08 December 2023

The growth inflation dynamics keep the RBI on pause

- In today's monetary policy meeting, the RBI kept the repo rate, unchanged at 6.50%. Furthermore, it retained the stance of "withdrawal of accommodation".
- The tone of the meeting was still leaning towards hawkish with a strong emphasis of the monetary policy to remain actively disinflationary and to align the inflation with the target of 4% in the statement and in the post-press conference.
- The RBI's cautiousness stems from its concerns regarding upside risks to the food inflation. Given the recurring supply-side shocks and transmission of the previous rate hikes still incomplete, the MPC decided to maintain the status quo on the rates and stance.
- On the growth outlook, with a better-than-expected Q2 print and a more positive outlook for H2, the RBI revised its GDP forecast upwards for FY24 to 7.0% from 6.5% earlier.
- The central bank drew comfort from the moderation in core inflation while remaining cognizant of the upside risks to the outlook. For FY24, it kept the inflation forecast unchanged at 5.4%.
- On the liquidity front, the central bank did not conduct any Open Market Operations (OMO) sales via auction as the liquidity got tighter in October-November. However, it does not imply that OMO sales are off the table as a liquidity absorption tool, rather this tool will probably be exercised over a long-term period.
- The central bank also announced the reversal of the liquidity facilities under both the Standing Deposit Facility (SDF) and Marginal Standing Facility (MSF) even during weekends and holidays with effect from Dec 30, 2023, to facilitate better fund management by the banks.
- With inflation expected to remain above 5%, we retain our view of the central bank remaining on a pause in FY24 and possibly in the first quarter of FY25 as well. Instead, the focus is likely to remain on keeping liquidity conditions tight to accelerate the transmission of monetary policy hikes.

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The RBI keeps the policy rate and stance unchanged

Against the backdrop of a more supportive external environment with the rising expectation of a soft landing in the US, better-than-anticipated domestic economic growth, and continued moderation in core inflation, **the RBI decided to keep the repo rate unchanged at 6.50% for the fifth consecutive meeting**. Accordingly, **the Standing Deposit Facility (SDF) Rate remains unchanged at 6.25% and the Marginal Standing Facility (MSF) Rate and Bank Rate remain unchanged at 6.75%**. Furthermore, it decided with a **5-1 majority** to **"remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth".** With the RBI decision largely on expected lines, the 10-year bond yield did not move significantly post the meeting.

The RBI drew comfort from the broad-based easing in core inflation, but recognized the upside risks to food inflation which is likely to push inflation upwards in November and December. The frequent occurrence of such shocks can lead to a generalisation of the price pressures and can impede the ongoing disinflation process. At this juncture, it is hard to ascertain if and when these shocks will abate, especially given that we are looking at yet another year of El Nino. **Given the recurring supply-side shocks and the transmission of the previous rate hikes still incomplete, the MPC decided to maintain the status quo on the rates and stance while remaining alert and prepared to take appropriate action should the situation warrant**. Additionally, a resilient domestic growth has provided the MPC with the space to prioritise controlling inflation over growth.

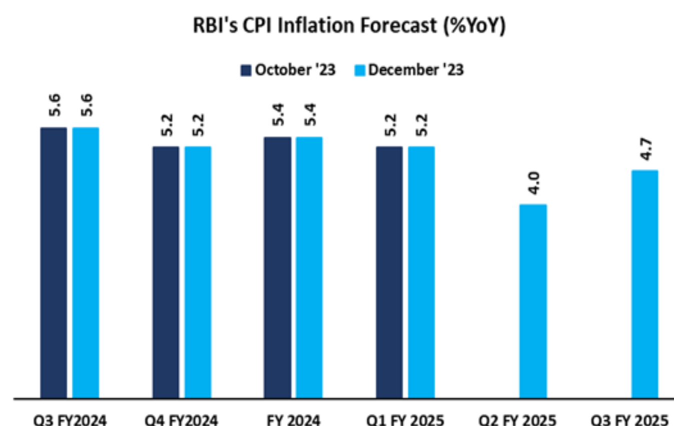
Statement tone assessed to be leaning towards hawkish; The RBI likely to remain on pause in the remainder of FY24 and possibly in Q1 FY25

While the RBI maintained the status quo on the policy rate and the stance, **the strong emphasis of the monetary policy to remain actively disinflationary and to align the inflation with the target of 4% in the statement underscores the cautiously hawkish tone of the policy.**

The governor, in his concluding remarks, mentioned that policy makers **have to be mindful of the risk of overtightening**. While this may have sent some confusing signals at first, **the governor in the post-policy conference mentioned that usage of this word should not be construed as an indication that any financial loosening is on the table**. The focus of the central bank very much remains aligning the inflation to the target of 4% and not being complacent with bringing it below the upper threshold. Hence, **with inflation expected to remain above 5%, we retain our view of the central bank remaining on a pause in FY24 and possibly in the first quarter of FY25 as well. Especially, with the Fed rate cut not in sight before July 2024, the RBI opting for a rate cut earlier than that seems unlikely.**

Further, we do not anticipate any change in the policy stance, as such a change is likely to give a wrong signal to the market that the MPC may pivot soon, potentially leading to a loosening of financial conditions and creating room for a second-round impact on inflation.

The RBI remained cautious about inflation; kept the forecast unchanged at 5.4%



Source: RBI; Note: October '23 and December '23 refer to projections given by the RBI in its October and December 2023 MPC updates, respectively.

The RBI remained cautious about the inflation. While it drew comfort from the moderating core inflation, it also recognized the inflationary pressures in certain food items which is likely to push the inflation upwards in November and December. Based on the data for October, the food inflation pressures were broad-based with 50% of the food basket by weight observing inflation above 6%. This is likely to increase in the November print with the resurgence of onion prices along with the persistence of price pressures in other categories such as cereals, pulses, spices etc. Further, as per the first advanced estimates, the Kharif food grain production is estimated to be 4.6% lower than last year's final estimates. If materialized, this could exert upward pressure on the headline number. Additionally, the adverse base effect in Nov-Dec will also push the inflation higher.

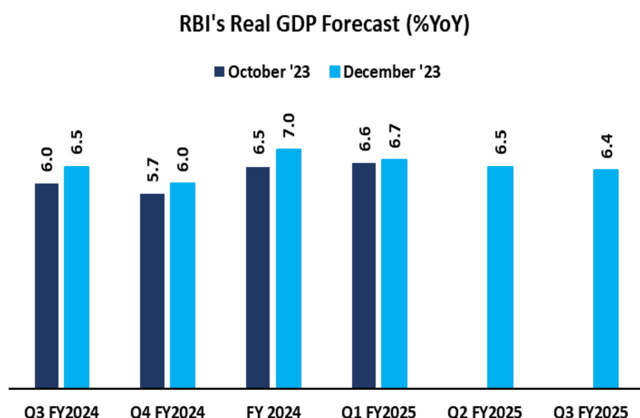
While the RBI will look past the transient increase in food prices, it will be vigilant about any spillovers from food inflation to the core components. As of now, the core inflation has remained well behaved with October observing the lowest print since the pandemic. Additionally, the positive also comes from the moderation in global commodity prices. Overall, on balance, the RBI has kept the inflation forecast unchanged at 5.4% in FY24. It has projected the inflation for

Q1, Q2, and Q3 of FY25 at 5.2%, 4.0% and 4.7% respectively.

The RBI remains positive on growth prospects

Turning to the growth, the RBI assessed that economic activity has remained buoyant in Q2. This is reflected in the Q2 GDP print which came in at 7.6% surpassing the market and the RBI expectations. The growth in the second quarter was supported by investment and government expenditure, as private consumption slowed likely reflecting the softer rural demand on account of subdued monsoons. This was also observed in the slowdown in agricultural output in Q2. High-frequency indicators for Q3 suggest the continuation of momentum buoyed by the festive season demand. Lead demand indicators for October including passenger-vehicle sales, two-wheeler sales, domestic air passenger traffic, etc. remained upbeat. As highlighted in our previous monthly, while the latest data seems encouraging, the downside risks from the rural sector demand, softening labour market, and potential risk of resurgence in food inflation persist. Investment activity has also likely remained buoyant led by the government's increased capex spending. Further, healthy twin balance sheets of banks and corporates, high-capacity utilisation, continuing business optimism and the government's thrust on infrastructure spending should bode well for the private sector capex. Meanwhile, some softness was observed in the PMI readings for both the manufacturing and services sectors in Oct-Nov, although they stayed comfortably above the long-term historical levels. Overall, with a higher-than-expected economic growth in Q2 and a more positive outlook for H2, the RBI has revised its GDP forecast upwards for FY24 to 7.0% from 6.5% earlier, with Q3 and Q4 at 6.5% and 6.0% respectively from 6.0% and 5.7% earlier. Further, the growth for Q1, Q2, and Q3 of FY25 is pegged at 6.7%, 6.5% and 6.4% respectively.

FY24 growth revised to 7.0% from 6.5% earlier

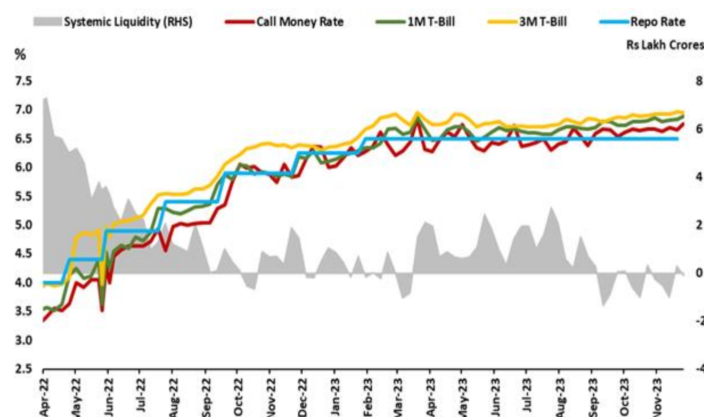


Source: RBI; Note: October '23 and December '23 refer to projections given by the RBI in its October and December 2023 MPC updates, respectively.

Focus remains to keep liquidity consistent with monetary policy

Taking the market by surprise, the RBI in its earlier meeting had hinted at the use of Open Market Operations (OMO) sales (auction route) as and when required to absorb excess liquidity. However, with liquidity getting tighter in October and November due to higher currency leakage during the festive season, government cash balances, and FX intervention by the central bank, the central bank did not resort to using OMO sales via auction. This does not in any way imply that OMO sales are off the table; rather this tool will probably be exercised over a long-term period as opposed to what the market had anticipated. Moving ahead, the liquidity conditions are expected to ease with a pick-up in the government spending and potential foreign capital inflows in the debt market ahead of India's integration into the JP Morgan EM Bond Indexes next year. Consequently, the central bank will actively manage liquidity to keep it consistent with the monetary policy and to prevent any generalisation of price pressures.

Liquidity was in deficit in October and November; overnight call rates were above the repo rate



Source: CMIE; Note: Data till 7th December

In its earlier meeting the central bank had highlighted the skewed distribution of the liquidity with an increase in demands for funds under the MSF window, while at the same time, substantial funds were parked under SDF. This had led to the firming up of the short-term rates with the overnight call rate (on average) hovering above the repo rate at around 6.6%-6.7% in Oct-Nov. To address the same, the RBI has allowed the reversal of liquidity facilities under both SDF and MSF even during weekends and holidays with effect from Dec 30, 2023. This move is expected to facilitate better fund management by the banks and will be reviewed after six months or earlier if needed.

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The RBI also announced the developmental and regulatory policy measures listed below:

Regulation and Supervision

- **Review of the regulatory framework for hedging of foreign exchange risks:**
  After reviewing the framework governing the hedging of foreign exchange risks in 2020, the RBI has made the framework more comprehensive by consolidating the directions with respect to all types of transactions – over the counter (OTC) and exchange-traded - under a single Master Direction. It has been done to enhance operational efficiency and ease access to foreign exchange derivatives.

- **Framework for Connected Lending:**
  The RBI has decided to come out with a unified regulatory framework on connected lending for all the regulated entities (REs) of the Reserve Bank, as the extant guidelines are limited in scope and not uniformly applicable to all REs.

- **Regulatory Framework for Web-Aggregation of Loan Products:**
  The RBI has decided to come up with a regulatory framework for web aggregators of loan products (WALP). WALP includes aggregation of loan offers from multiple lenders on an electronic platform which enables the borrowers to compare and choose the best available option to avail a loan.

Payment System and FinTech

- **Enhancing UPI transaction limit for Specified Categories:**
  To encourage the use of UPI for medical and educational services, the central bank has proposed to enhance the limit for payments to hospitals and educational institutions from ₹1 lakh to ₹5 lakh per transaction.

- **e-Mandates for recurring online transactions – Enhancement of limit for specified categories:**
  The RBI has e-Mandates in place for recurring transactions where the current limit above which additional factor authentication (AFA) is required is Rs 15,000. It has proposed to exempt the requirement of AFA for transactions up to ₹1 lakh for the categories including subscription to mutual funds, payment of insurance premiums and payment of credit card bills.

- **Establishment of Cloud Facility for the Financial Sector in India:**
  To enhance the security, integrity and privacy of the financial sector data, the RBI has decided to set up a cloud facility for the financial sector in India. The proposed cloud facility will be set up and initially operated by Indian Financial Technology & Allied Services (IFTAS), a wholly owned subsidiary of the RBI and will be later transferred to a separate entity owned by financial sector participants.

- **Setting up of FinTech Repository:**
  To better understand the developments in the FinTech ecosystem and to support the sector, the RBI has proposed to set up a repository for capturing essential information about FinTechs, encompassing their activities, products, technology stack, financial information etc. The repository will be operationalised by the Reserve Bank Innovation Hub in April 2024 or earlier.

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