10 August 2023

The RBI maintains a cautiously hawkish stance; doubles down on draining excess liquidity

- In today's meeting, the Monetary Policy Committee of the RBI decided to hold the repo rate, at its current level of 6.5% and maintain the stance of withdrawal of accommodation.

- Despite a third consecutive status quo meeting, the tone of the governor's statement was much more hawkish. In this regard, the RBI announced that all scheduled banks will need to maintain an incremental CRR of 10% on the increase in their net demand and time liabilities between May 19 – July 28 temporarily. This is expected to absorb liquidity of ~₹1 lakh crore.

- The RBI assessed economic activity to have remained robust over the past few months. Looking ahead, it expects a pickup in demand conditions due to the festive season, continued government push on CAPEX and revival of private investment in select sectors to sustain growth momentum. Extreme weather conditions, slowing global growth and geopolitical tensions pose risks to the outlook.

- The RBI's GDP growth projection for FY24 remained unchanged at 6.5%. Growth in Q1 FY25 is projected to be 6.6%.

- The pickup in food price inflation is likely to outweigh the easing effects of a brighter outlook for Kharif crop harvest and lower core inflation. As such the RBI's inflation projection for FY24 was nudged up to 5.4% from 5.1% previously (with increases in Q2-Q3 FY24 projections). Inflation in Q1 FY25 is projected to be 5.2%.

- As mentioned by the governor in his statement, the MPC is likely to look through high inflation prints in the short term caused by temporary food price spikes. With the recent easing in core inflation and deflation in the wholesale price index, we assess the likelihood of further rate hikes to be very low. Only a sharp and durable rise in core inflation could force the RBI to resume rate hikes again.

- With inflation expected to remain much above the central bank's target of 4% until Q1 FY25, we do not expect any rate cuts, at least during the current financial year.

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The RBI holds policy rate steady and stance unchanged

In line with the consensus, the Monetary Policy Committee (the MPC) decided unanimously to keep the policy rate i.e., the repo rate, **unchanged at 6.5%** in its policy meeting today, and maintained its cautiously hawkish policy outlook. Accordingly, the Standing Deposit Facility (SDF) Rate remains unchanged at 6.25% and the Marginal Standing Facility (MSF) Rate and Bank Rate remains 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 the expected lines, the 10-year bond yield remained flat while there was some hardening observed at shorter end of the curve.

Explaining the rationale behind the MPC's decisions the Reserve Bank of India (RBI) Governor recognized the acceleration of price pressures in June and expected further pick-up in July-August led by a seasonal spike in vegetable prices but stated that monetary policy can look through high inflation prints caused by such shocks for some time. Apart from the temporary spike in inflation due to vegetable prices, the governor emphasized the need to remain vigilant on the evolving inflation trajectory owing to the impact of El Niño conditions on global food prices against the backdrop of a skewed south-west monsoon so far. Given the upside risks to inflation owing to the above reasons, and the fact that the cumulative rate hike of 250 basis points undertaken by the MPC is still working its way into the economy, the MPC decided to keep the rates unchanged while remaining watchful of the emerging inflationary conditions. Furthermore, given that headline inflation, despite significantly easing from six months ago, still remains much above the 4% target, the stance of withdrawal of accommodation was retained.

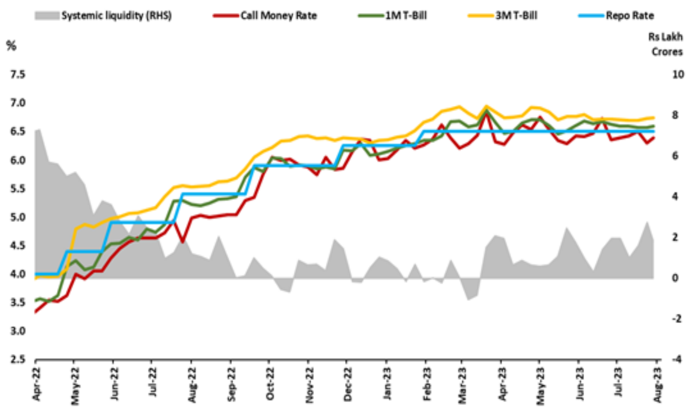
Tone of the latest statement was more hawkish than before

Despite a third consecutive status quo policy, we assess the tone of the governor's statement to be **much more hawkish, compared with the previous statements**. Firstly, the governor reiterated his point from the previous statement – "bringing headline inflation within the tolerance band is not enough; we need to remain firmly focused on aligning inflation to the target of 4%. Secondly, the RBI doubled down on its efforts to drain out excess liquidity from the system by introducing a temporary requirement for all scheduled commercial banks to maintain **an incremental cash reserve ratio (I-CRR) of 10% on the increase in their net demand and time liabilities (NDTL)** between May 19 – July 28, 2023. The desire to quickly bring liquidity to a more neutral level reflects nervousness around the risks that excessive liquidity poses to price and financial stability.

The RBI takes temporary measure to scale back the excess liquidity

Liquidity conditions have been easing in the past two months with average systemic liquidity rising to ₹2.3 lakh crores in the first 9 days of August from ₹70K crores in the first week of May. The uptick is driven by a combination of factors including the transient boost from the withdrawal of ₹2000 banknotes from circulation, a pick-up in government spending, the transfer of the RBI's dividend and FX interventions. Indeed, the central bank has undertaken net dollar purchases worth US $15.1 bn in the spot market in the first two months of Q1 FY24. Additionally, as per the latest figures from the RBI, 88% of the bank notes have been returned by the end of July (₹ 3.1 lakh crore) with 87% of the same being in the form of deposits while the rest is exchanged for other denominations. With the continuous increase in systemic liquidity the RBI has conducted multiple VRRR operations (14 day) since June, however the response to the same has been tepid by the banks. In lieu of the same, the RBI has announced that with effect from the fortnight beginning August 12, scheduled banks shall maintain an I-CRR of 10% on the increase in their NDTL, between May 19 – July 28, 2023. As per the press conference, the measure is likely to lead to a temporary liquidity reduction of ~₹1 lakh crore. Consequently, it could lead to some hardening of the money market rates. This decision will be reviewed on September 8 or even earlier to return the impounded funds to the banking system ahead of the festival season.

Liquidity conditions remained in surplus; overnight call rates closer to the policy rates

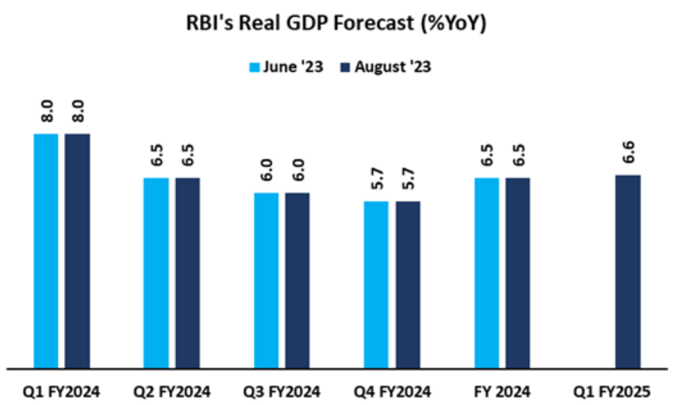


Source: CMIE; Note: Data in August is till 9th August.

Growth conditions remain favourable

The RBI assessed the momentum of economic activity in India to be positive despite a challenging global economic environment. In the agriculture sector, sowing has improved with the progress of the southwest monsoon, although the spatial distribution continues to pose a concern. Momentum in the manufacturing sector and construction sector remained robust in Q1 FY24 according to high frequency indicators like IIP and Eight Core Industry Output. Services sector momentum also leans towards the positive with decadal high PMI readings. Urban and rural demand indicators have improved with higher growth in air passenger traffic, retail credit and two-wheeler sales. Investment activity is supported by a strong government push on CAPEX and pickup of private investment in select sectors like metals, petroleum and chemicals, automobiles, iron and steel, cement, and food and beverages. With strong bank and corporate balance sheets, and high manufacturing sector capacity utilization, conditions are primed for a private sector CAPEX revival. On the negative side, spillovers from a weak external demand and continued uncertainty in the global economic environment owing to protracted geopolitical tensions will pose downside risks to the outlook. On balance, the RBI has kept its GDP growth projections unchanged at 6.5% for FY24. We flag additional risks to the outlook in the form of extreme weather conditions which could impact rural incomes and thereby consumption, especially in the upcoming festive season. Lately weakness has been observed in the labour market which could further put a dampener on demand. Furthermore, in line with the RBI's view, we believe that India's services exports will be at risk owing to a weaker global demand.

The RBI remains positive on India's growth prospects; retains forecast at 6.5%

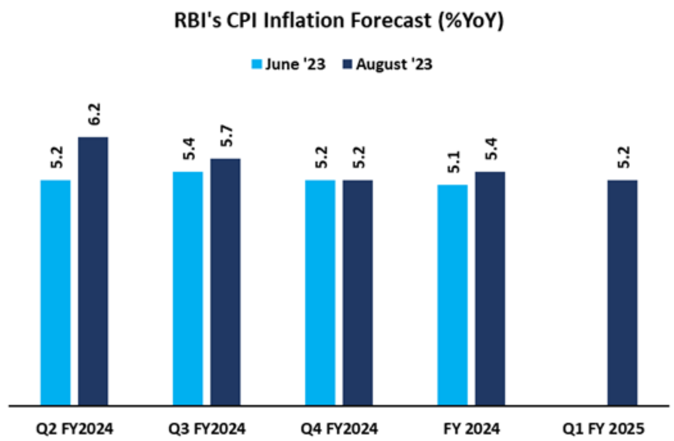


Source: RBI; Note: June '23 and August '23 refer to projections given by the RBI in its June and August 2023 MPC updates, respectively.

Inflation control remains a concern

The main reason for the RBI's continuing cautiously hawkish stance is the pickup in inflation in June and the expectation of further increase in July-August on account of a seasonal spike in vegetable prices. While the MPC acknowledged the recent easing in core inflation and brightening prospects for Kharif crops harvest owing to the improving progress of monsoon, the short-term spike in inflation outweighed the positive developments leading to an upward revision in its inflation forecast for Q2 FY24 from 5.2% to 6.2% for Q3 FY24 from 5.4% to 5.7%. Apart from the short-term spike in food prices, a hardening bias on global food prices and recent firming up of crude oil prices were additional reasons for an upward revision in the RBI's inflation projections. As such the FY24 inflation projection stands adjusted to 5.4%, compared with 5.1% previously. For Q1 FY25, the RBI projects inflation to be 5.2%.

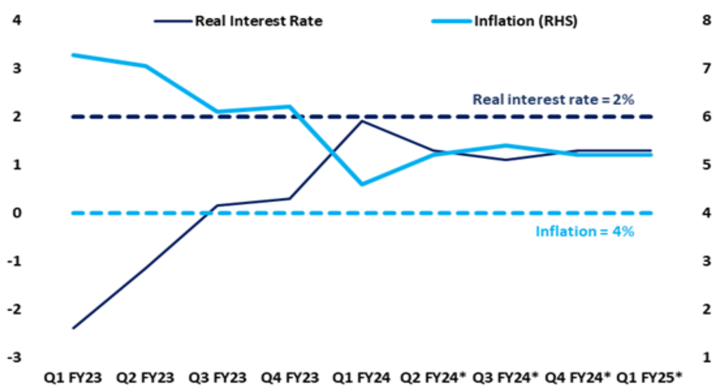
The RBI has nudged up its inflation forecasts in response to the food price spike



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

As we expected and as also mentioned by the governor in his statement, the MPC is likely to look through high inflation prints caused by short term food price spikes. With the recent easing in core inflation and deflation in the wholesale price index, we assess the likelihood of further rate hikes to be very low. Only a sharp and durable rise in core inflation could force the RBI to resume rate hikes again,

No rate cut expected, at least in FY24



Source: CMIE, RBI; Note – Calculation of real interest rate for Q2 FY24 onward is based on repo rate of 6.5% and the RBI's latest inflation projections.

With inflation expected to remain much above the central bank's target of 4% until Q1 FY25, we do not expect any rate cuts at least during the current financial year. As mentioned in our India Economic Monitor for July 2023, the RBI's previous rate cut decisions in the Inflation Targeting Regime were usually preceded by a prolonged period of below 4% inflation and a real interest rate of 2% or above. Considering the RBI's latest inflation projections and a repo rate of 6.5%, neither of these conditions are likely to be met in our current forecast period.

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

Financial Markets

- **Review of Regulatory Framework for Financial Benchmark Administrators:**
  The RBI has decided to revise the extant regulations issued in June 2019 and put in place a comprehensive, risk-based framework covering administration of all benchmarks such as foreign exchange rates, interest rates, money markets, and government securities to provide greater accuracy and integrity of financial benchmarks.

Regulation and Supervision

- **Review of Regulatory Framework for NBFC – Infrastructure Debt Funds (IDF-NBFCs):**
  To enhance the financing role of Infrastructure Debt Funds (IDFs) and streamline regulatory norms for different categories of non-banking financial companies (NBFCs), the RBI is revising the regulatory framework for IDFs. The new framework will eliminate the requirement for a sponsor for IDFs, allow direct lending to Toll Operate Transfer (ToT) projects, provide access to External Commercial Borrowings (ECBs), and make tri-partite agreements optional for Public-Private Partnership (PPP) projects. Detailed guidelines for these changes will be issued soon, promoting greater efficiency and flexibility.

- **Responsible Conduct in Lending: Greater Transparency in Interest Rate Reset of Equated Monthly Instalments (EMI) based Floating Interest Loans:**
  Addressing issues of elongated tenors and a lack of transparency in floating-rate loans, the RBI has decided to put in place a transparent framework for reset of interest rates on floating-interest loans. This framework will ensure clear communication with borrowers for interest rate and EMI resets, offer options to fixed-rate loans or loan foreclosure, transparent disclosure of associated charges, and effective communication of key information.

- **Consolidation and Harmonisation of Instructions for Supervisory Data Submission:**
  To streamline supervisory data submission, the RBI plans to consolidate multiple guidelines into a single Master Direction, providing clarity, reducing compliance burdens, and ensuring consistency.

Payment and Settlement Systems

- **Conversational Payments in UPI:**
  Leveraging artificial intelligence, "Conversational Payments" will enable users to engage in secure transactions through conversations with AI-powered systems. Available on both smartphones and feature phones, this approach will enhance digital penetration and inclusivity, initially in Hindi and English, with plans to include more Indian languages.

- **Offline Payments in UPI:**
  To accelerate the speed of small-value transactions, the RBI is introducing offline transactions using Near Field Communication (NFC) technology through "UPI-Lite." This feature will provide reliability and speed for retail digital payments in areas with weak or no internet connectivity.

- **Enhancing Transactions Limits for Small Value Digital Payments:**
  With the aim of promoting wider adoption of small-value digital payments, the RBI plans to increase the per transaction limit from ₹200 to ₹500 in the offline mode, while retaining an overall limit of ₹2000 to manage associated risks. This adjustment will facilitate faster, contactless, and efficient payments for everyday transactions.

Fintech

- **Public Tech Platform for Frictionless Credit:**
  In line with India's digital public infrastructure, a digital Public Tech Platform is being developed by the RBI Innovation Hub. This platform will harness data from various entities to streamline the credit appraisal process, making it more seamless and efficient. Building on successful pilot projects, this platform will facilitate frictionless lending through open architecture, APIs, and standardized connections, ultimately enhancing lending efficiency, reducing costs, and enabling faster disbursement.

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