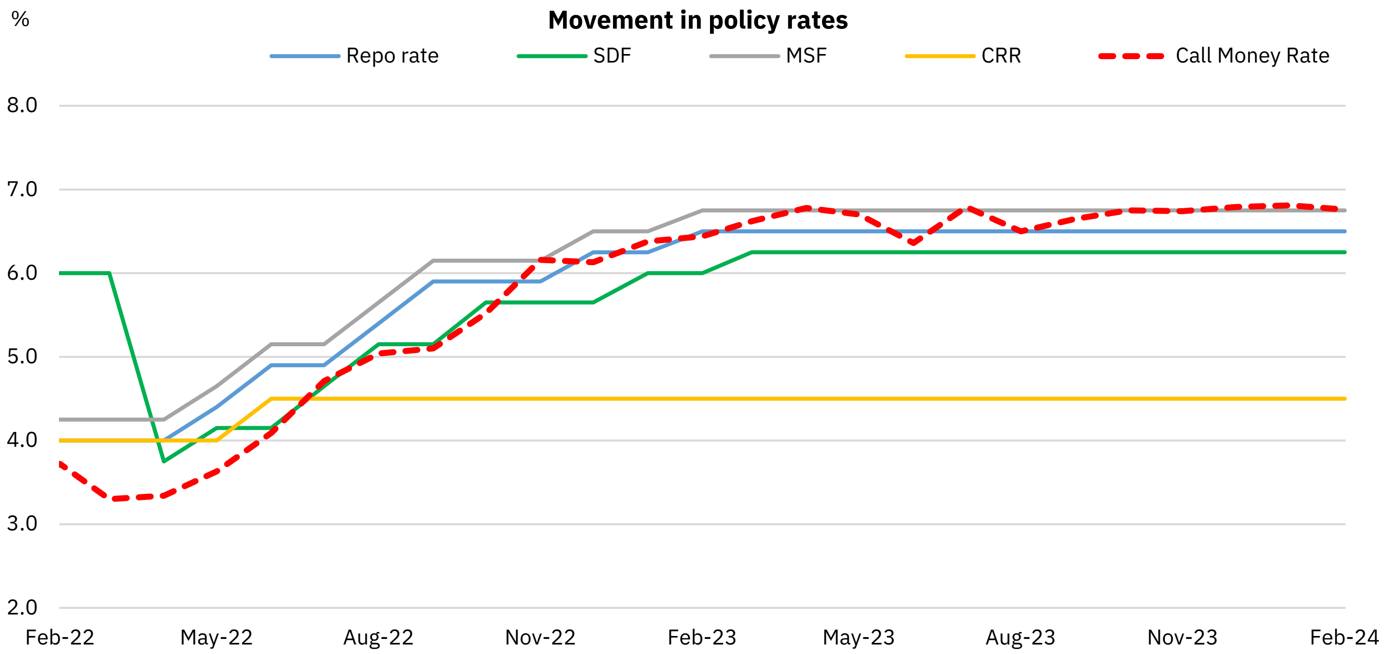
The policy repo rate was retained at 6.5% in the February policy, accompanied with continuation of "withdrawal of accommodation" stance.

Key rates	Aug 2023	Oct 2023	Dec 2023	Feb 2024
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:

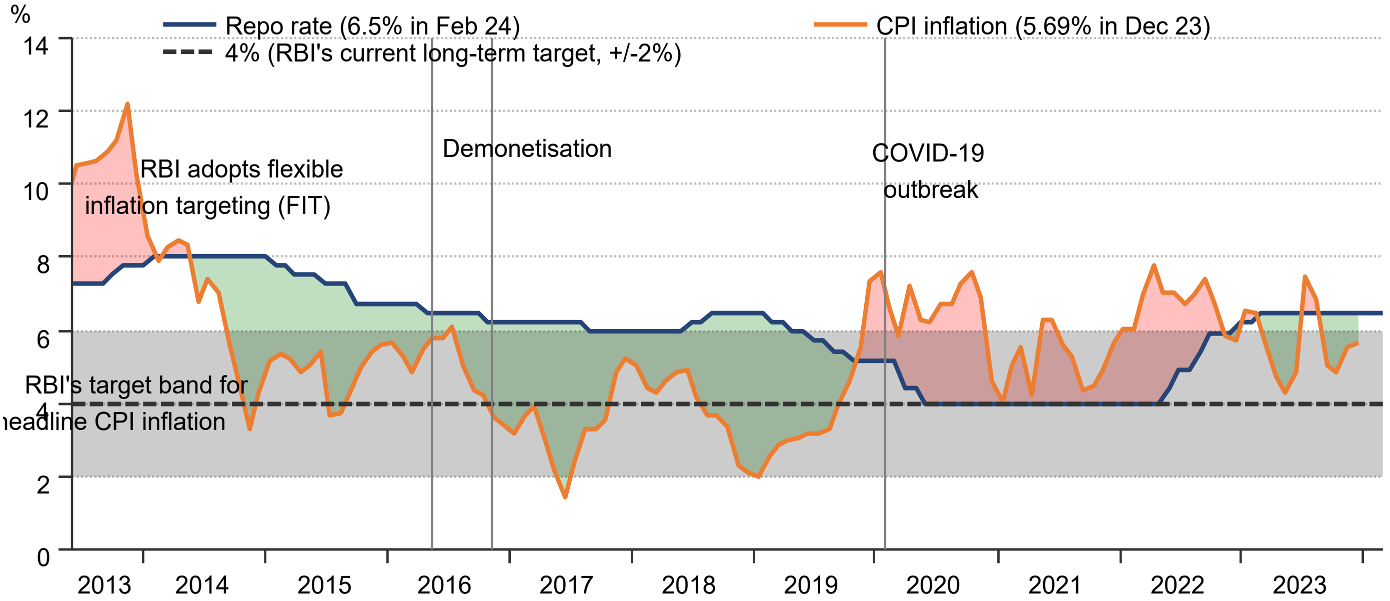
Call money rate exceeded the 6.75% mark in 25 out of the 43 days since the last policy meeting, peaking thrice at 6.81%. However, since the last one-week it has moderated even below the repo-rate, thanks to easing liquidity conditions on account of pick-up in govt. spending and measures taken by RBI. (Call rate: 6.48% on 7 Feb'24).



Source: Refinitiv Datastream, NSE EPR.

Figure 2: Real interest rates

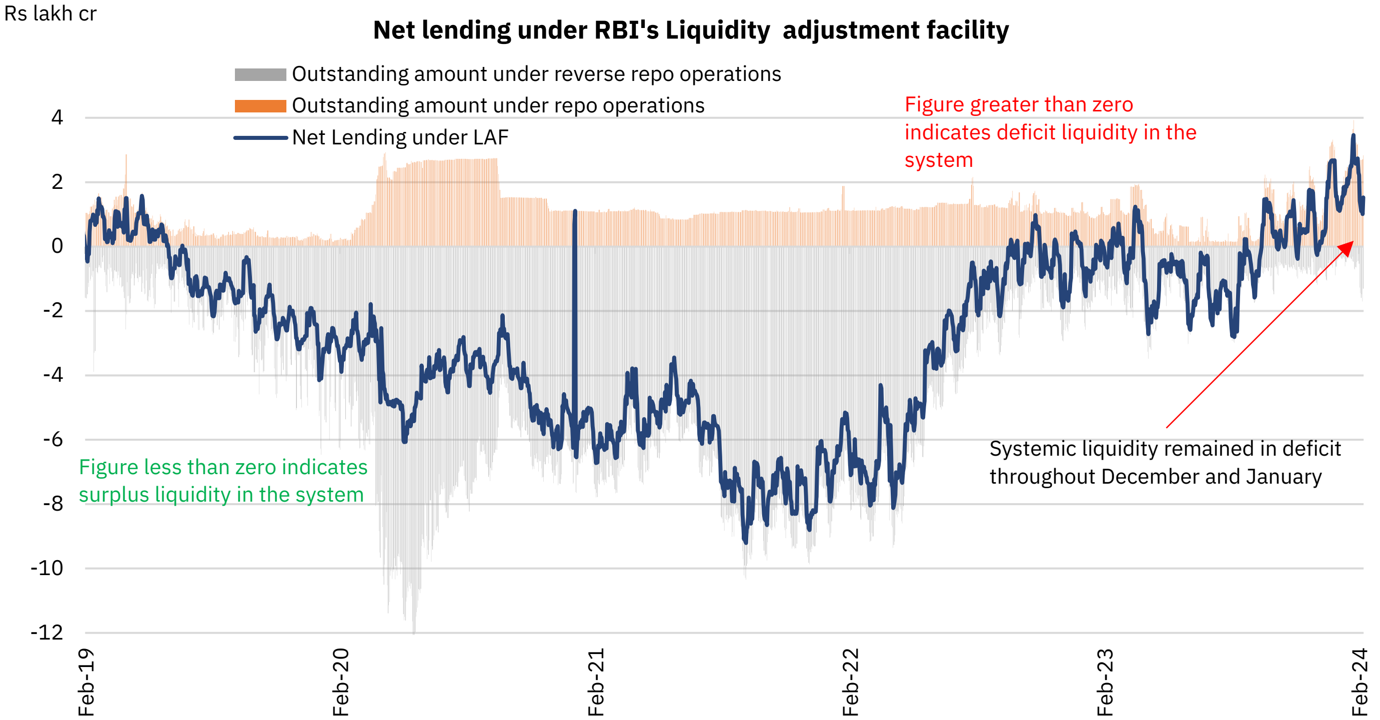
Since 2019 real interest rates have turned positive only momentarily, thanks to higher inflation. Now with inflation coming-off, the real interest rates have come back to the positive territory that could have implications for growth.



Source: Refinitiv Datastream, NSE EPR.

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

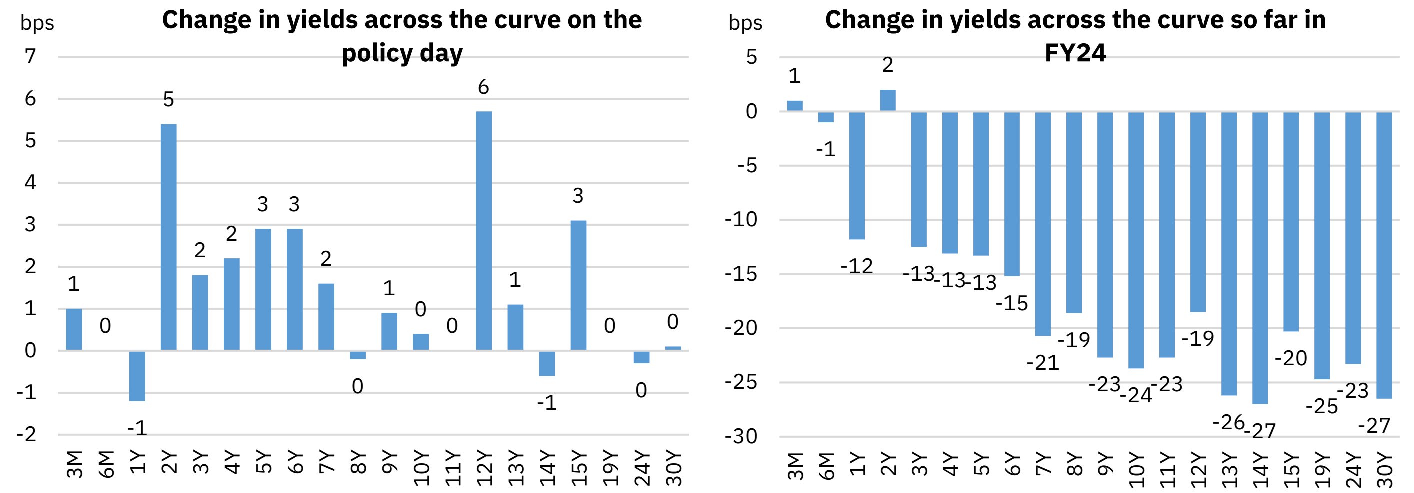
Net systemic liquidity remained remained in deficit throughout December and January, peaking at Rs 3.5 lakh crore on 24th January 2024. This was the highest level of liquidity deficit ever recorded.



Source: CMIE Economic Outlook, NSE EPR.

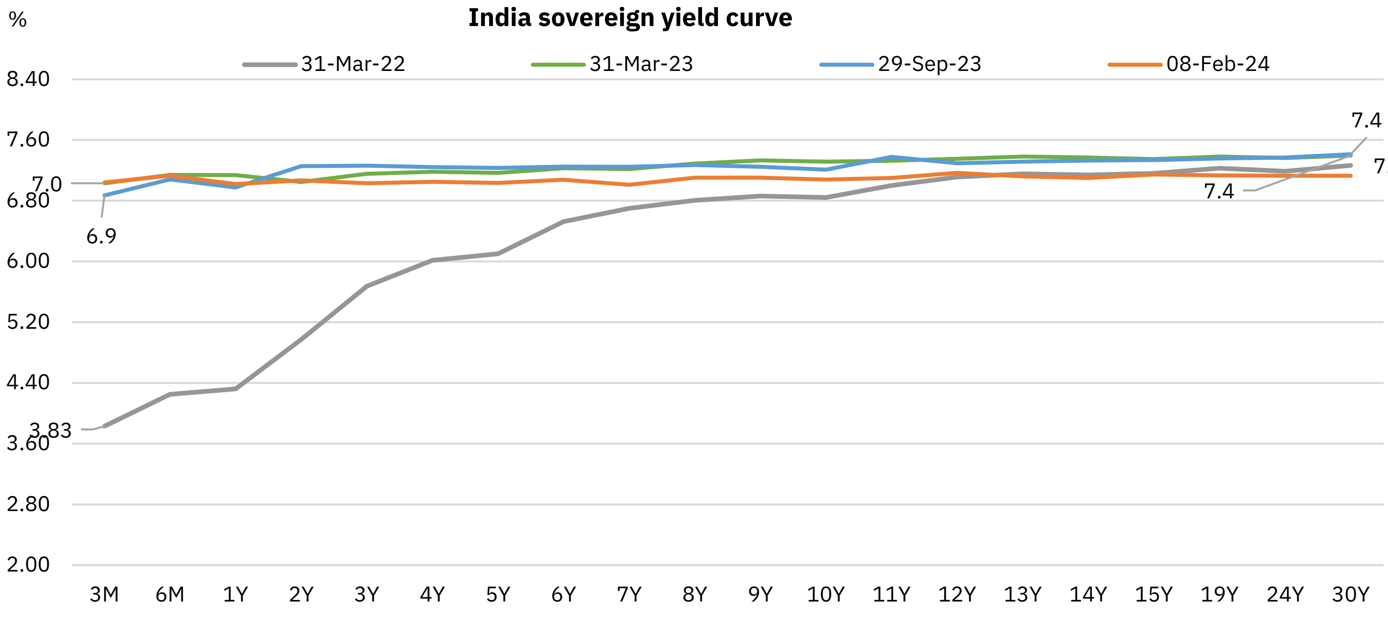
Figure 4: Change in yield curve on the policy day and in FY24 thus far (As on February 8th, 2024)

Yields have hardened on the short-end of the yield curve owing to hawkish commentary of the policy without much indication on liquidity easing.



Source: Refinitiv Datastream, NSE EPR.

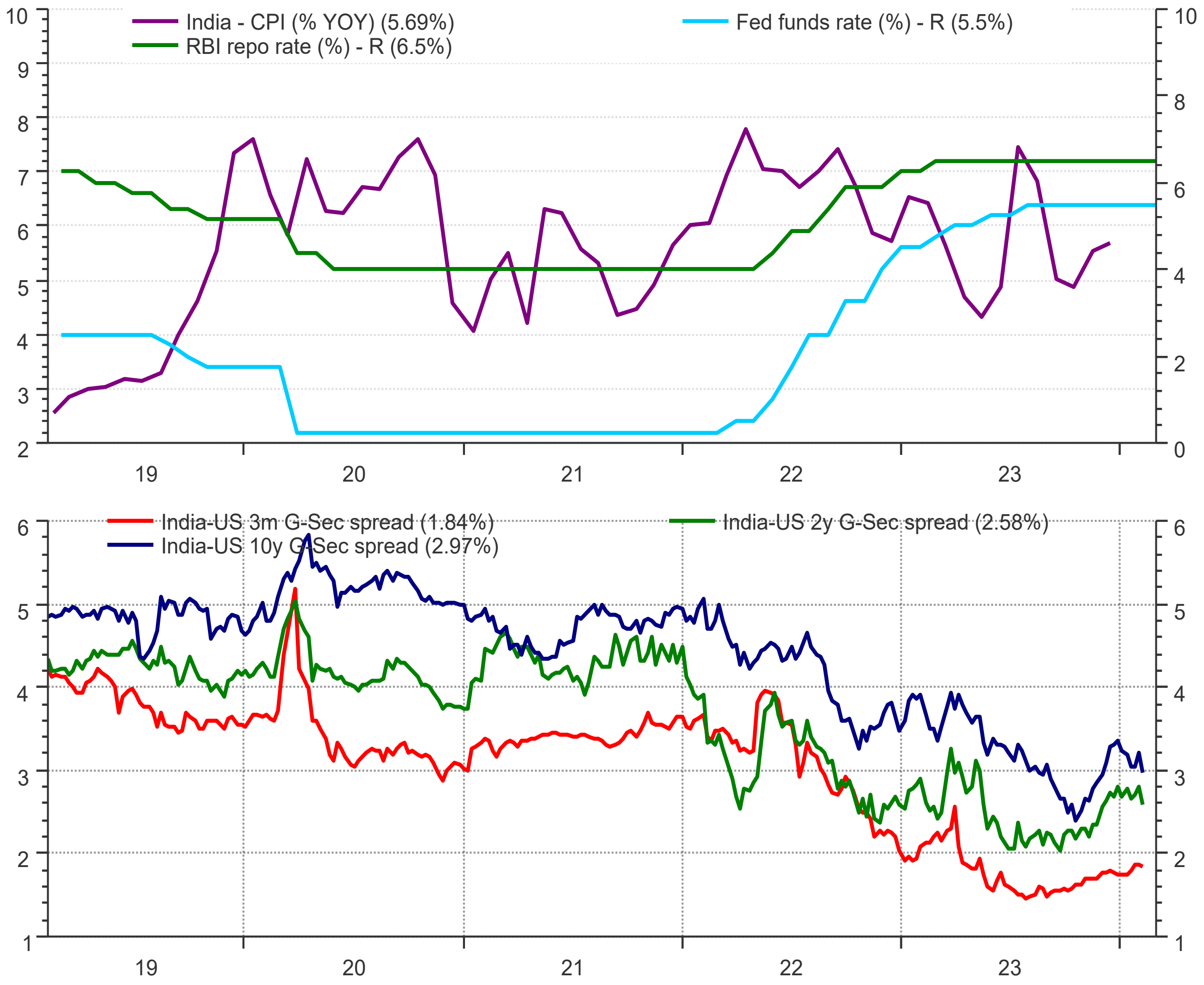
Figure 5: India sovereign yield curve



Source: Refinitiv Datastream, NSE EPR.

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

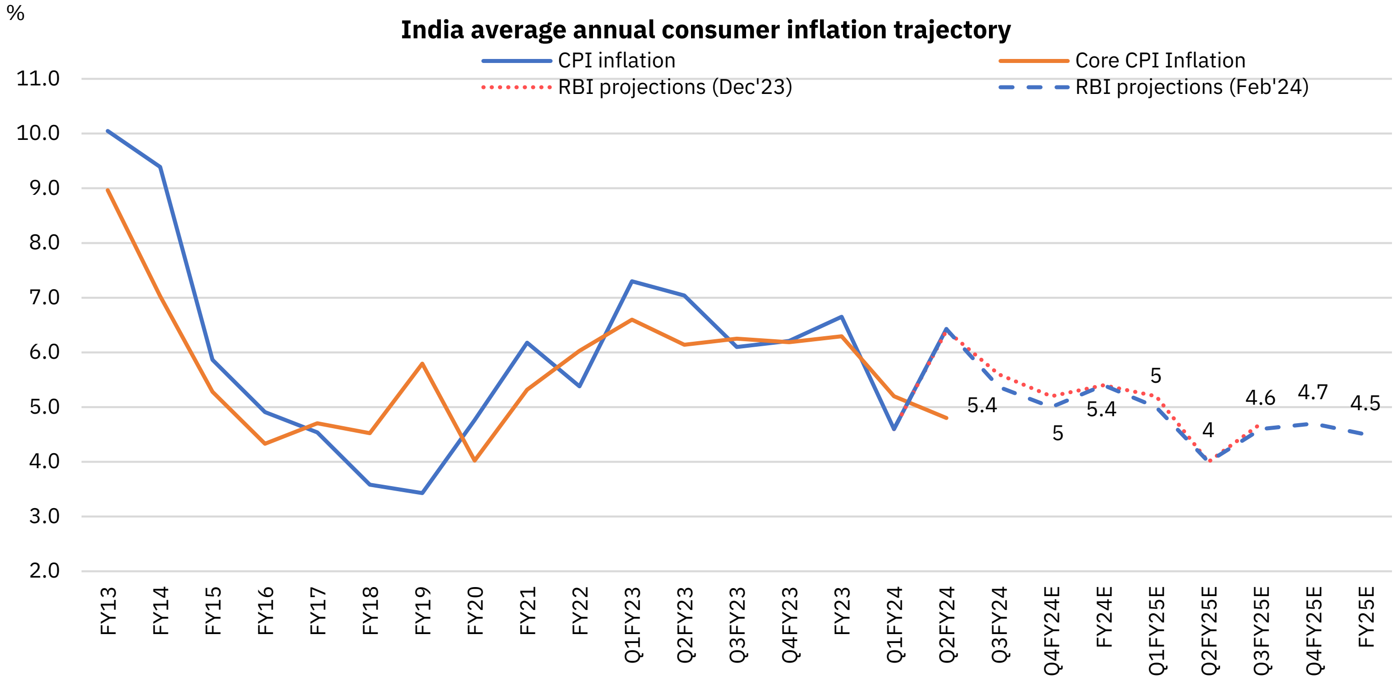
Unions focus on fiscal consolidation along with US treasury rate well above the 4% level has helped ease the spread between India and US bonds.



Source: Refinitiv Datastream, NSE EPR.

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

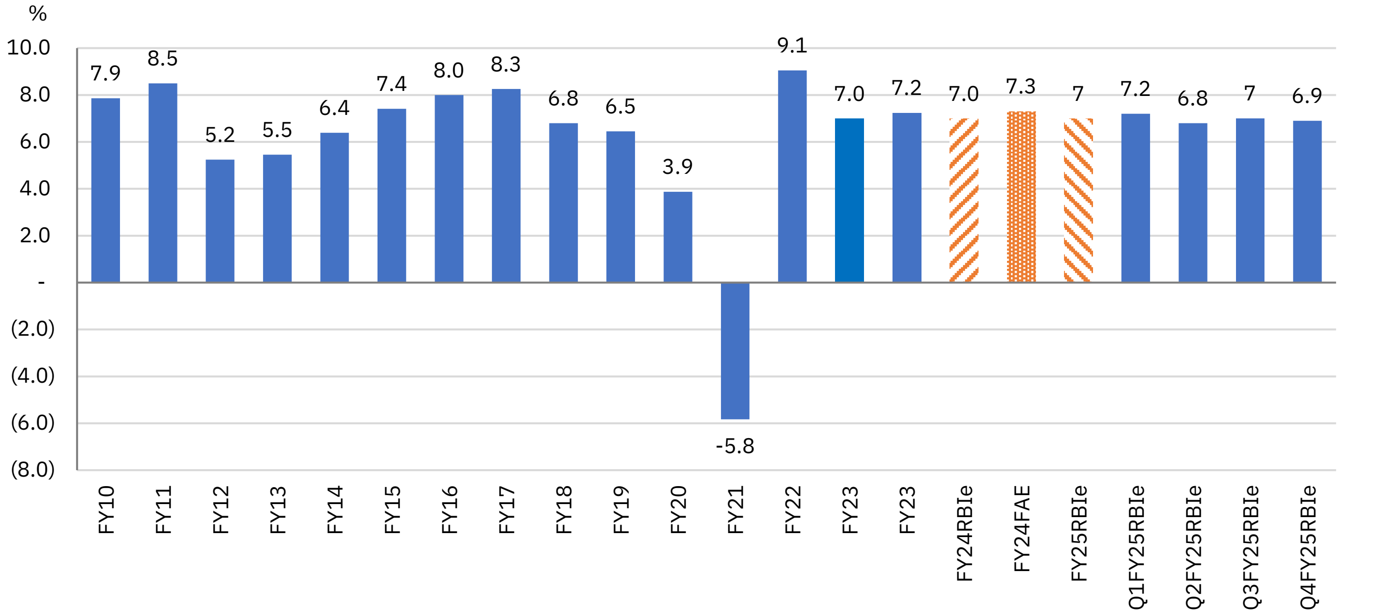
The RBI maintained its headline inflation forecast for FY24 at 5.4%, however, revised downwards its Q4 forecast by 20 bps to 5%. Further, CPI inflation is projected at 4.5% in FY25 with marginal downward revisions in Q1FY25 (20 bps) and Q3FY25 (10bps).



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 RBI's estimates

The growth momentum is expected to sustain in FY25, with growth forecast pegged at 7% in FY25 and Q1, Q2 and Q3 figures revised upwards to 7.2% (+50bps), 6.8% (+30bps) and 7%(+60bps) respectively.



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

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