NSE

Macro Review

December 08, 2023 | Vol. 5, Issue 11

RBI Monetary Policy: Status quo on rates, sanguine growth outlook

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, as the past rate hikes continue to work their way through the economy. Even as the headline inflation has fallen sharply since the last meeting, there are upside risks emanating from recurring food price shocks and their implications on inflation expectations. Further, volatility in crude oil prices and global financial markets pose additional risks. That said, the headline inflation estimate for FY24 has been retained at 5.4% for the second consecutive policy, falling to RBI's mid-point target of 4% by the second quarter of FY25. The RBI remained sanguine on the growth outlook and has revised its FY24 GDP growth estimate upwards by 50bps to 7.0%, moderating slightly to an average of 6.5% in the first three quarters of FY25. While strong manufacturing and construction activity, and gradual recovery in the rural sector is expected to improve consumption demand, investment growth is expected to remain robust, aided by healthy balance sheets of banks and corporates, and robust capex push by the Government. Liquidity conditions remained tight in November, thanks to high festive-led currency demand, and Government cash balances, nullifying the need of OMO sales. That said, liquidity pressure is likely to ease going forward with a pick-up in Government spending.

The MPC's decision on maintaining status quo on rates and stance is in line with expectations, accompanied with a balanced commentary. While the MPC reiterated its commitment to aligning inflation to the target, it also highlighted the need for remaining *'mindful of the risk of overtightening'* for the first time in the current cycle. 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 unanimously decided to retain the policy repo rate at 6.5%, citing the need to maintain vigilance given the upside risks stemming from food prices in the near-term. 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 ninth time in a row.

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

- **Inflation forecast for FY24 retained at 5.4%:** Moderating inflation conditions are expected to sustain in the near-term with vegetable prices coming off and a sharp cut in LPG prices. This, coupled, with softening of gobal commodity prices and import dependent food products serves as a positive. That said, uncertainty around food prices and Rabi sowing getting pushed-off due to delayed Kharif harvest poses upside risks to the outlook. Further, recurrence of food price shocks and volatility in crude-oil prices could result in second-order effects in the form of generalisation and persistence of inflation. Taking these risks into consideration, the RBI has maintained its inflation forecast for FY24 at 5.4%, retaining its Q3 and Q4 forecast at 5.6% and 5.2% respectively. Assuming a normal monsoon next year, CPI inflation is projected at 5.2% in Q1FY25, falling to 4% in Q2FY25, only to rise marginally to 4.7% in Q3FY25.

Inflation forecast for FY24 was retained at 5.4% while GDP growth was revised upwards by 50% to 7%.

- **GDP growth revised up by 50bps to 7%:** Even as global economy remains fragile, domestic growth outlook has exhibited resilience, thanks to durable urban consumption demand and strong Government spending. Following a significant

[1] WADTDR (Weighted Average Domestic Term Deposit Rate) and WALR (weighted average lending rate) on fresh deposits and rupee loan increased by 228 and 172bps respectively while outstanding term deposit rates and lending rates rose by much lower 199 and 112bps respectively in the current tightening cycle.

positive surprise in Q2, the RBI revised its FY24 GDP growth forecast upwards by 50bps to 7%, with Q3 and Q4 figures revised up to 6.5% (+50bps) and 6% (+30bps) respectively. The momentum is expected to sustain in FY25, with growth forecast pegged at 6.7% in Q1FY25, 6.5% in Q2FY25 and 6.4% in Q3FY25. Robust manufacturing activity amidst easing input cost pressures, revival in construction and a gradual recovery in the rural sector bodes well for overall consumption demand. Investment growth is also expected to remain robust, aided by improving business confidence and robust capex spending by the Government. Further, healthy balance sheets of banks and corporates provide a conducive environment for a steady recovery in private capex. Key downside risks to the growth outlook may emanate from a weaker-than-expected external demand, heightened geopolitical tensions and strengthened financial market volatility.

- **Focus remains on liquidity management:** After falling into deficit in September for the first time in 4.5 years, systemic liquidity remained in deficit for a large part of October and November, thanks to strong festival-led currency demand, higher Government cash balances and liquidity operations by the RBI. After OMO (open market operations) sales amounting to Rs 85.9bn in October 2023 following the last policy announcement, tighter-than-expected liquidity conditions in November precluded RBI from undertaking further OMO sales. While average borrowing through MSF increased from Rs 946bn in Sep'23 to Rs 1.2trn in Oct-Nov'23, money parked in overnight SDF declined from Rs 760bn in Sep'23 to Rs580bn in Nov'23, indicating a decline in the skewness of liquidity even as conditions continue to remain tight. That said, liquidity pressure is likely to ease going forward with a pick-up in Government spending.

- **Prolonged pause for now:** While the pause on rates and stance was widely expected, the commentary became much more balanced vis-à-vis a hawkish rhetoric in the previous three policies. Even as the Governor reiterated MPC's commitment to aligning inflation to the 4% target, he also cautioned against the "risk of overtightening" which looks like a first step towards moving to a neutral stance. 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.

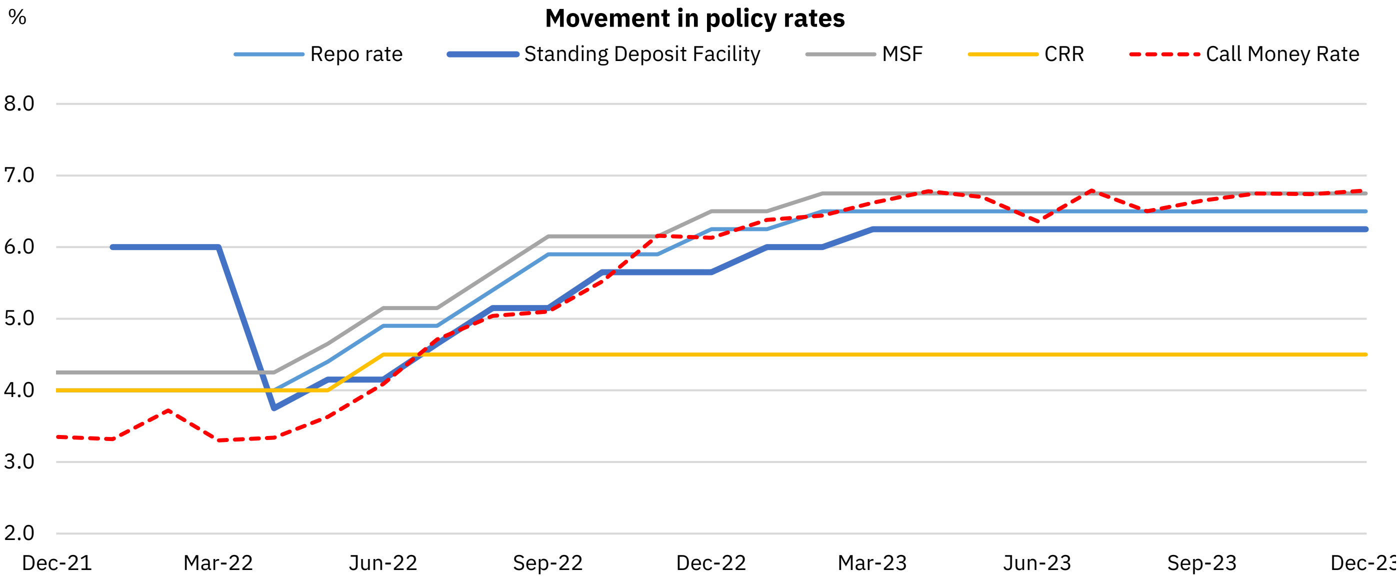
Table 1: Current policy rates

Key rates	Jun 2023	Aug 2023	Oct 2023	Dec 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.

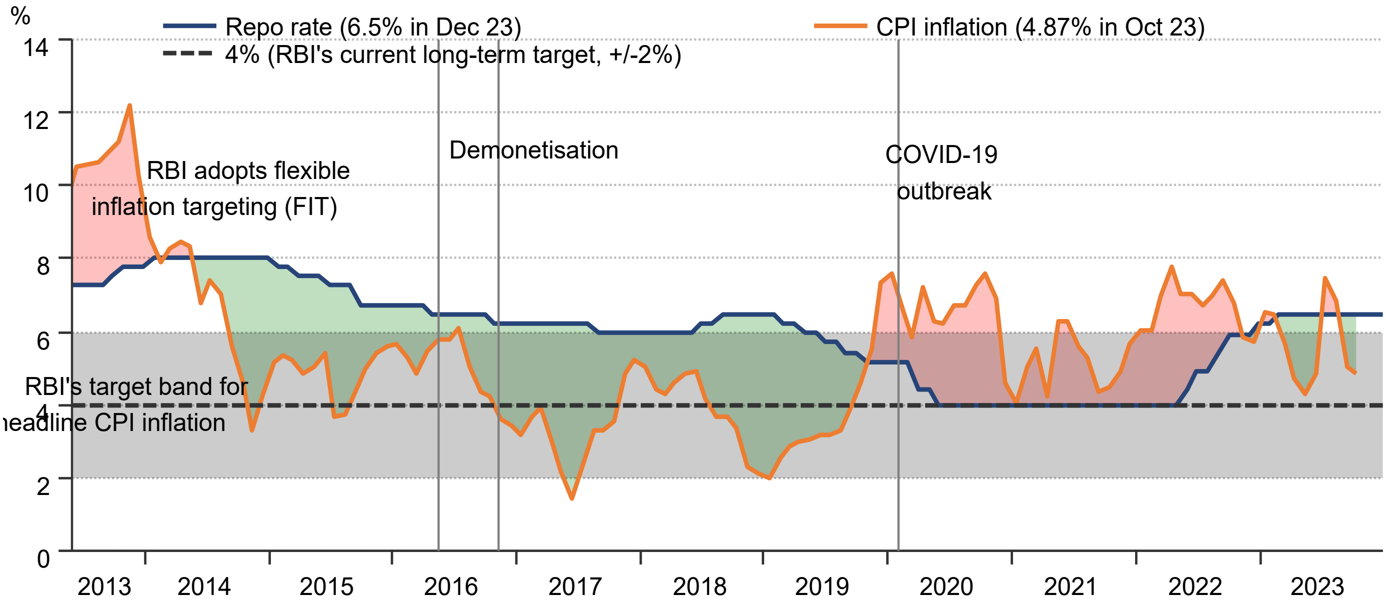
Figure 1: Movement in key policy rates

The policy repo rate was retained at 6.5% in the December policy, accompanied with continuation of "withdrawal of accommodation" stance. Call money rate exceeded the repo rate after the previous policy announcement that followed OMO sale by the RBI. It further increased in November to 6.8% (30bps above MSF) after the announcement of the increase in risk weights on NBFCs.



Source: Refinitiv Datastream, NSE EPR.

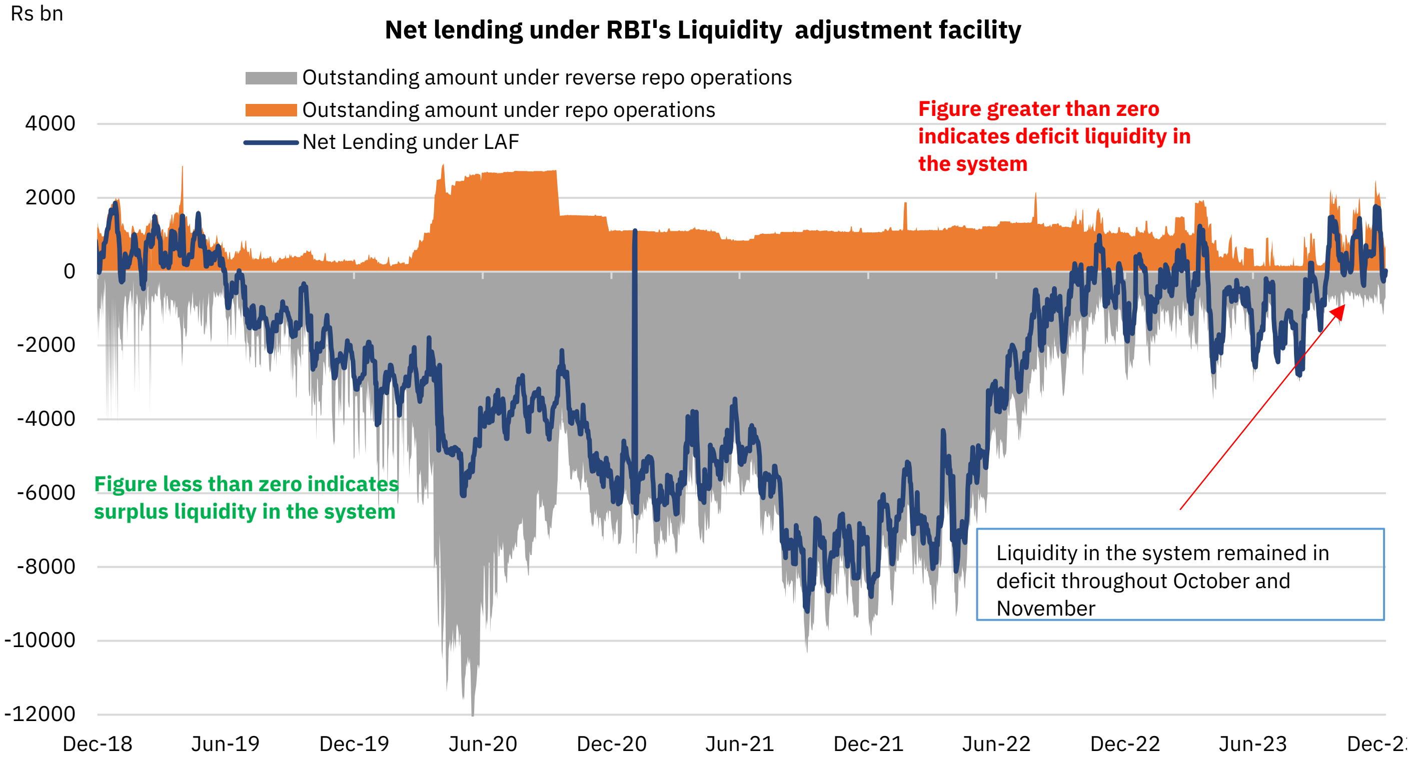
Figure 2: Real interest rates



Source: Refinitiv Datastream, NSE EPR.

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

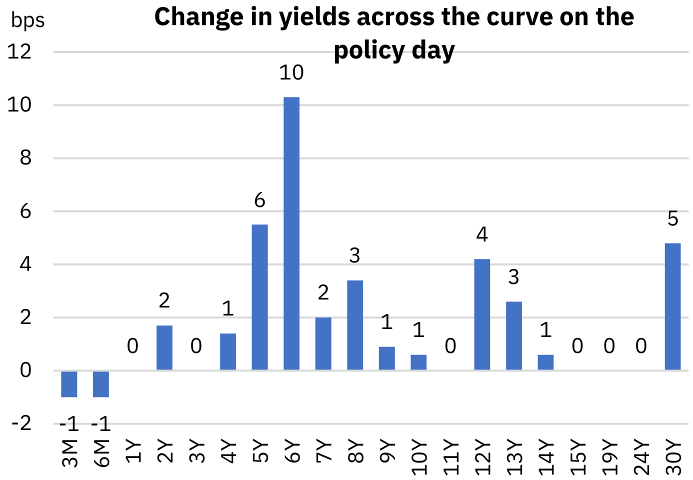
Net systemic liquidity remained mostly in deficit throughout October and November, with liquidity injections through the LAF peaking at Rs 1.8trn on November 22nd, the highest since Dec'18.

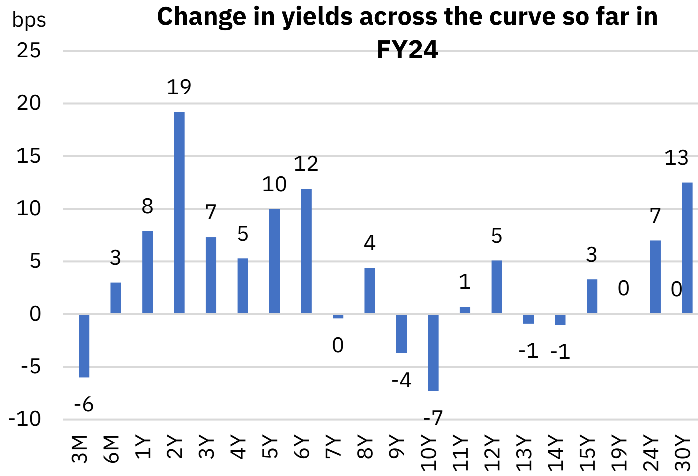


Source: CMIE Economic Outlook, Refinitiv Datastream, NSE EPR.

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

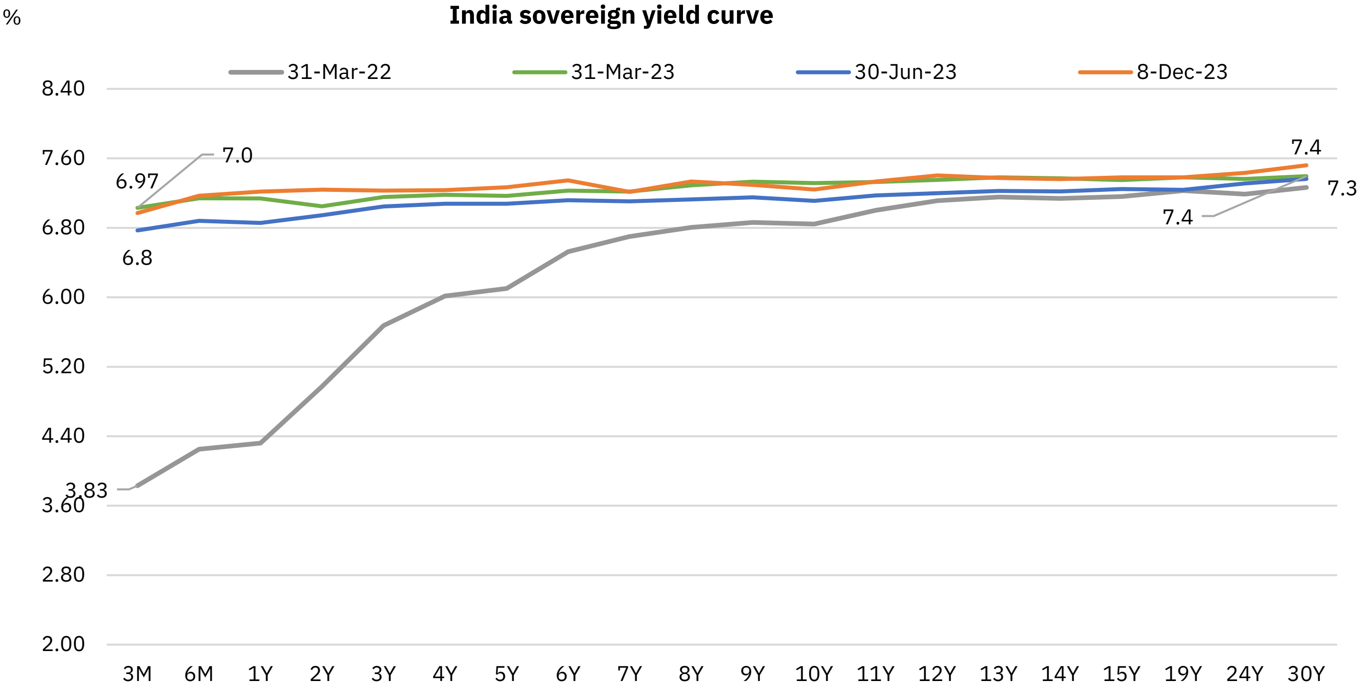
Yields have hardened across the curve since the last policy following the OMO sales in October and increase in risk weights for NBFCs in November.





Source: Refinitiv Datastream, NSE EPR.

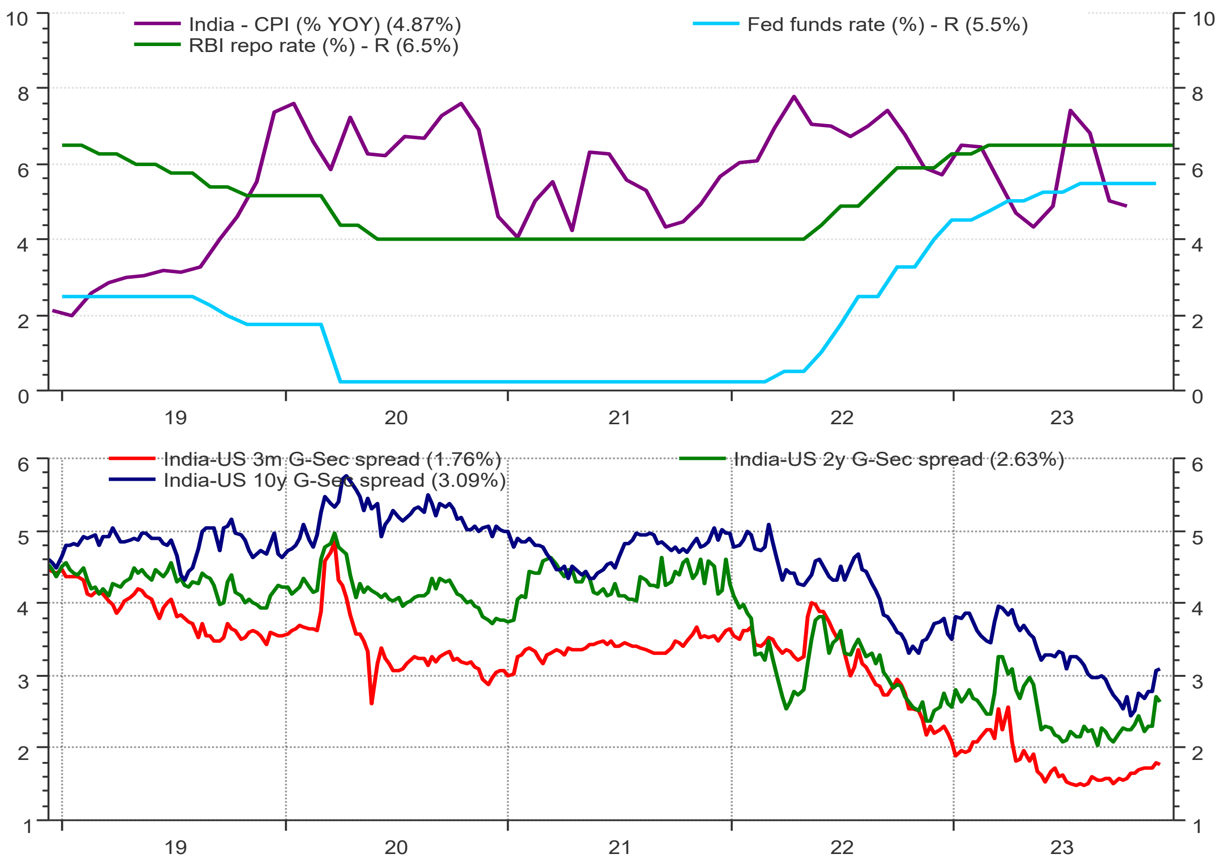
Figure 5: India sovereign yield curve



Source: Refinitiv Datastream, NSE EPR.

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

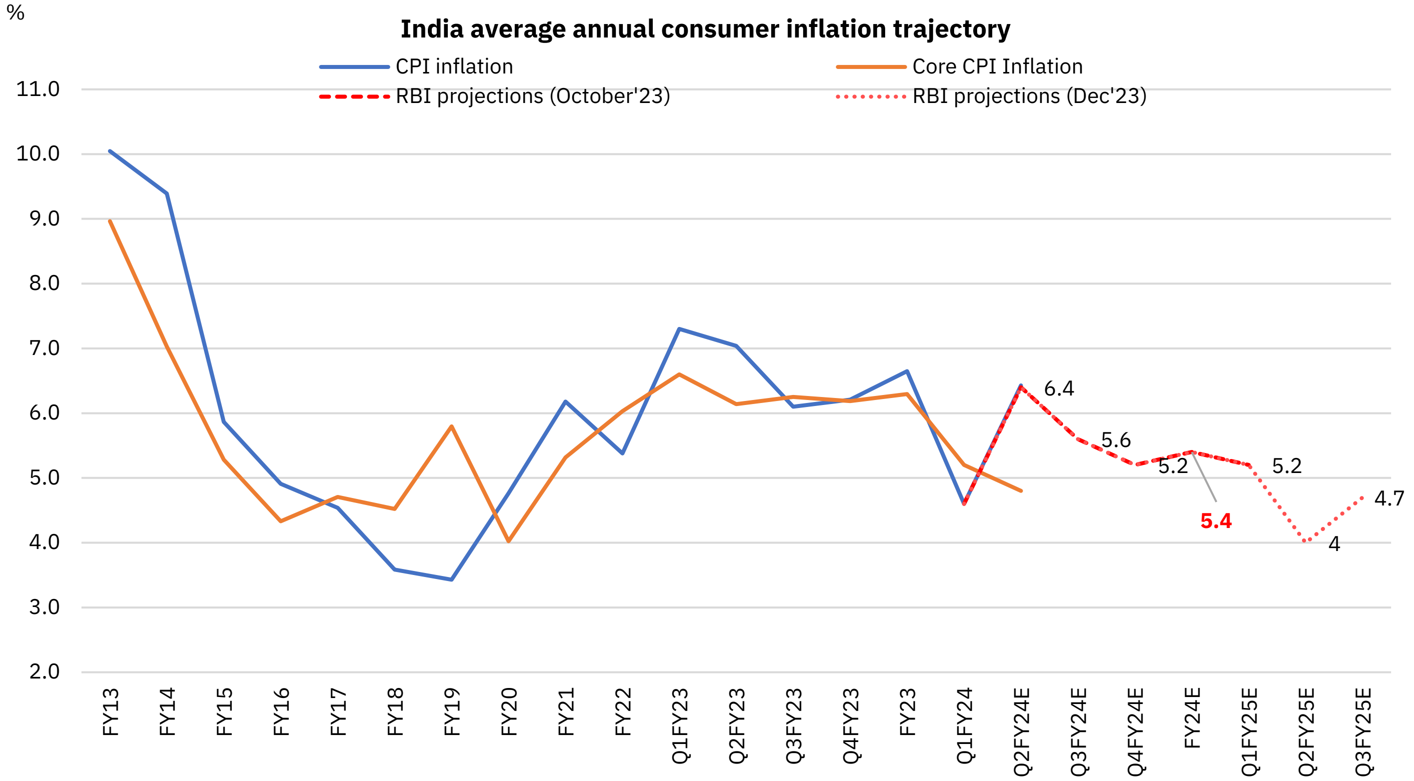
Softening in global yields has resulted in widening of spreads between India and US bonds.



Source: Refinitiv Datastream, NSE EPR.

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

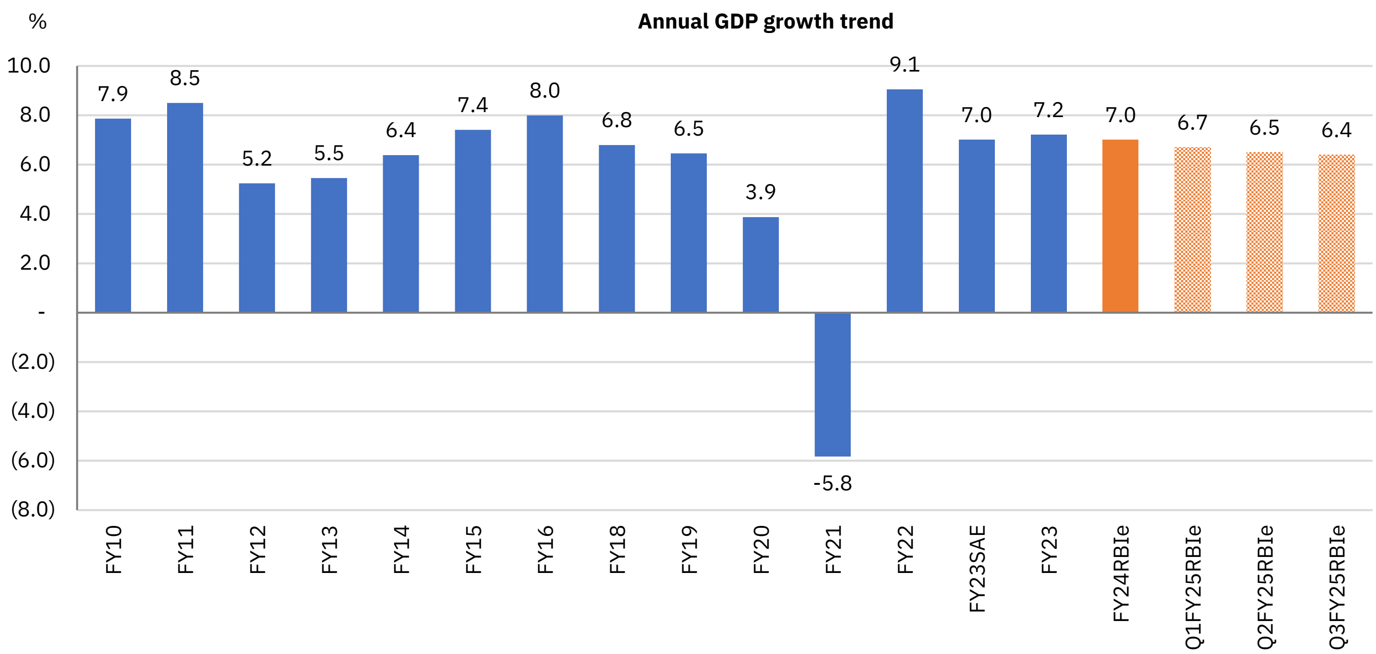
The RBI maintained the headline CPI inflation forecast for FY24 at 5.4%. Further, RBI expects inflation to decline to 4% in Q2FY25 while increasing to 4.7% in the third quarter.



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 RBI has turned sanguine on the growth outlook and has revised its FY24 GDP growth estimate upwards by 50bps to 7.0%. The forecast for Q3FY24 and Q4FY24 have also been revised upwards by 50bps and 30bps respectively from the last policy. The momentum is expected to sustain in FY25, with growth forecast pegged at 6.7% in Q1FY25, 6.5% in Q2FY25 and 6.4% in Q3FY25.



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

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