The RBI remains hawkish amid inflationary concerns; focuses on reining in liquidity

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- In today's monetary policy meeting, the RBI kept the policy rate, the repo rate, unchanged at 6.5%. Furthermore, it retained the stance of "withdrawal of accommodation".

- The tone of the meeting was still hawkish as reflected in the continued reiteration of aligning inflation to the target of 4%. Additionally, the governor announced that the RBI may undertake Open Market Operations (OMOs), further reflective of a tightening liquidity stance.

- The RBI's cautiousness stems from its concerns regarding the generalization of food price pressures, and elevated global food and energy prices. Given that transmission of the cumulative policy rate hike of 250 bps so far to the banking rates is not yet complete, the stance was kept unchanged.

- The RBI assesses domestic economic activity to be resilient despite the clouded global landscape. As such the GDP growth projection for FY24 remained unchanged at 6.5%.

- The RBI remains cautious about inflation and remains cognizant of the upside risks to the outlook. Given the overshoot of inflation in Q2 FY24, it nudged up its Q2 inflation forecast and adjusted its Q3 forecast down. For FY24 the inflation forecast remained unchanged at 5.4%.

- Given resilient economic activity and the central bank's commitment to align inflation to its target of 4%, we believe the central bank is likely to hold the policy rate at the existing level in FY24. Only a sharp and durable rise in core inflation could force the RBI to resume rate hikes again, however, we assign a very low probability to such an event.

- Instead, the focus is likely to remain on keeping liquidity conditions tight to accelerate the transmission of monetary policy hikes.

- 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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RBI continues with hawkish policy stance; held the repo rate steady at 6.50%

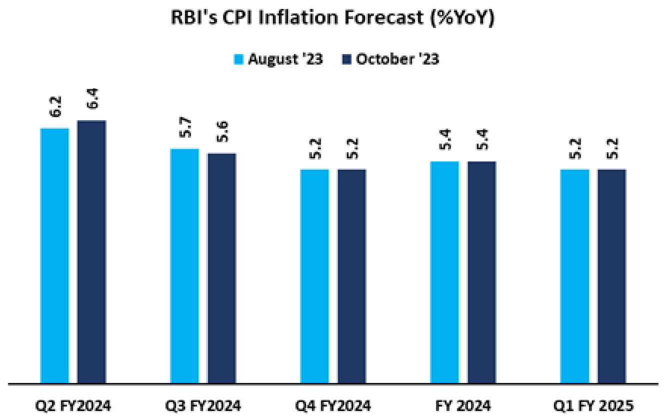
Amidst the resilient domestic economy and uncertainty besieging the inflation outlook, ***the MPC unanimously voted to keep the repo rate unchanged at 6.50%*** for the fourth consecutive meeting. Accordingly, the Standing Deposit Facility (SDF) Rate remains unchanged at 6.25% and the Marginal Standing Facility (MSF) Rate and Bank Rate remains at 6.75%. It also retained the policy stance of ***"withdrawal of accommodation"*** by a majority of 5 out of 6 members as the transmission of the prior rate hikes is still incomplete. Accordingly, in the post press conference, the governor noted that the central bank will undertake "***active liquidity management"*** to keep liquidity consistent with the current policy stance. To do so, the central bank may utilize Open Market Operations (OMO) – sales from its toolkit as highlighted in the statement. ***The explicit hinting at the use of OMO sales led to a surge in the 10-year G-sec yield by ~14 bps to 7.35% at the time of writing.***

Explaining the rationale behind the MPC decision, the governor highlighted the following reasons to keep the status quo on rates and stance: Firstly, while the surge in inflation in July-August (due to tomato prices) is likely to ease in September, the recurrence of incidents of large and overlapping food price shocks can impart generalisation and persistence to headline inflation. Secondly, the outlook on inflation remains marred with uncertainty owing to elevated global food and energy prices and adverse weather conditions. Thirdly, the transmission of the cumulative policy rate hike of 250 bps so far to the banking rates is not yet complete. Overall, we assess the policy tone to be ***hawkish*** with continued reiteration of aligning the inflation to the target of 4% and not just the 2-6% range and tighter liquidity stance.

RBI continues to remain cautious on inflation; noting risks from volatile global prices and lower sowing

The RBI remains cautious about inflation. While it recognised that inflationary pressures are likely to ease in September, on the back of vegetable price correction, especially tomatoes, and the reduction in LPG prices, it is cognizant of the potential risks which could cause price pressures to return in Q3 FY24. These risks are brewing in the form of lower kharif sowing for key crops like pulses and oilseeds, as well as seasonal demand supply mismatches in items like onions and spices. Furthermore, exogenous factors such as El Niño conditions, and volatile global food and energy prices could also exert upward pressure on inflation. On the positive side, the RBI drew comfort from moderation in core inflation and anchored inflation expectations. Overall, for FY24 the RBI kept the inflation projection unchanged at 5.4% while making changes to quarterly projections (given the overshoot of inflation in Q2 FY24; Jul-Aug average tracking at 7.1% compared with a previous forecast of 6.2% for Q2).

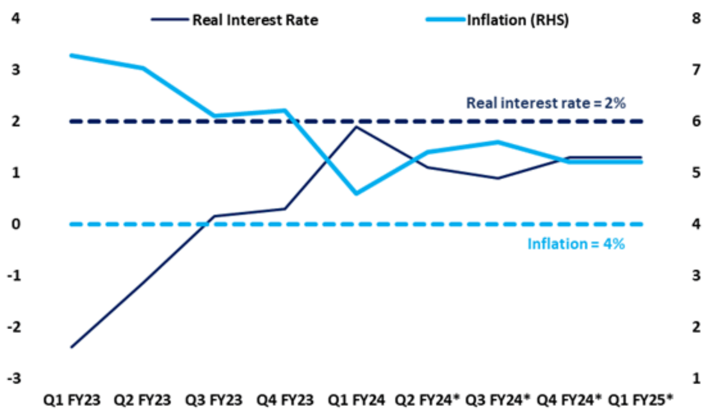
The inflation forecast for FY24 unchanged at 5.4% with adjustments to the quarterly profile



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

Amidst the economic growth holding up and the MPC's unwavering resolution to bring inflation down to its target of 4%, we believe ***the central bank is likely to hold the rates at the existing levels in the remainder of FY24***. Only any durable signs of pick up in core inflation are likely to nudge the central bank to hike rates, however, we assign a very low probability to such an event. 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 MPC may pivot soon and could lead to a loosening of financial conditions creating room for a second-round impact on inflation.***

No rate cut expected, at least in FY24

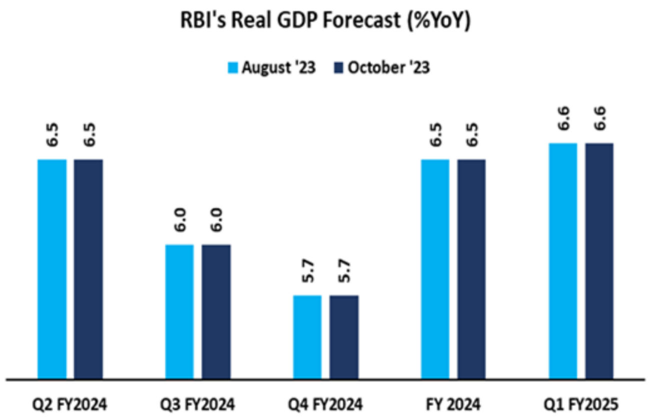


Source: CMIE, RBI; Note – Calculation of real interest rate for Q2 FY24 onward is based on repo rate of 6.5% and the RBI's latest inflation projections

Regarding the rate cuts, as mentioned in our previous report, 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 is likely to be met in our current forecast period.

RBI retains growth forecast for FY24, noting the headwinds from the external sector and monsoon performance



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

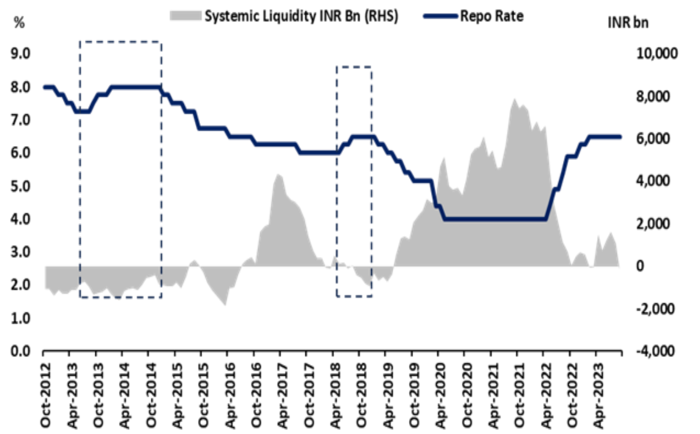
The RBI assessed that domestic economic activity continues to exhibit resilience despite the clouded global landscape. In the agriculture sector, Kharif sowing is tracking mildly above last year's levels, although the spatial distribution remains uneven. High-frequency indicators such as the PMI survey and core sector growth for the month of July-August suggest traction in manufacturing and construction activity. Services sector momentum remains upbeat with decadal high PMI readings. From the demand side, the steady urban demand and nascent signs of revival are supporting domestic consumption which is expected to pick up further ahead of the festive season. Meanwhile, the investment activity is supported by a strong government push on CAPEX. The strong bank and corporate balance sheets, rising capacity utilization in the manufacturing sector (75.4% in Q1 FY24, higher than the long-term average of 73.7%) and higher flow of resources to the commercial sector (Rs 10.6 lakh crore FYTD from Rs 10.4 lakh crore last year) augurs well for the private sector investment. On the flip side, the slowing external demand, volatile global financial markets, and uneven monsoon are likely to pose a downside risk to the growth outlook. Overall, the RBI retained its growth projection for FY24 at 6.5% with no changes in quarterly projections.

RBI likely to undertake OMO sales to keep liquidity aligned with its quantitative tightening stance

Systemic liquidity conditions have tightened in the recent past with the RBI announcing the imposition of I-CRR (Incremental Cash Reserve Ratio) in the previous meeting. As per the statement, the measure sucked out the liquidity worth Rs 1.1 lakh crore from the banking system. While the RBI discontinued the I-CRR in a phased manner starting in September the liquidity conditions have remained tight with the systemic liquidity tracking in deficit in the first week of October (~26K crore in the first five days of October compared to around 1 lakh crore deficit in the end of September). With the moderation in the excess liquidity there was an increase in demands for funds under the MSF window, while at the same time, substantial funds were parked under SDF suggesting skewed liquidity distribution across the banks. This led to firming up of the short-term rates while the long-term rates moved due to other factors including rising US treasury yields and surging crude oil prices. To address the skewed liquidity distribution, the RBI has advised banks to assess their actual liquidity requirements and according to bid under the main 14-day VRRR auctions and explore lending in the interbank call market.

In the post press conference, the governor mentioned that overall liquidity balances are still in surplus after alienating the impact of the withdrawal of Rs 2000 notes and advance tax payments. With an expected pick-up in government spending, the RBI announced that it may undertake OMO sales as and when required to keep liquidity conditions in sync with the monetary policy. The move hints at the central bank's preference to keep liquidity tighter to preserve price and financial stability. The move does not seem odd when seen in conjunction with the previous tightening cycle where liquidity was tracking in deficit during the period of the policy rate hike. For instance, in the period of the taper tantrum when the repo rate reached 8% (CY14), the average systemic deficit was tracking near Rs 1 lakh crore. Overall, we expect the liquidity to get tighter in the period ahead.

Systemic Liquidity is likely to remain in deficit like previous tightening cycle



Source: CMIE

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

Regulation and Supervision

- **Prudential Framework for Income Recognition, Asset Classification and Provisioning pertaining to Advances - Projects Under Implementation:**
  With a view to strengthen the extant regulatory framework governing the project finance and to harmonise the instructions across all regulated entities (REs), the extant prudential norms for projects under implementation have been reviewed and a comprehensive regulatory framework applicable for all REs is proposed to be issued. Detailed draft guidelines on the above will be issued separately.

- **Credit Concentration Norms – Credit Risk Transfer:**
  In addition to the NBFCs in the upper layer, now those in the middle layer and base layer will also be allowed to offset exposure to the original counter party with certain eligible credit risk transfer instruments. The instructions in this regard shall be issued shortly.

- **Gold Loan – Bullet Repayment Scheme – UCBs:**
  The Urban Cooperative Banks have been allowed to extend the glide path for the achievement of priority sector lending targets beyond March 2023. With a view to incentivise those UCBs that have met the targets as on March 31, 2023, the ceiling of gold loans that can be granted under the bullet repayment scheme will be increased from Rs 2 lakh to Rs 4 lakh.

- **Framework for recognition of Self-Regulatory Organisations (SROs) for REs of Reserve Bank:**
  The RBI will issue an omnibus framework for recognising SROs for various REs. The omnibus SRO framework shall prescribe the broad objectives, functions, eligibility criteria, governance standards, etc., which will be common for all SROs, irrespective of the sector. The RBI may prescribe sector-specific additional conditions at the time of calling for applications. To begin, a draft of the framework will be released for stakeholder comments.

Payment and Settlement Systems

- **Payments Infrastructure Development Fund – Extension of Scheme to Dec 31, 2025, and Inclusion of PM Vishwakarma Scheme beneficiaries**
  This decision to expand the targeted beneficiaries under the PIDF scheme will provide fillip to the Reserve Bank's efforts towards promoting digital transactions at the grassroots level. Further, based on the feedback received from industry, deployment of emerging modes of payment acceptance, such as soundbox devices and Aadhaar-enabled biometric devices, are proposed to be encouraged under the PIDF Scheme.

- **Introducing new channels for Card-on-File Tokenisation (CoFT):**
  RBI introduced CoFT in Sep 2021 and began implementation from Oct 2022. It has improved transaction security and transaction approval rate. At present, CoF token can only be created through merchant's application or webpage. It is now proposed to introduce CoF token creation facilities directly at the issuer bank level. This measure will enhance convenience for cardholders to get tokens created and linked to their existing accounts with various ecommerce applications. Instructions in this regard will be issued separately.

Consumer Protection

- **Master Direction on Internal Ombudsman mechanism in REs:**
  The RBI introduced an Internal Ombudsman mechanism in select SCBs in 2015 to strengthen internal grievance redressal and ensure fair resolution of customer complaints by enabling an apex level review. This was gradually extended to other REs. The extant guidelines for various categories of REs have similar design features but carry certain variations on operational matters which will now be harmonised, and a consolidated Master Direction will be issued.

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