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RBI retains a hawkish pause; no rate cut is in sight before Q2 FY25

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- 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".

- However, while the voting for the stance was similar to that for the previous policy with a 5-1 vote split, what was rather interesting was the vote split on the rates as one of the external members (Prof Jayanth Verma) voted for a 25-bps rate cut.

- The tone of the meeting was still hawkish as reflected in the reiteration of the need for the monetary policy to remain actively disinflationary to bring the inflation down to a target of 4% and incomplete transmission of rate hikes.

- On the inflation front, the central bank revised its inflation forecast downward for Q4 FY24. Further, it pegged the forecast for FY25 at 4.5% but highlighted the risks from the uncertain food and energy prices considering the possibility of adverse weather events and geopolitical events causing supply-side disruptions.

- Meanwhile, it remained optimistic about the growth prospects as it pegged the FY25 forecast at 7.0% on account of improved agricultural sector activity, resilient manufacturing and services sectors and continued thrust on investment via the government's capital spending and pickup in private sector investments in select industries.

- On the stance, it was clarified that it should not be linked to the regular liquidity conditions and should be read in the context of the policy rate outlook as the former is affected by the exogenous factors, suggesting that the central bank will continue to manage evolving liquidity via two-way fine-tuning operations.

- Given the upbeat growth forecast and headline inflation remaining above the target, we do not expect any rate cut before Q2 FY25. Having said that, there is a possibility that rate cuts could be delayed further with the central bank showing minimal concerns about the growth and recognising the need to remain vigilant to navigate the last mile of disinflation successfully.

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RBI maintains status quo on policy rate and stance: tone remains hawkish without any signs of softening

In line with our expectations, the ***Reserve Bank of India (RBI) retained the key policy rate and the stance of withdrawal of accommodation*** in the first policy meeting of the calendar year 2024. The ***repo rate stands at 6.5%, 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%.*** While the voting for the stance was similar to that for the previous policy with a 5-1 vote split, what was rather interesting was the vote split on the rates as one of the external members (Prof Jayanth Verma) voted for a 25-bps rate cut.

Further, on the stance it was clarified (in the statement and the press conference) that it should not be linked to the regular liquidity conditions and should be read in the context of the policy rate outlook as the former is affected by exogenous factors. This suggests, that while the RBI will continue to conduct two-way fine-tuning operations to manage the evolving liquidity conditions, the stance will only be changed when the central bank intends to signal the change in policy rates.

The tone of the governor's address remained very much hawkish with a reiteration of the need for the monetary policy to remain actively disinflationary to bring down the inflation to a target of 4% and incomplete transmission of rate hikes. With no signs of softening in the policy tone, the markets reacted negatively, reflected in upward movement in bond yields and a fall in the equity indices.

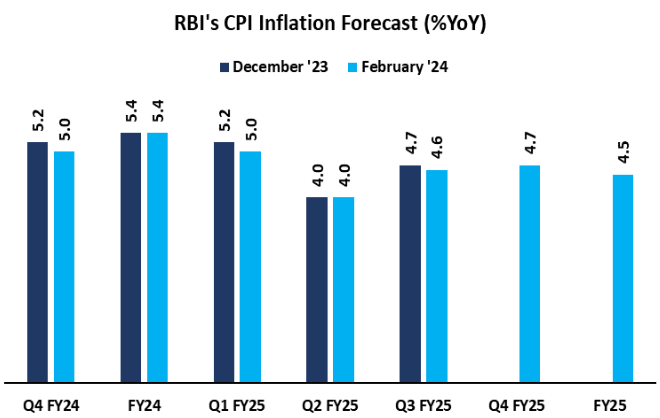
Rate cut to not begin before Q2 FY25

We retain our view of no rate cut before Q2 FY25 given that inflation is likely to remain at elevated levels up until Q1 FY25. For the outlook, the RBI sounded upbeat on the growth for FY25 – which potentially provides the policy space to remain tighter for longer. The RBI estimates on inflation suggest that inflation is likely to come down to an average of 4% in Q2 FY25, but then accelerate again to 4.7% by Q4 FY25. If the economic growth in this period aligns with the RBI's expectations and inflation continues to moderate, even if not in a straight line, the case for an easier monetary policy likely would be limited just to some fine-tuning much later in the year***. Therefore, we do not eliminate the possibility of easing being delayed further with the central bank showing minimal concerns about the growth and recognising the need to remain vigilant to navigate the last mile of disinflation successfully***.

Inflation outlook improves with quicker than expected disinflation recently

The RBI revised down its forecast for headline inflation in Q4 FY24 to 5% from 5.2% previously, likely driven by the faster normalising of food prices. Indeed, we expect inflation in the month of January to ease from the elevated level of 5.7% in December, based on the daily prices of food items like onions, tomatoes, and cereal, which were the major culprits behind elevated food inflation in November-December 2023 and supportive base effect. Additionally, Rabi sowing levels are now higher both on a yearly basis as well as compared to normal acreage, despite a delayed start of sowing activity this season and lower reservoir levels. That said, inflationary risks remain. The governor's statement highlighted that there is still considerable uncertainty associated with food inflation with the primary risk arising from adverse weather events. Furthermore, he pointed out volatility in the price of key commodities like crude oil owing to supply disruptions caused by increasing geopolitical tensions (referencing the Red Sea crisis).

The RBI revises down its inflation forecasts



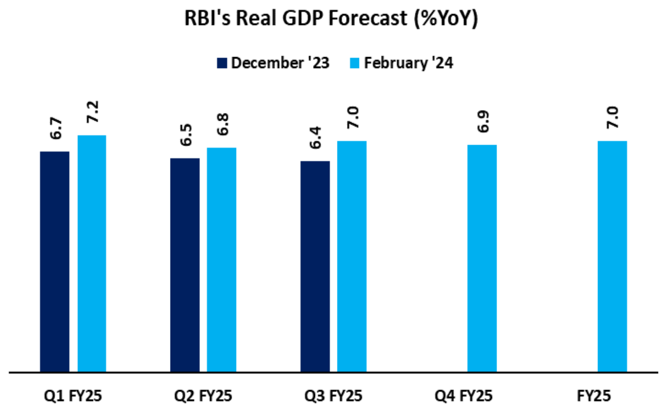
Source: RBI; Note: December '23 and February '24 refer to projections given by the RBI in its December 2023 and February 2024 MPC updates, respectively.

While the inflation forecast for the next fiscal year as well has been adjusted downwards, the tone towards prioritising inflation over GDP growth has not changed. ***The governor emphasised that "the job is not yet finished" and that "the monetary policy has to remain vigilant to ensure that we successfully navigate the last mile of disinflation".***

Growth outlook remains upbeat; activity momentum to continue in FY25

The RBI remains upbeat about India's growth prospects as it forecasts GDP growth in FY25 to be 7%. The central bank's optimism comes from the strong GDP growth momentum of FY24 (first advance estimates peg real GDP growth for FY24 at 7.3%) which it expects to continue in the next year.

The GDP forecasts are revised upwards



Source: RBI; Note: December '23 and February '24 refer to projections given by the RBI in its December 2023 and February 2024 MPC updates, respectively.

The RBI assesses activity in the agriculture sector to have recovered well despite a delayed start of sowing in the Rabi season and lower reservoir levels. Indeed, sowing activity has caught up to last year's levels (from a deficit of 6.5% two months ago) and stood at 109% of the normal area sown (as of 2nd February). Further support is expected to be provided by the allied sectors with continued strong activity momentum in horticulture and fisheries sub-sectors. The RBI highlighted positive signals from supply side indicators like consistently expansionary PMI readings, strong corporate profitability, strong domestic demand and stable global prospects as the reason for it to be bullish on manufacturing and services sectors. Furthermore, the construction sector is likely to remain a bright spot given the buoyant demand for residential housing and the continued focus of the government on pushing CAPEX.

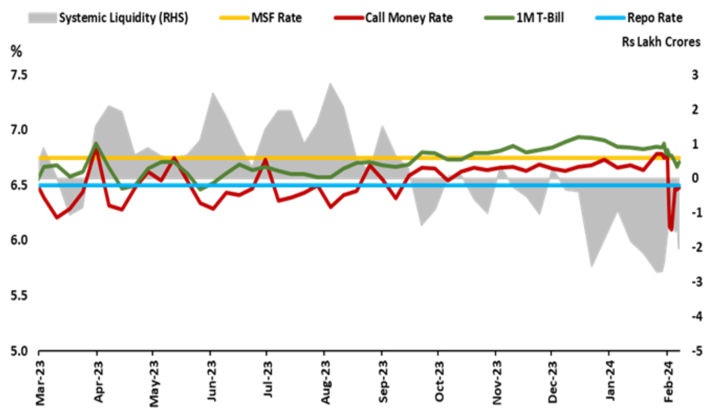
From the demand side, improvement in the performance of the agricultural sector is expected to help in rural demand recovery, early signs of which can be seen in the declining demand for work under the MNGREGA. The continuation of the food security scheme (PMGKAY) will further support rural consumption. The RBI remains hopeful of a revival in private investment supported by a larger flow of resources to the commercial sector and policy support from schemes such as the PLI. Signs of private investment revival are already being observed in industries like steel, petroleum, textiles, power, chemicals, food processing, and construction. Overall, the RBI revised up its quarterly profile of GDP forecasts for FY25 (Q1-Q3) by an average of 0.5pp.

No rate cuts before Q2 FY25; possibility of higher for longer remains

The RBI assesses that the cumulative effect of policy repo rate increases is still working its way through the economy. It stressed that the policy needs to remain actively disinflationary to anchor inflation expectations. Given that GDP growth is expected to remain robust and the RBI's emphasis on aligning the headline inflation to the target of 4% on a durable basis we remain of the view that there will be no rate cuts before Q2 FY25. With the US Fed not expected to cut at least until May (at the earliest), the RBI opting for a rate cut earlier than that seems highly unlikely.

The RBI has projected inflation in FY25 to average 4.5%. The quarterly profile suggests that inflation is likely to come down to an average of 4% in Q2 FY25, but then accelerate again to 4.7% by Q4 FY25. This suggests that room for substantial cuts is very limited and that interest rates could continue to remain higher for longer. The possibility of such a scenario will increase especially if persistently high food inflation spills over to other categories reversing the gains from the easing in core inflation.

Overnight call rates tracking closer to the repo rate following the VRRR auctions in the first week of Feb



Source: CMIE; Note: Data for Feb is till 7th Feb.

RBI to continue to conduct two-way fine-tuning operations to maintain overnight call rates closer to the repo rate

Liquidity conditions tightened significantly over the last couple of months with the average liquidity deficit increasing to Rs 2.1 lakh crore in January from Rs 1.2 lakh crore in December due to the currency leakage and the build-up of government cash balances. This led to the firming of the short-term rates with the overnight call rate hovering closer to the MSF rate. Therefore, the central bank has been proactively infusing liquidity via VRR (Variable Repo Rate) auctions since mid-December to keep the overnight rates below the MSF rate. This led to some easing of the liquidity deficit and moderation in the overnight call rate. With government spending picking up (over the past few weeks since mid-January) and increased foreign capital inflows in the debt market the overnight call rate slipped below the policy rate at the beginning of February. Consequently, the RBI conducted six-fine tuning VRRR (Variable Reverse Repo Rate) auctions signalling its intent to keep the overnight rates closer to the repo rate in line with the monetary policy stance of withdrawal of accommodation.

Looking ahead, with the government expenditure expected to pick up further in the coming months, liquidity conditions are likely to somewhat ease. The central bank will continue to manage the evolving liquidity conditions through its two-way fine-tuning operations.

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

Financial Market

- **Review of the Regulatory Framework for Electronic Trading Platforms (ETPs):**
  The RBI has decided to review the extant regulatory framework for ETPs (2018) and issue a revised version separately for stakeholders' feedback, following requests from market makers to access offshore ETPs offering permitted INR products. This decision comes as the market witnessed increased integration of the onshore forex market with offshore markets, notable technological advancements, and a rise in product diversity.

- **Hedging of Gold Price Risk in the Over-the-Counter (OTC) Market in the International Financial Services Centre (IFSC):**
  The RBI decided to allow resident entities to hedge gold prices in the IFSC's OTC segment to enhance their flexibility and facilitate easier access to derivative products for hedging gold price exposure.

Regulations

- **Key Fact Statement (KFS) for Retail and MSME Loans & Advances:**
  To benefit borrowers in making an informed decision the RBI decided to mandate all Regulated Entities (REs) to provide Key Fact Statement (KFS) to all retail and MSME loan borrowers. The KFS contains key information regarding loan agreements including the all-in-cost of the loan in a simple and easy to understand format.

Payment and FinTech

- **Enhancing the Robustness of AePS (Aadhaar Enabled Payment System):**
  To enhance the security of AePS transactions, the RBI proposed streamlining the onboarding process, including mandatory due diligence for AePS touchpoint operators, to be followed by banks. Moreover, additional fraud risk management requirements will also be considered for integration.

- **Principle-based Framework for Authentication of Digital Payment Transactions:**
  The RBI is proposing the adoption of a principle-based "Framework for Authentication of Digital Payment Transactions" to leverage technological innovations and provide alternative authentication methods, aiming to enhance digital security beyond the adopted SMS-based OTP.

- **Introduction of Programmability and Offline Functionality in Central Bank Digital Currency (CBDC) Pilot:**
  The RBI plans to expand CBDC Retail's use cases through programmability and offline features. The programmability addition to the Digital Rupee will allow transactions for specific or targeted purposes, while the offline functionality addition to the Digital Rupee will enable transactions in areas with poor or limited Internet access. Further, additional features like validity periods or geographical areas within which CDBC may be used can also be programmed. These enhancements will be gradually introduced through pilot programs.

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