RBI Monetary Policy: A hawkish tone with vigilance on food inflation risks

The RBI's Monetary Policy Committee (MPC), with a 4:2 majority, decided to keep the policy repo rate unchanged at 6.5% for the ninth consecutive time. The *'withdrawal of accommodation'* stance was also retained, citing the need to remain vigilant on inflation amid a strong growth landscape. For the second consecutive meeting, two external members (Prof. J. R. Varma and Dr Ashima Goyal) have dissented by voting for a 25bps rate cut and a change in the stance to 'neutral'. The GDP growth forecast for FY25 has been retained at 7.2%, reflective of sustained growth momentum, underpinned by a revival in rural demand amid an expected normal monsoon, buoyancy in services reflecting steady urban demand, healthy corporate balance sheets, sustained thrust on government capex and signs of pick-up in private investment activity. Similarly, the inflation forecast for FY25 was kept unchanged at 4.5%, with near-term risks emanating from base-effect tapering off, hike in telecom tariff rates and adverse climate conditions. The Governor has specifically emphasised on the importance of remaining vigilant to elevated food inflation, its persistence and the second-round effects on core inflation. The RBI's nimble and flexible approach towards liquidity management via variable rate repo (VRR) and reverse repo (VRRR) operations has ensured liquidity conditions remain aligned with the monetary policy stance.

A data-dependent approach with a focus on navigating a plethora of domestic and external risks and its concomitant impact on headline inflation is likely to continue, preserving the gains made so far in monetary policy credibility. As India's growth is resilient, monetary policy has greater elbow room to pursue the goal of inflation targeting and align it with the 4% target. Given the explicit emphasis on domestic risks factors to inflation, a status quo on policy rate is likely to continue for now. Going forward, it is important to note that this is the last MPC meeting of the current members with a rejig of the external members.

- **MPC chooses status quo for the ninth consecutive time:** The RBI's MPC expectedly decided to retain the policy repo rate at 6.5% and the 'withdrawal of accomodation' stance with a 4:2 majority, holding the rates steady for the ninth consecutive time. Two external members (Prof. J R Varma and Dr Ashima Goyal) have dissented for the second consecutive time from the Committee's view, voting instead for a 25-bps rate cut and a change in stance to 'neutral'. The MPC reiterated its commitment to ensuring price stability on a durable basis, which in turn would provide a conducive environment for sustainable growth. 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—remained unchanged at 6.25%, and 6.75% respectively.

The RBI expectedly kept the policy repo rate unchanged at 6.5%, retaining the "withdrawal of accommodation" stance with a 4:2 majority.

- **Inflation forecast retained at 4.5% for FY25:** After registering a steady decline during Dec'23-May'24, headline inflation picked up in June, primarily driven by a sharp acceleration in vegetable prices. Food inflation has remained north of 7% over the last eight months and has been a key factor derailing the path of disinflation. The MPC has retained the headline inflation target at 4.5% for FY25, albeit with an upward revision of 60 bps in Q2FY25 (to 4.4%) and 10 bps in Q3FY25 (to 4.7%). That said, there has been a downward revision of 20 bps in Q4FY25 inflation forecast to 4.3%, with Q1FY26 forecast pegged at 4%. Food price pressures could be contained, supported by a steady progress in monsoon (cumulative rainfall at 107% of LPA), healthy progress in sowing (+2.9% YoY), sizeable foodgrains buffer stocks and easing of global food prices. Conversely, near term risks to inflation outlook emerge from telecom tariff hikes, revision in milk prices, tapering off base-effect and adverse climate events. The inflation projection for FY26 is pegged at 4.1% as per the April's Monetary Policy Report.

Inflation projected at 4.5%/4.1% in FY25/26, whereas GDP growth forecast for FY25 has been retained at 7.2%

- **GDP growth forecast kept unchanged at 7.2% for FY25:** RBI retained the GDP growth forecast at 7.2% for FY25, notwithstanding a 20bps downward revision in the growth forecast for Q1FY25 to 7.1%. Growth forecasts for Q2, Q3 and Q4 were kept unchanged at 7.2%, 7.3% and 7.2% respectively, with forecast for Q1FY26 pegged at 7.2%. Key drivers to India's growth trajectory include a) healthy balance sheets of banks and corporates, b) continued thrust on government capex, c) visible signs of private investment pick-up, d) revival in rural demand, e) improving prospects of global trade, and f) buoyancy in services to support urban consumption. Key downside risks include headwinds from geopolitical tensions, volatility in the international commodity prices and geoeconomic fragmentation.

- **Food inflation to be the focus amidst headline-core divergence:** The RBI governor has elucidated reasons on the importance given by the MPC to food inflation amidst the prevailing divergence between elevated food and record-low core inflation. With food taking up a lion share of 46% in the CPI basket, food inflation pressures cannot be ignored. For instance, food inflation contributed to 75% of the headline inflation in June and July. Further, high food inflation has adverse implications on household inflation expectations, which if persists at elevated levels could lead to second-order effects on core inflation and behavioural changes, thereby resulting in stickiness in overall inflation trajectory.
- **Banking liquidity moves from deficit to surplus:** Since the previous MPC in June, the banking system liquidity has moved from deficit of Rs 0.45 lakh crore in June to a surplus of Rs 1.1 lakh crore in July and further to Rs 2.7 lakh crore till August 6th. This transition can be largely attributed to higher government spending. The RBI conducted VRR operations of Rs 3.5 lakh crore during June 10-28 while liquidity absorption of Rs 7.1 lakh crore was managed via VRRR operations during July-August (till August 6th). RBI's nimble liquidity management operations has effectively translated to anchor the weighted average call rate within the LAF corridor. The WACR averaged 6.54% during June-August (up to August 6th, 2024) period, slightly below the 6.58% seen in April-May period.
- **Regulatory measures:** The RBI announced a slew of measures aimed at easing the digital lending and payment landscape in India. These include: a) a public repository of digital lending apps (DLAs), b) reduction in the reporting frequency of credit information to Credit Information Companies (CISs) from monthly to fortnightly, thereby providing faster updates to borrowers of their credit information and assisting lenders in making better risk assessments, c) Increase in the transaction limit for tax payments through UPI from Rs 1 lakh to Rs 5 lakh, d) introduction of a facility of "Delegated Payments" in UPI, and e) reduction in the clearing cycle and faster cheque payments process by introducing continous clearing with 'on-realisation-settlement' in the Cheque Truncation System (CTS).
- **Status quo for now:** A data-dependent approach with a focus on navigating a plethora of domestic and external risks and its concomitant impact on headline inflation is likely to continue, preserving the gains made so far in monetary policy credibility. As India's growth is resilient, monetary policy has greater elbow room to pursue the goal of aligning inflation with the 4% target. The global pivot to an accommodative policy, with rising rate cut probability in the forthcoming US FOMC meeting, could have some implications to the response function of the RBI. However, given the MPC's explicit emphasis on domestic risks to inflation, rate cut likelihood looks remote in the current fiscal year. During this period, the RBI is likely to continue to resort to nimble and flexible liquidity management to ensure orderly movement in money market rates and consequently financial stability.

Table 1: Current policy rates

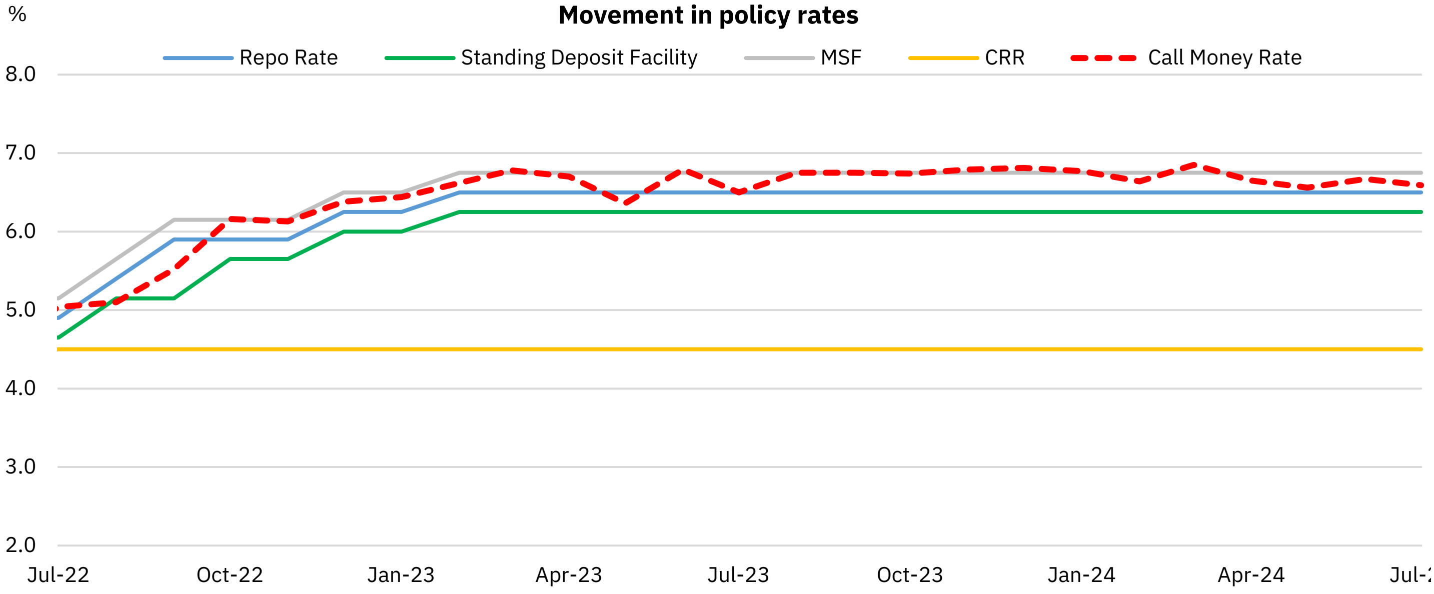
The policy repo rate was retained at 6.5% in the August policy, accompanied with continuation of "withdrawal of accommodation" stance, with a 4:2 majority.

Key rates	Feb 2024	Apr 2024	June 2024	August 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.

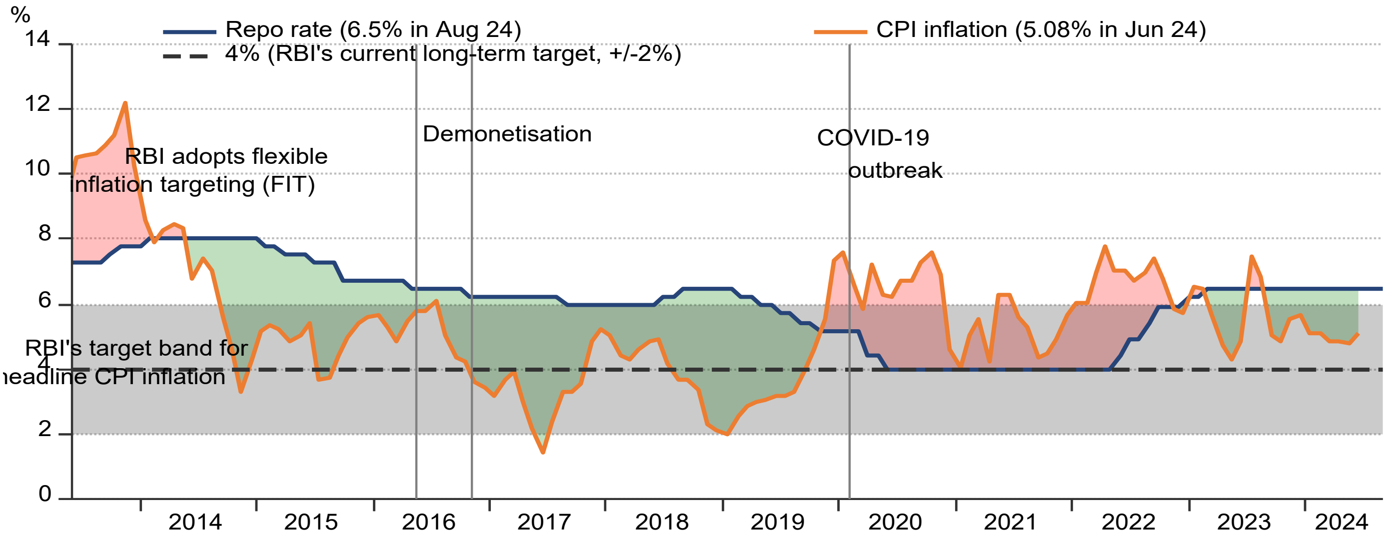
Figure 1: Movement in key policy rates

Flexible liquidity management by the RBI has helped bring down money market rates closer to the policy repo rate. The average Weighted Average Call Money Rate (WACR) fell to 6.54% during June — August (up to 6th) from 6.58% during April-May.



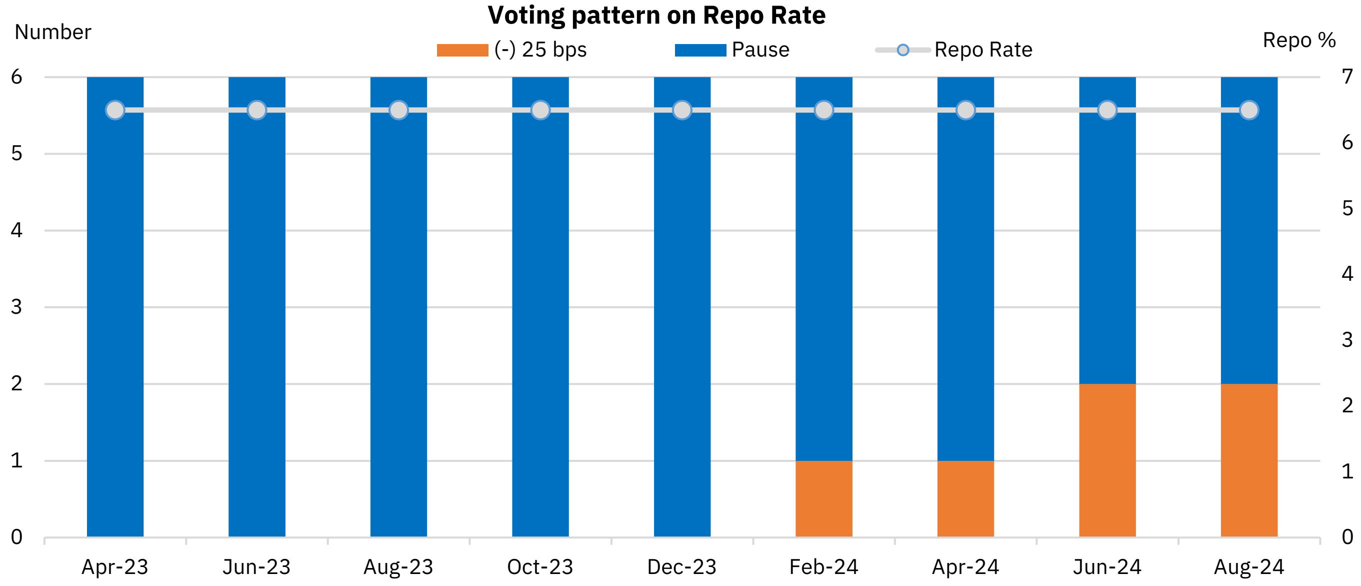
Source: LSEG Datastream, NSE EPR.

Figure 2: Real interest rates



Source: Refinitiv Datastream, NSE EPR.

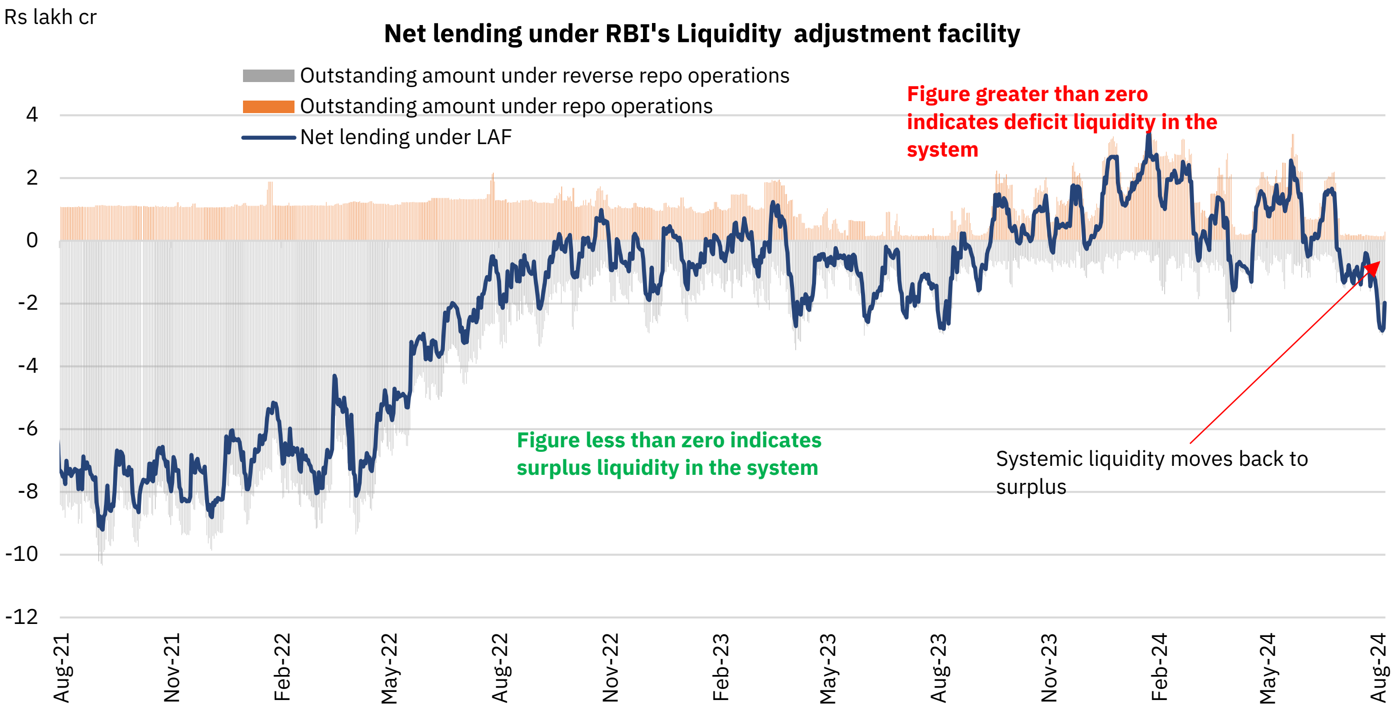
Figure 3: MPC members' voting pattern



Source: RBI, NSE EPR.

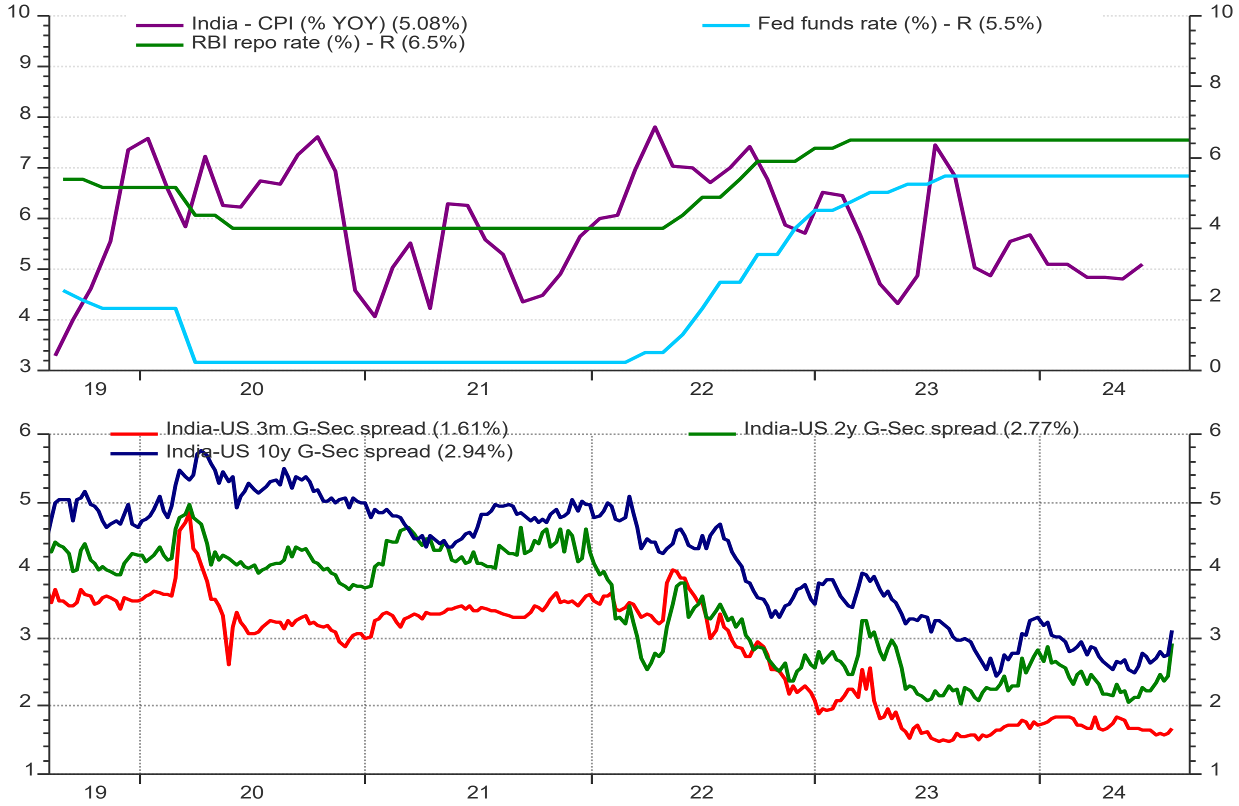
Figure 4: Net lending under RBI's Liquidity Adjustment Facility

System liquidity has changed from an average deficit of Rs 0.45 lakh crore during June to a surplus of Rs 1.1 lakh crore in July. Thereafter, the surplus has widened further to Rs 2.7 lakh crore up to August 6th. The transition into surplus beginning June 28th can be ascribed to increase in government spending.



Source: CMIE Economic Outlook, NSE EPR.

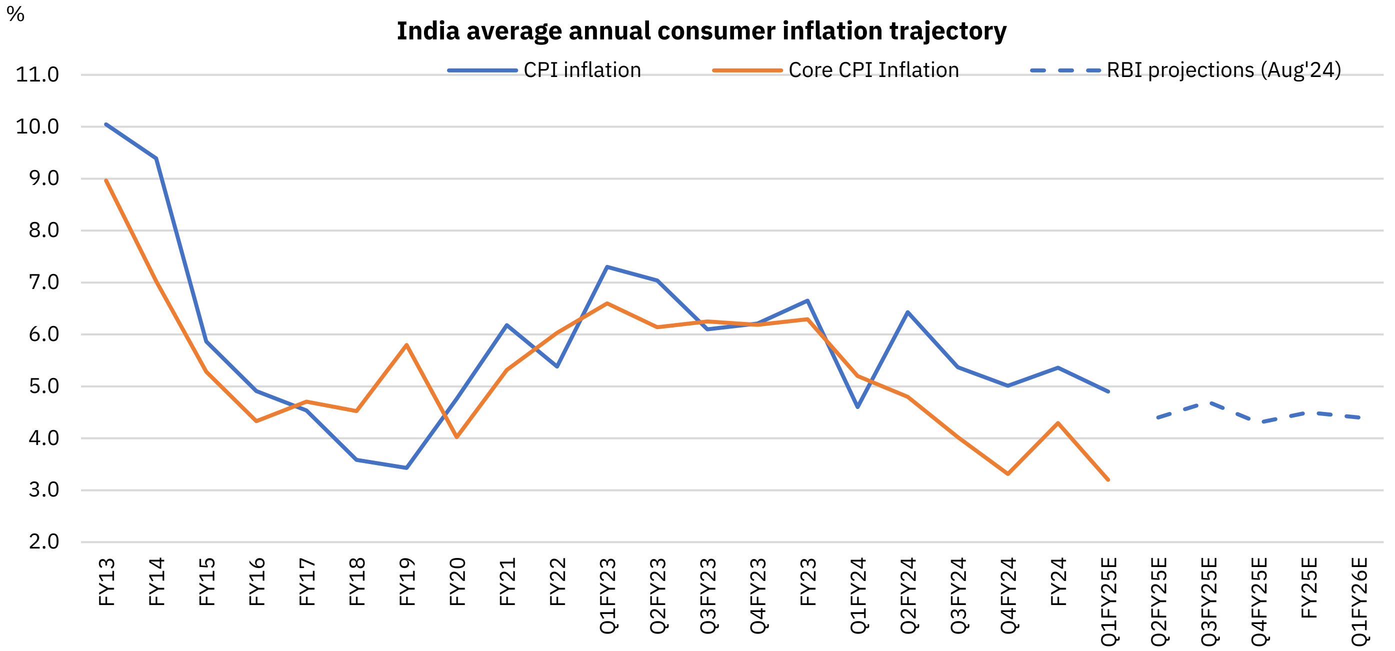
Figure 5: India vs. US policy rates and yield differential



Source: LSEG Datastream, NSE EPR.

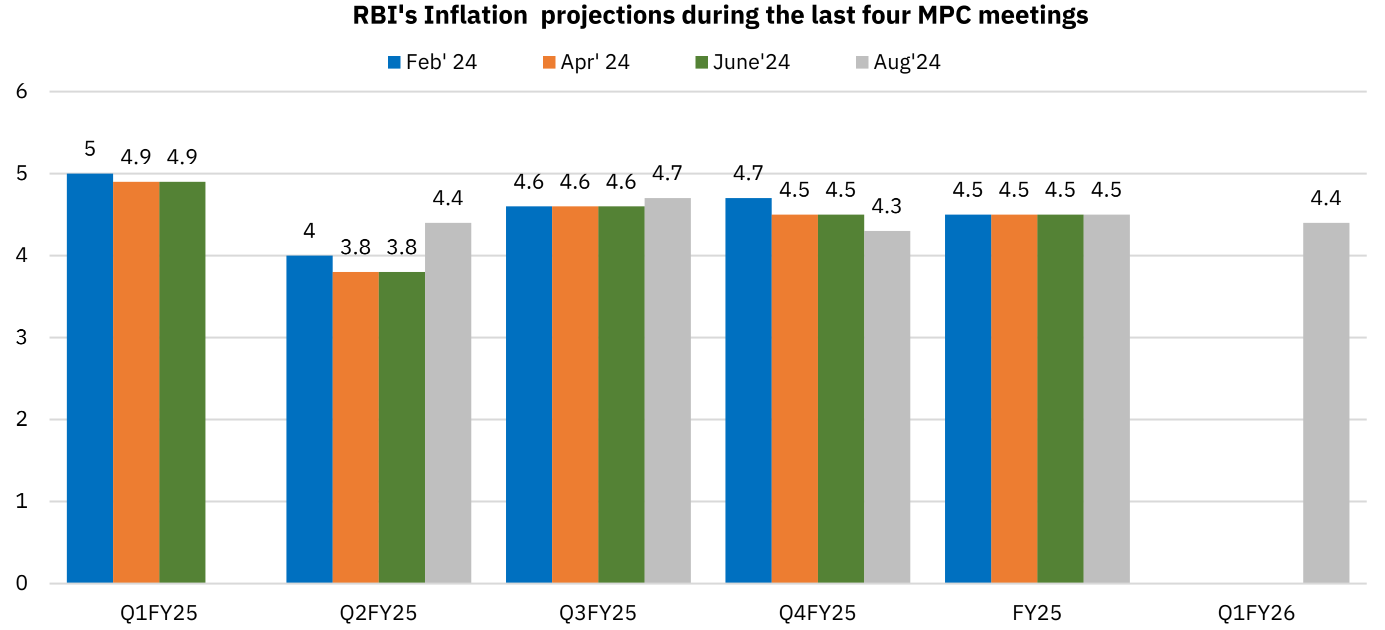
Figure 6: India's consumer inflation trajectory and RBI's forecasts

The headline inflation for FY25 is projected at 4.5%, with upward revisions in Q2 and Q3 by 60bps and 10bps respectively while downward revision of 20 bps projected in the last quarter of FY25. For Q1FY26, the MPC has provided a new projection of 4.4%. For FY26, assuming a normal monsoon and no external shocks, CPI inflation is expected to average 4.1%, as per the Monetary Policy Report published in April 2024.



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

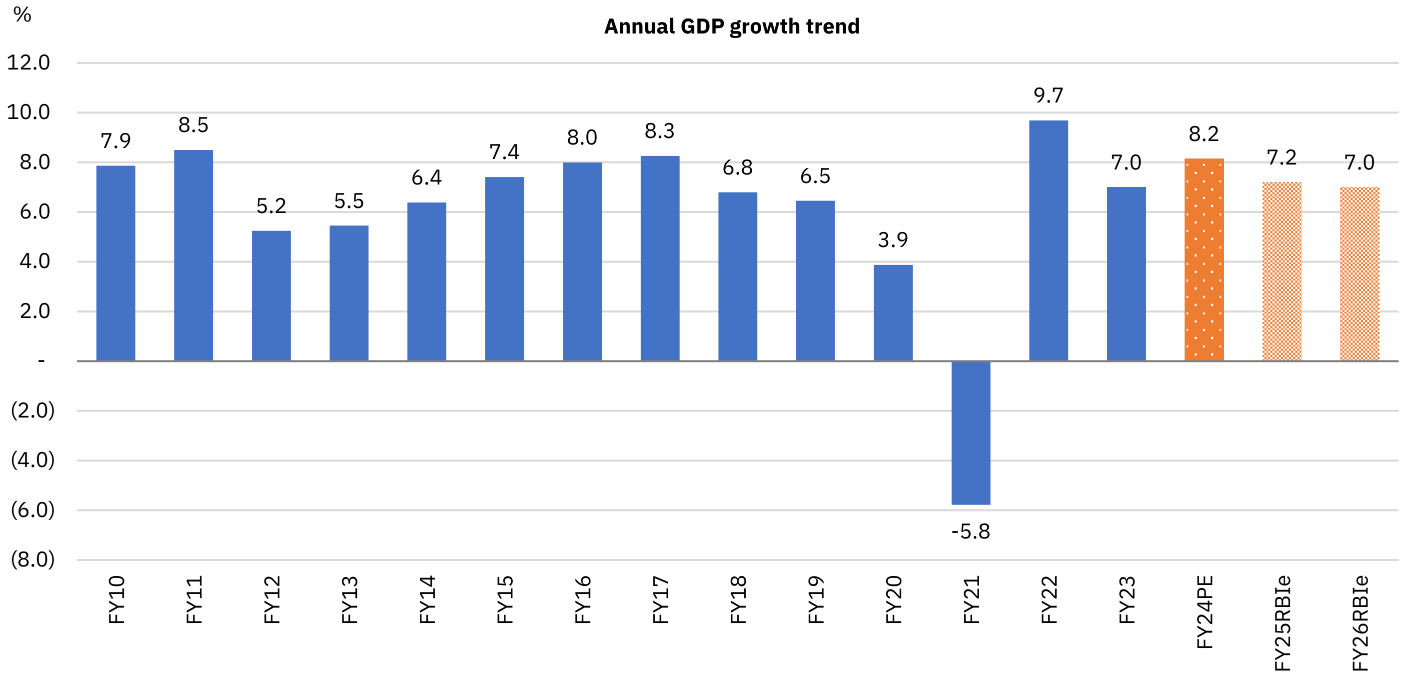
Figure 7: Quarterly inflation forecasts by RBI for FY25



Source: RBI, NSE EPR.

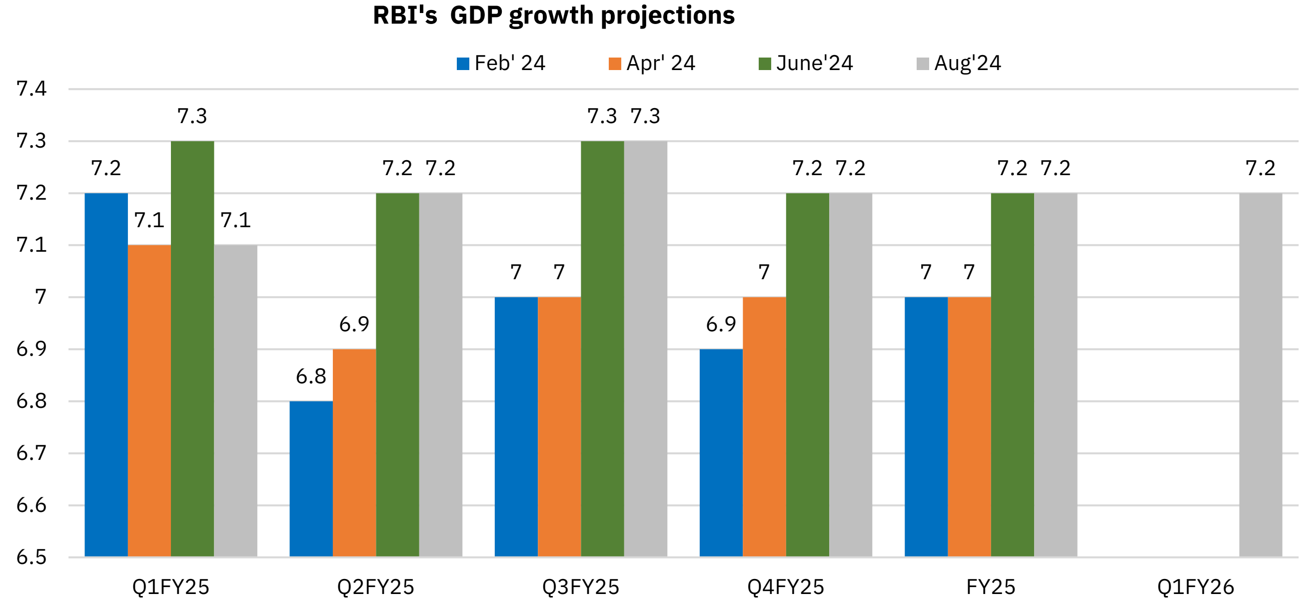
Figure 8: GDP growth trend and RBI's estimates

The GDP growth projection for FY25 has been retained at 7.2%.



Source: CMIE Economic Outlook, RBI, NSE EPR. RBIe = RBI estimate, PE= Provisional Estimate.

Figure 9: RBI's quarterly GDP growth forecasts for FY25



Source: RBI, NSE EPR.

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Tirthankar Patnaik, PhD	tpatnaik@nse.co.in	+91-22-26598149
Prerna Singhvi, CFA	psinghvi@nse.co.in	+91-22-26598316
Ashiana Salian	asalian@nse.co.in	+91-22-26598163
Prosenjit Pal	ppal@nse.co.in	+91-22-26598163
Sushant Hede	shede@nse.co.in	+91-22-26598237
Anand Prajapati	aprajapati@nse.co.in	+91-22-26598163
Gautam Sodani	gsodani@nse.co.in	
Sumiti Manchanda	smanchanda@nse.co.in	

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