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RBI Monetary Policy: Status quo with a liquidity booster

The RBI's MPC expectedly decided to retain the policy repo rate[1] at 6.5% for the 11th consecutive time with a 4:2 majority and unanimously decided to retain the 'neutral' stance. Dr Nagesh Kumar and Dr Ram Singh dissented by voting for a 25bps rate cut. The RBI's MPC acknowledged that the growth-inflation outcomes have turned adverse since October, and the medium-term focus on further realigning inflation to the target while ensuring pick-up in growth momentum remains imperative. The GDP growth forecast for FY25 has been trimmed by 60bps to 6.6%, with a stable prognosis for H2FY25 fuelled by strengthening agriculture outlook, revival in rural demand, increased government expenditure, pick-up in industrial activity and upbeat exports. Headline inflation estimates for FY25 have been revised upwards by 30bps to 4.8%, and a sharp upward revision of 90bps in Q3FY25 to 5.7%. Notwithstanding the near-term spike, the MPC expects food prices to soften, on record *kharif* output, higher mandi arrivals and better *rabi* crop prospects. To address the expected near-term tightening in liquidity conditions, the RBI announced a 50bps cut in the Cash Reserve Ratio (CRR)[2] to 4%, to be implemented in two tranches of 25bps each from December 14th and 28th. This is likely to add nearly Rs 1.16 lakh crore to the banking system liquidity.

The RBI's MPC faces an interesting conundrum amid slowing growth and elevated inflation, in turn complicating policy decisions. Notwithstanding a positive growth outlook for the second half of the fiscal, emerging signs of moderation in domestic growth drivers, coupled with global uncertainties, could open room for a rate cut, provided inflation follows a glide path towards the 4% target. That said, the MPC is expected to tread cautiously, closely monitoring persistent food price pressures and their second-round effects. During this period, the RBI is likely to remain nimble and flexible on liquidity management to ensure orderly money market rates and maintain financial stability, with the possibility of a rate moderation evenly balanced in the remaining part of the fiscal.

- **MPC maintains status quo on rates and stance:** The RBI's MPC expectedly decided to retain the policy repo rate at 6.5% for the 11th consecutive time with a *4:2 majority*, while *unanimously* deciding to retain the stance as *neutral*. 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 rationale behind maintaining status quo is the need for durable price stability to ensure a conducive environment for sustainable growth and restoring the inflation growth balance.

The RBI expectedly kept the policy repo rate unchanged at 6.5% with a 4:2 majority, while unanimously retaining the stance as "neutral".

- **Inflation forecast revised higher to 4.8% for FY25:** The headline inflation projection for FY25 has been revised upward by 30bps to 4.8% for FY25, with a sharp 90bps increase in Q3FY25 inflation projection to 5.7% along with a shallower upward revision of 30bps in Q4 estimate to 4.5%. The Q1/Q2FY26 inflation forecast stood at 4.6%/4% respectively. The upward revision has been ascribed to persistent food price pressures, alongside firming up of prices of manufacturing and services firms, translating into a pick-up in core inflation. That said, expectation of some softening is expected from record *kharif* production, higher mandi arrivals, conducive *rabi* sowing and seasonal winter correction in vegetable prices. Upside risks emanate from unexpected weather events, lingering geopolitical conflicts, volatility in crude oil prices and rise in international ahriculture commodity prices.

Inflation forecast for FY25 has been revised upwards by 30bps to 4.8% while GDP growth forecast has been trimmed by 60bps to 6.6% in FY25.

- **GDP growth forecast for FY25 revised lower by 60bps to 6.6%:** After retaining the FY25 GDP forecast at 7.2% in the previous three meetings, the MPC decided to reduce it by 60bps to 6.6%, with Q3FY25, Q4FY25 and Q1FY26 GDP forecast revised downward to 6.8% (-60bps), 7.2% (-20bps) and 6.9% (-40bps) respectively. After the lower-than-anticipated growth in Q2FY25, the economic

[1] Repo rate is the rate at which the RBI lends money to commercial banks. Standing Deposit Facility (SDF) rate is the rate at which the RBI accepts uncollateralised deposits on an overnight basis from banks. Marginal Standing Facility (MSF) rate is the rate at which banks borrow from RBI in an emergency when inter-bank liquidity dries up.
[2] Cash reserve ratio (CRR) is the minimum fraction of total deposits that banks have to hold as reserves with the RBI.

growth for the remainder of the fiscal is expected to be supported by a) an improved agriculture outlook and revival in rural demand, b) sustained buoyancy in services, c) an expected pick-up in industrial activity, d) resilient world trade prospects, thereby aiding exports, and f) higher government spending. Potential headwinds may emerge from ongoing geo-political tensions, volatility in international commodity prices and uncertain global growth outlook.

- **Liquidity booster via a 50bps CRR cut:** The RBI announced a reduction in the Cash Reserve Ratio (CRR) by 50 bps to 4.0%, marking the first cut since May 2022. This cut will be implemented in two equal tranches of 25bps each (from December 14th and 28th respectively) and is expected to infuse nearly Rs 1.16 lakh crore into the banking system. This move aims to ease potential liquidity stress arising from tax-related outflows, increased currency in circulation, and capital flow volatility in the coming weeks. During October-November 2024, banking system liquidity remained largely in surplus averaging Rs 1.5 lakh crore, aided by sustained government spending and a reduction in government cash balances. To manage this surplus, the RBI conducted five main and 23 fine-tuning VRRR auctions during the period, absorbing a total of Rs 11.7 lakh crore. Additionally, five fine-tuning VRR operations were conducted from late October to the end of November to manage short-term liquidity strains. The weighted average call rate (WACR) remained well anchored within the LAF corridor of 6.25%-6.75%, averaging 6.51% during October-November as against 6.53% observed in August-September. With the CRR cut and continued liquidity management, the banking system is expected to remain adequately liquid, supporting financial stability in the months ahead.
- **Regulatory measures:** The RBI announced the linking of the FX-Retail platform, with NPCI's Bharat Connect platform, allowing users to transact via mobile apps from banks and non-bank providers. The RBI also proposed the introduction of the Secured Overnight Rupee Rate (SORR), a new benchmark based on secured overnight money market transactions, to strengthen the interest rate derivatives market. Further, to support small farmers amidst rising agricultural input costs, the limit for collateral-free agriculture loans has been increased from Rs 1.6 lakh to Rs 2 lakh. Pre-sanctioned UPI credit lines will now be available through Small Finance Banks, promoting financial inclusion. Additionally, the RBI introduced the 'MuleHunter.AI™' AI solution to address digital fraud and mule bank accounts. Lastly, the RBI launched the 'Connect 2 Regulate' initiative, inviting stakeholder feedback on regulatory topics and proposed adding podcasts to its communication toolkit for wider dissemination of information.
- **A status quo vs rate cut dilemma on the cards:** The RBI's MPC faces an interesting conundrum amid slowing growth and elevated inflation, in turn complicating policy decisions. Notwithstanding a positive growth outlook for H2FY25, emerging signs of growth moderation, coupled with global uncertainties, could open room for a rate cut, provided inflation follows a glide path towards the 4% target. That said, the MPC is expected to tread cautiously, closely monitoring persistent food price pressures and their second-round effects. With the near-term inflation-growth outlook turning adverse, the focus of the MPC will be to further align inflation with the target while ensuring a pick-up in growth momentum. During this period, the RBI is likely to remain nimble and flexible on liquidity management to ensure orderly money market rates and maintain financial stability. The possibility of the start of rate cut cycle in the remaining part of the fiscal remains evenly balanced for now.

Table 1: Current policy rates

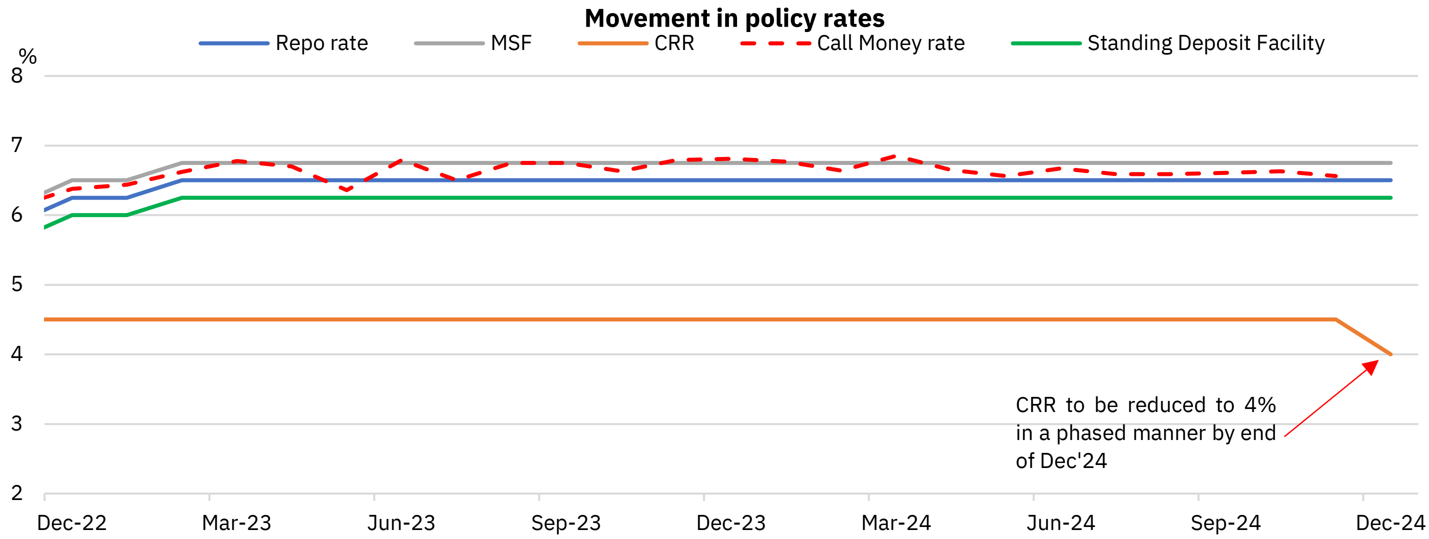
The policy repo rate was retained at 6.5% in the December policy with a 4:2 majority, while the policy stance has been unanimously retained at “neutral”. The CRR will be reduced from 4.5% to 4.0% in a phased manner, with the first tranche of a 25bps cut effective from December 14th, followed by the second equal cut from December 28th.

Key rates	Jun 2024	August 2024	October 2024	December 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%	4.00%

Source: RBI, NSE EPR. * Introduced in April 2022 policy as the new floor of the LAF corridor. + after implementation of the phased reduction of CRR

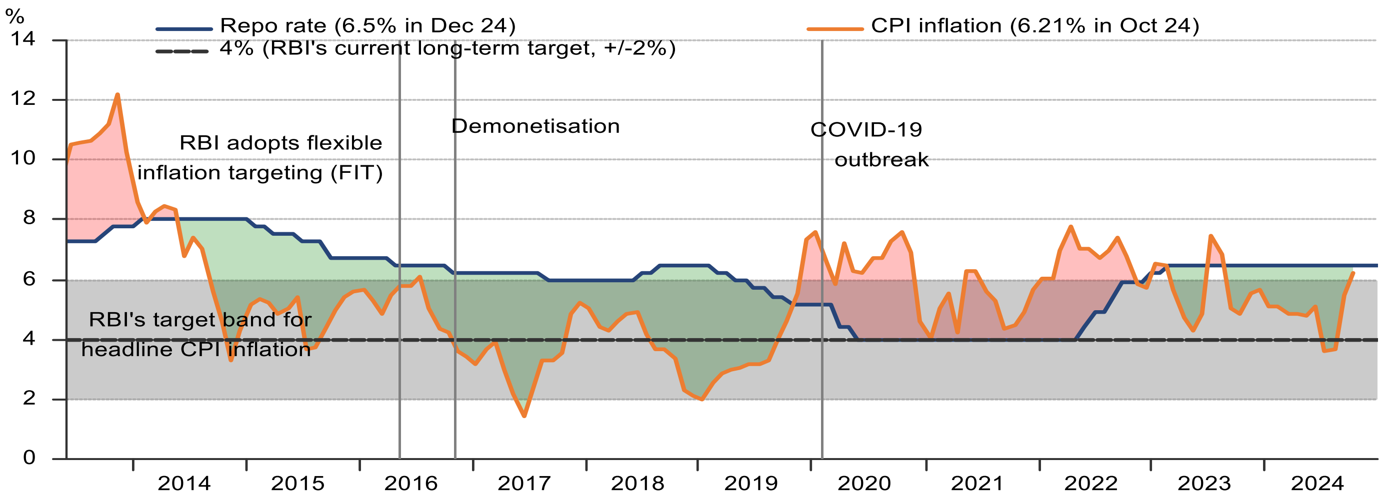
Figure 1: Movement in key policy rates

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 marginally to 6.51% during October-November from 6.53% during August-September.



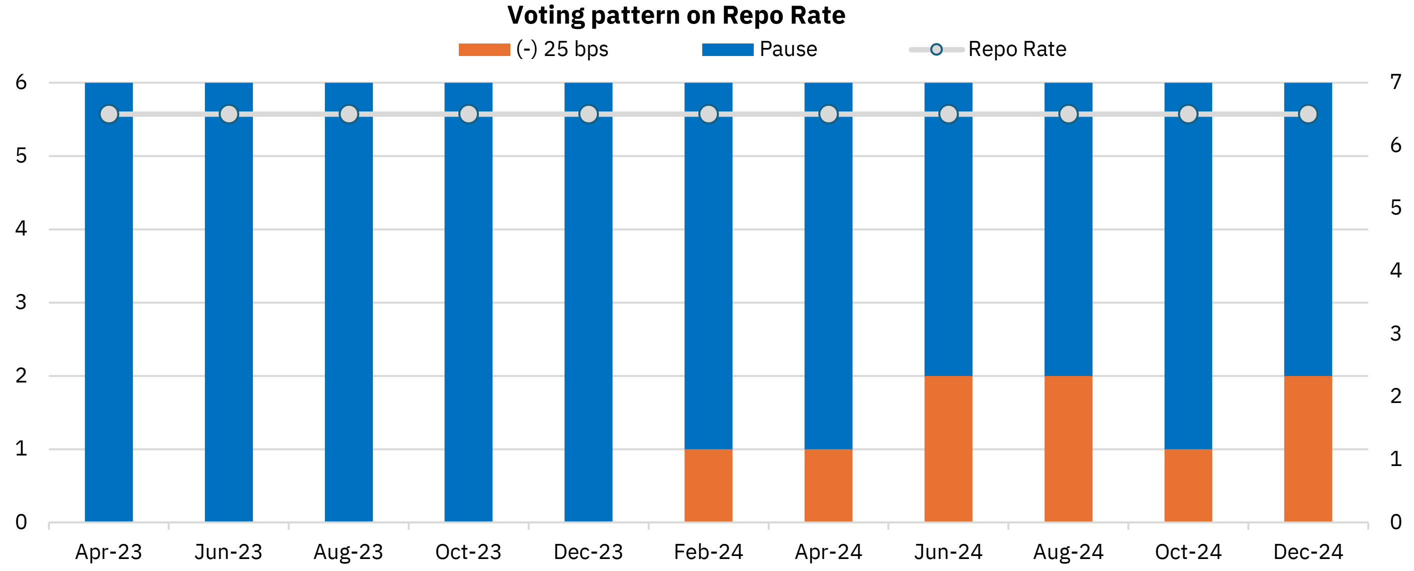
Source: LSEG Datastream, NSE EPR.

Figure 2: Real interest rates



Source: Refinitiv Datastream, NSE EPR.

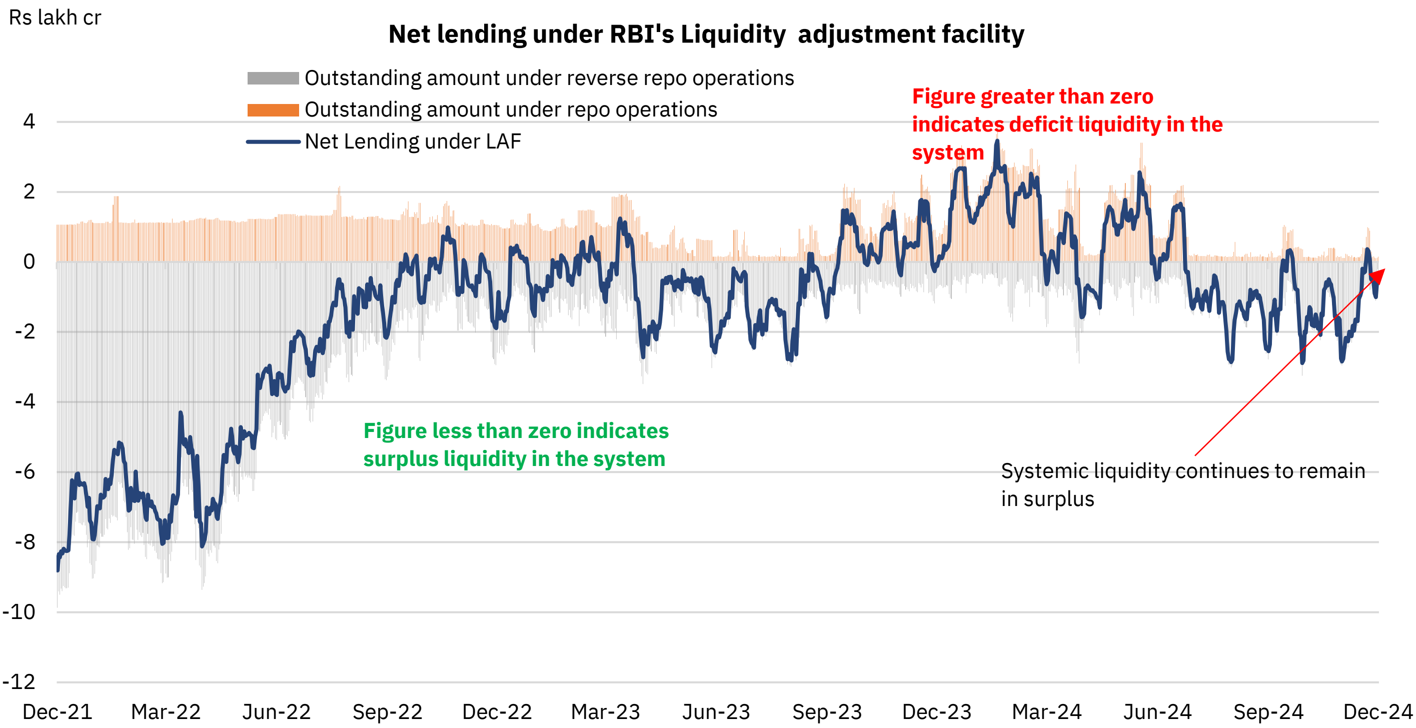
Figure 3: MPC members' voting pattern



Source: RBI, NSE EPR.

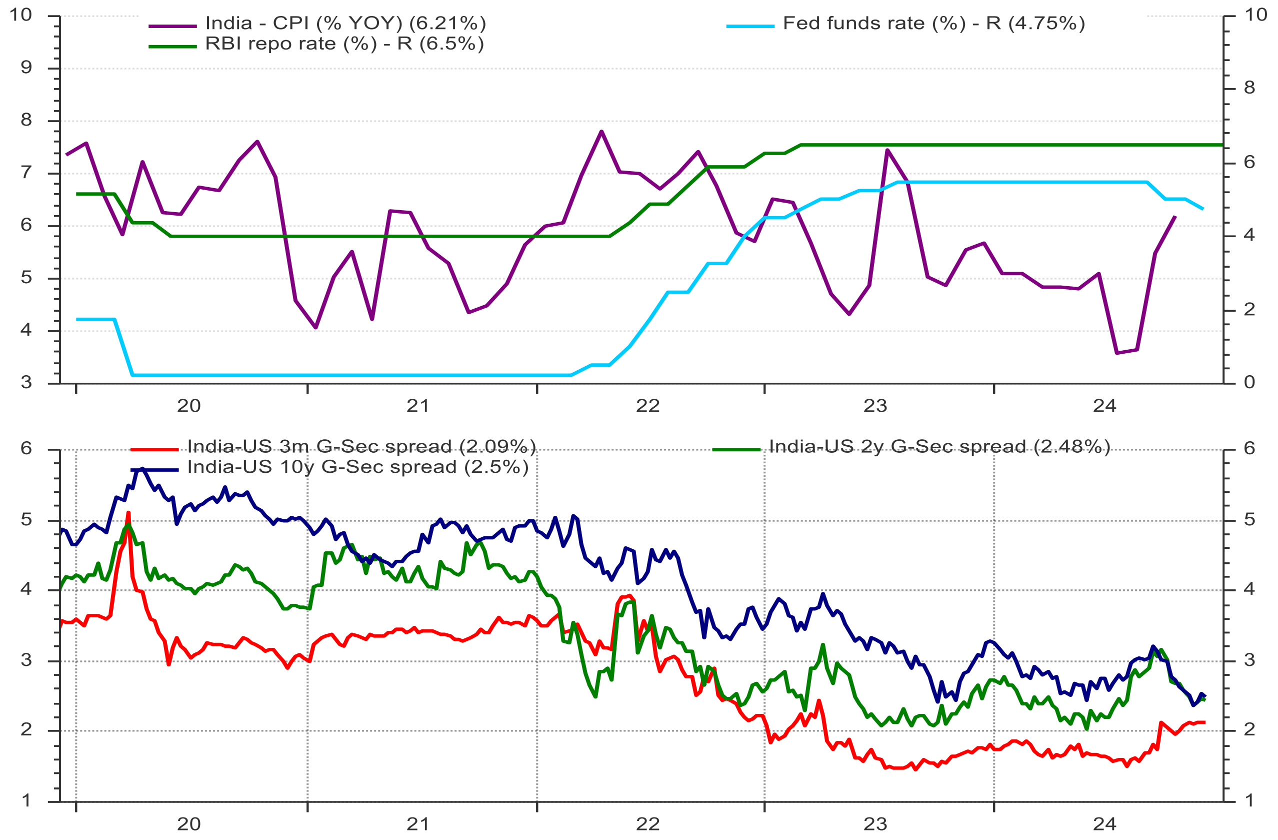
Figure 4: Net lending under RBI's Liquidity Adjustment Facility

System liquidity continued in surplus during October-November 2024, averaging Rs 1.5 lakh crore. It moved into deficit for a brief period in late November (26-28), before returning to a surplus of Rs 0.42 lakh crore as of December 5th, 2024. This surplus was mainly due to higher government spending, despite the downward pressure from increased currency in circulation and capital outflows.



Source: CMIE Economic Outlook, NSE EPR.

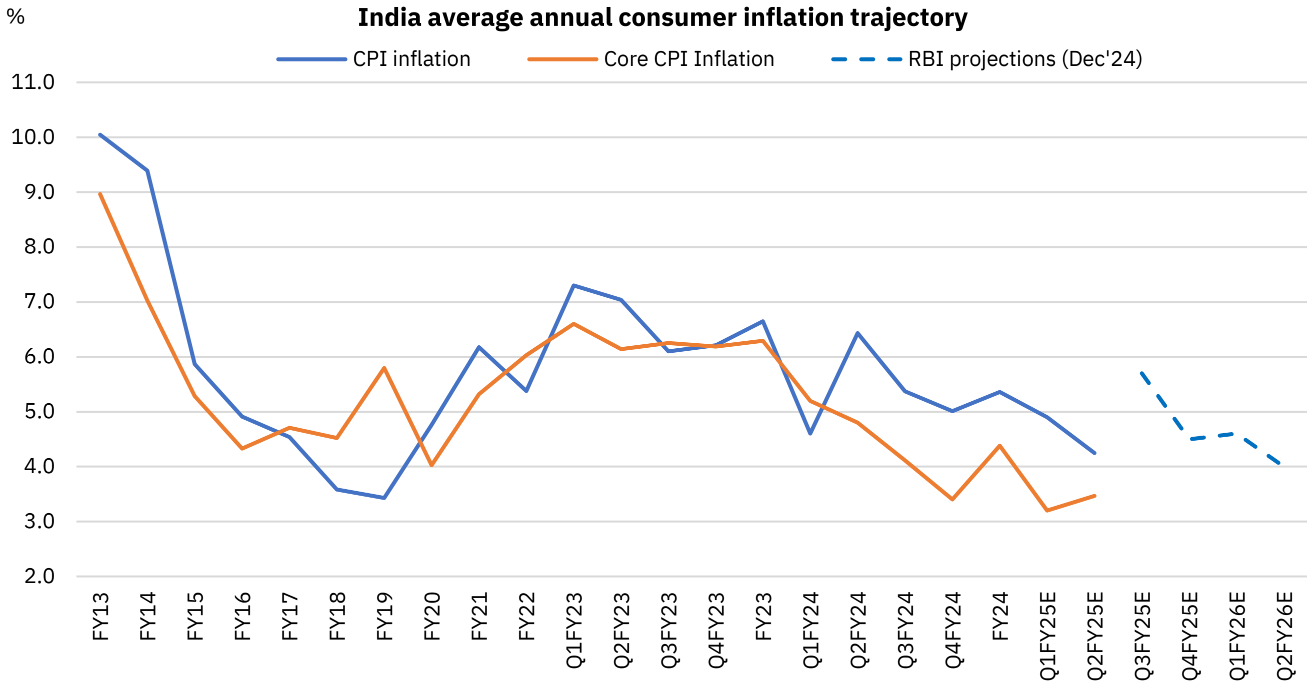
Figure 5: India vs. US policy rates and yield differential



Source: LSEG Datastream, NSE EPR.

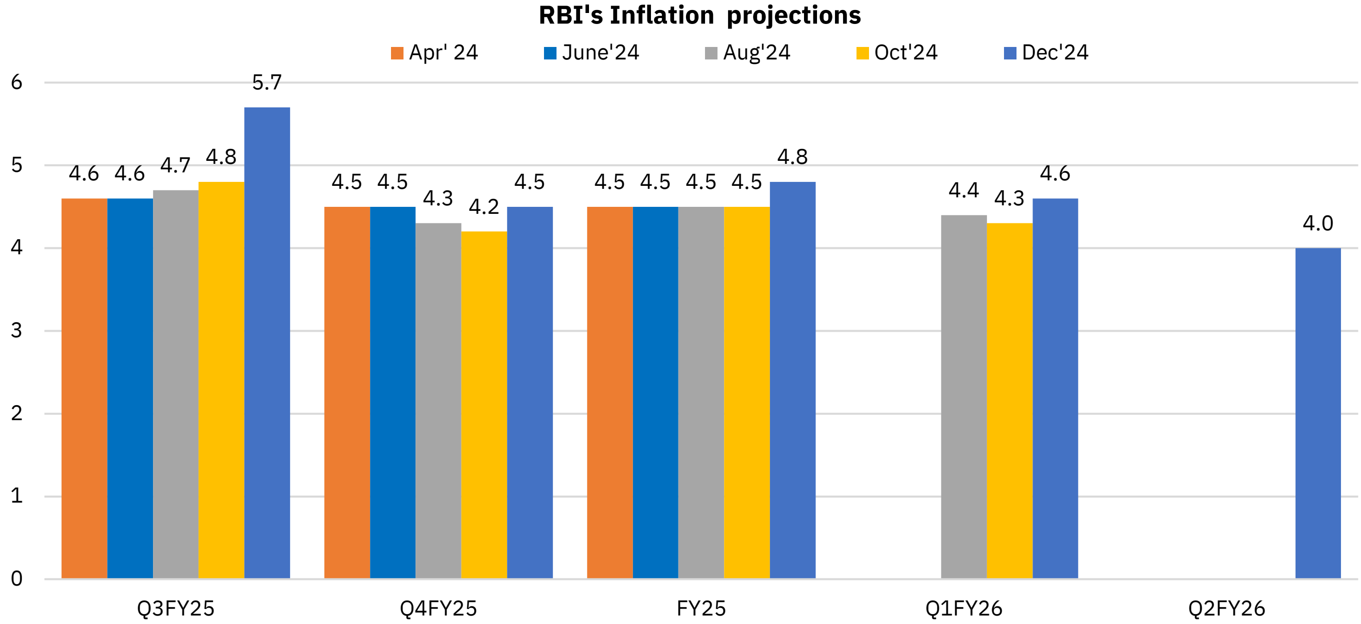
Figure 6: India's consumer inflation trajectory and RBI's forecasts

Headline inflation projection for FY25 has revised higher by 30bps to 4.8%, with a sharp upward revision in Q3 to 5.7% (+90bps) while a shallower increase of 30bps to 4.5% in Q4. The forecase for Q1/Q2FY26 has been pegged at 4.6% and 4% respectively.



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

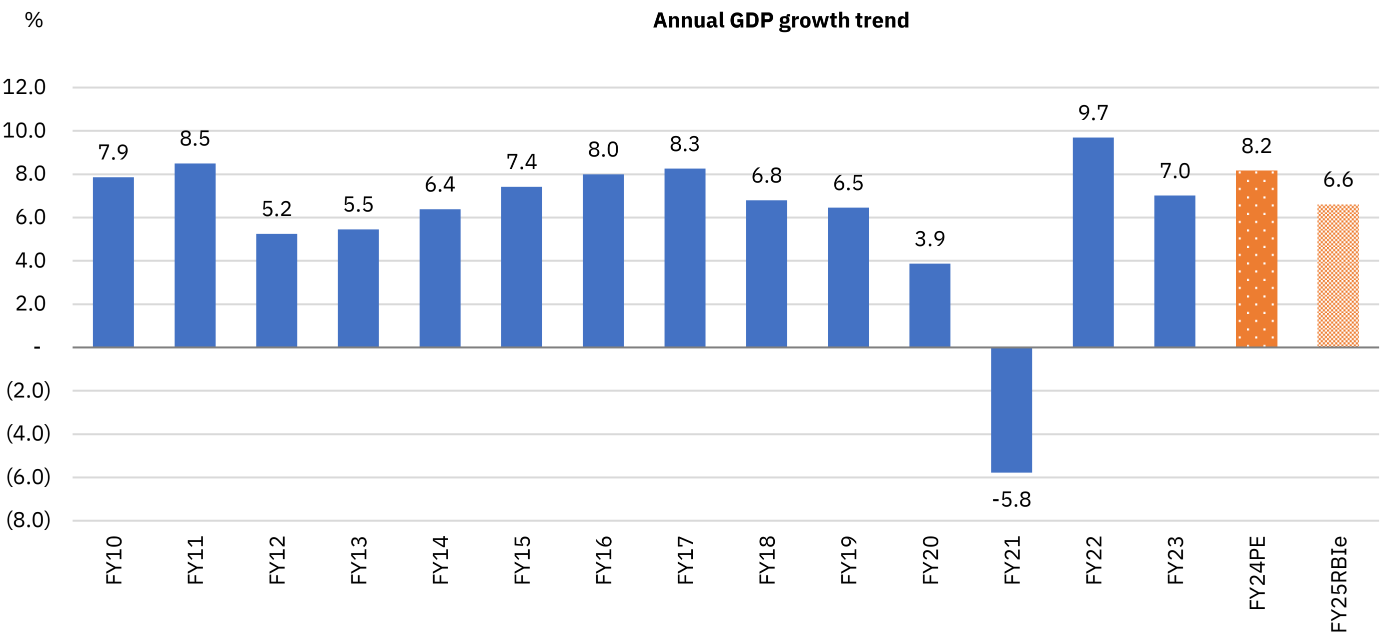
Figure 7: Quarterly and annual inflation forecasts by RBI



Source: RBI, NSE EPR.

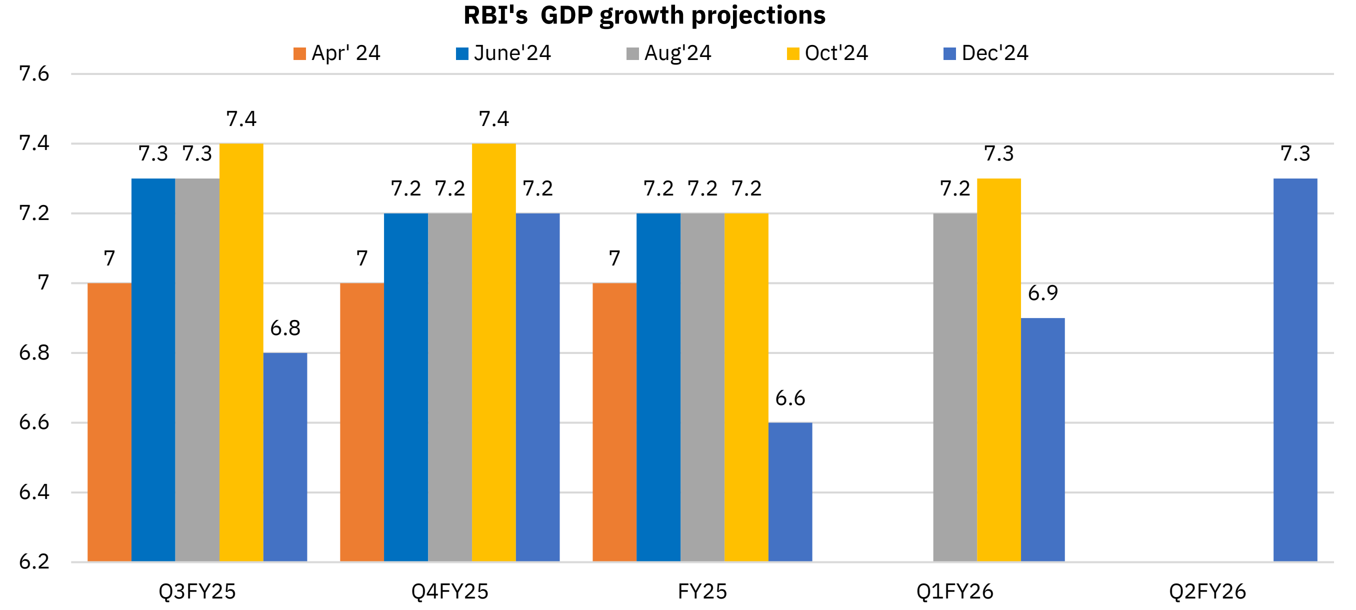
Figure 8: GDP growth trend and RBI's estimates

The GDP growth projection for FY25 has been revised lower by 60bps to 6.6%.



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

Figure 9: RBI's quarterly and annual GDP growth forecasts



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
Sounak Ghosh	sounakg@nse.co.in	
Gautam Sodani	gsodani@nse.co.in	
Sumiti Manchanda	smanchanda@nse.co.in	

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