07 June 2024

RBI maintains status quo and remains watchful of inflationary risks; rate cut unlikely before September

DMI FINANCE

- In today's monetary policy meeting, the RBI kept its policy rate, the repo rate, unchanged at 6.5% for the eighth consecutive monetary policy meeting while retaining the stance of withdrawal of accommodation.
- The divergence in views among the MPC members is growing, as reflected by the fact that the decisions on both the rate and the stance were not unanimous. Two MPC members voted to reduce the policy rate by 25 bps and change the stance to neutral, contrasting with only one member previously voting against the consensus.
- The tone of the governor's address is assessed to be cautiously hawkish. The governor emphasised that upside risks to inflation remain, and that the monetary policy should remain actively disinflationary to ensure fuller transmission and anchoring of inflation expectations.
- The RBI revised its growth forecast for FY25 up to 7.2% from 7.0%, likely driven by the stellar performance of the Indian economy in FY24. The central bank's outlook for FY25 remains bright, given positive signals from high-frequency indicators in April-May and the expectation of an above-normal monsoon, which should bode well for the agricultural sector and rural demand.
- On the inflation front, the RBI retained its FY25 inflation forecast at 4.5%. While it acknowledged the softening of core inflation and deflation in the fuel component, it remains concerned about the elevated level of food inflation and volatile global commodity prices.
- Despite the governor emphasising that the RBI's monetary policy decisions do not "follow the Fed", we believe that monetary policy in the US will continue to majorly influence the timing of a rate cut in India – which is generally a case for most emerging market economies.
- With market expectations of a Fed rate cut being pushed to September, and our assessment suggesting that September or even November could be the earliest possible timing for lower US policy rates, it seems highly unlikely that the RBI will opt for a rate cut before then.
- As such, we assign a higher probability to a rate cut happening in the final three months of the calendar year (Q3 FY25) v/s in August. Further, we continue to believe that the room for substantial cuts will be limited in FY25 given that headline inflation is expected to accelerate again towards the end of the year.
- Regarding liquidity, we expect liquidity conditions to ease due to a revival in government spending post-budget and foreign inflows due to India's inclusion in global bond indices. The RBI will remain flexible and nimble in managing evolving liquidity dynamics.

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

Yuva Simha
Economist
yuva.simha@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

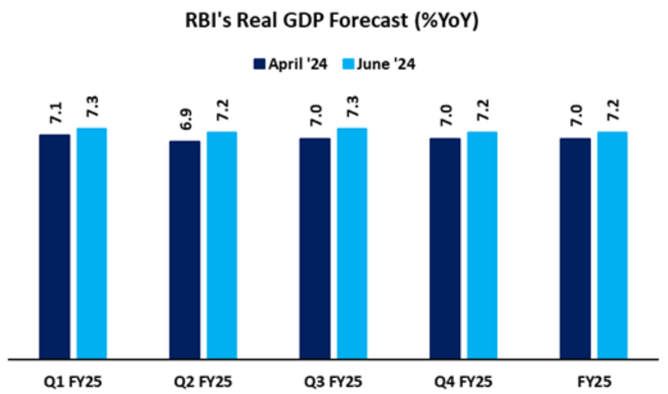
Status quo for the eighth consecutive time

In line with market expectations, the monetary policy committee (MPC) decided to keep the ***repo rate unchanged at 6.50%***, while ***retaining the stance of withdrawal of accommodation*** in its second meeting of FY25. Consequently, the ***Standing Deposit Facility (SDF) Rate remains at 6.25%***, and the ***Marginal Standing Facility (MSF) Rate and Bank Rate remain at 6.75%***. The divergence in views among the MPC members is growing, as reflected by the fact that the decisions on both the rate and the stance were not unanimous. ***Two MPC members, Dr Ashima Goyal and Prof Jayanth Varma, voted to reduce the policy rate by 25 bps and change the stance to neutral.*** In the previous meeting, Prof Varma was the only one who voted against the consensus.

Tone has remained hawkish; caution on inflation remains

The tone of the governor's statement is assessed to be cautiously hawkish. ***In his statement, the governor emphasised the need for monetary policy to remain disinflationary to ensure anchoring of inflation expectations and fuller transmission amid risks persisting from food inflation, continuing geopolitical conflicts, supply disruptions and commodity price volatility***. He noted that resilience of economic growth provides greater elbow room to pursue price stability to ensure that inflation aligns with the target (4%) on a durable basis. Given there was no major surprise in the monetary policy decision, the 10Y G-Sec yield barely moved after the announcement and was trading at 7.02% at the time of writing.

Growth forecast revised up on better-than-expected FY24 growth

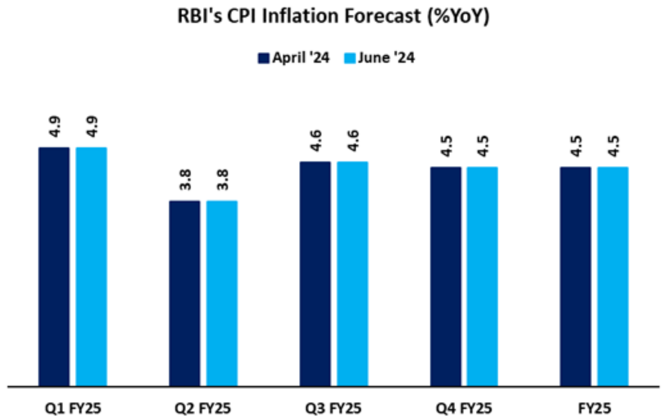


Source: RBI; Note: April '24 and June '24 refer to projections given by the RBI in its April 2024 and June 2024 MPC updates respectively.

The RBI revised up its growth forecast for FY25, likely driven by the stellar performance of the Indian economy in FY24. The economy grew by 8.2% in FY24, which was much higher than the second advance estimate of 7.6%. Growth in FY24 was mainly driven by a healthy pace of investment spending while consumption demand remained muted.

Data on early high-frequency indicators for April-May 2024 from both the demand and supply sides suggest that domestic economic activity has maintained resilience. The RBI's assessment of the outlook ahead remains positive given the IMD's forecast of an above-normal monsoon which should bode well for the agricultural sector and aid rural demand recovery. The government's continued push on CAPEX, healthy banks and corporates' balance sheets, improving capacity utilisation, and business optimism augur well for investment activity. Overall, the central bank now expects real GDP to grow by 7.2% in FY25, compared with a previous forecast of 7%.

Outlook on inflation maintained



Source: RBI; Note: April '24 and June '24 refer to projections given by the RBI in its April 2024 and June 2024 MPC updates respectively.

The RBI retained its FY25 inflation forecast at 4.5%. While it acknowledged the softening of core inflation and deflation in the fuel component, it remains concerned about the elevated level of food inflation. It also remains wary of higher prices of food and industrial metals in the global market, which could exacerbate the input cost pressures for firms. The trajectory of crude oil prices remains uncertain due to geo-political tensions. Although the outlook for food inflation, based on the forecast of an above-normal monsoon appears to be improving, the RBI is likely to continue to err on the side of caution and maintain a pause to assess the impact of the hot summer season and the impending monsoon on food prices.

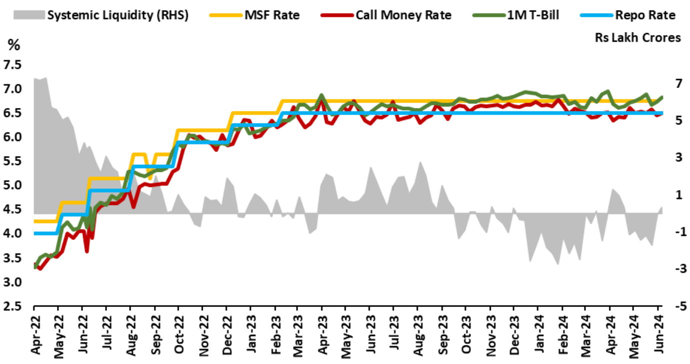
Expect a pause in August as well; rate cut likely in Q3 FY25

We retain our view that the RBI is likely to wait and watch the progress of the southwest monsoon to judge its impact on food prices before pivoting. Despite the governor emphasising that the RBI's monetary policy decisions do not “follow the Fed”, we believe that monetary policy in the US will continue to majorly influence the timing of a rate cut in India – which is generally a case for most emerging market economies. With market expectations of a Fed rate cut being pushed to September, and our assessment suggesting that September or even November could be the earliest possible timing for lower US policy rates, it seems highly unlikely that the RBI will opt for a rate cut before then. Given the tight control that the RBI maintains over the INR exchange rate, it would like to avoid introducing further volatility in the foreign exchange market by narrowing the interest rate differential with the US (which is already at historic lows). As such, ***we assign a higher probability to a rate cut happening in the final three months of the calendar year (Q3 FY25) v/s August. Further, we continue to believe that the room for substantial cuts will be limited in FY25 given that headline inflation is expected to accelerate again towards the end of the year and the prospect of continued favourable domestic economic growth.***

The RBI will remain flexible and nimble in managing evolving liquidity dynamics

Regarding the liquidity management approach, there were no changes in the governor’s statement as it stated that the central bank would continue to remain flexible and nimble in managing liquidity through its two-way, main, and fine-tuning operations. Liquidity conditions tightened significantly in May with average liquidity declining from a surplus of Rs. 0.15 lakh crore in April to a deficit of Rs. 1.4 lakh crore in May due to subdued government spending amidst the elections and outflows related to the goods and services tax. Consequently, the RBI conducted VRR auctions to inject liquidity in the latter part of April and May. Despite tightening of the systemic liquidity, the core liquidity remained in surplus due to elevated government cash balances which have further risen on account of the RBI’s record dividend transfer to the government of Rs 2.1 lakh crore. This has provided the government with the space to slash the first quarter borrowings (T-bill issuances) by Rs 60K crore, which potentially kept the short-term rates closer to the repo rate throughout May. In June, the liquidity again turned into a surplus, with average liquidity tracking at Rs. 0.4 lakh crore (data till 6th June) likely due to government month-end spending. Therefore, the RBI conducted VRRR auctions to mop up the excess liquidity in the system. Looking ahead, liquidity is expected to improve supported by the revival in government spending after the budget is announced in July and foreign inflows owing to India’s inclusion in the global indices. While the RBI refrained from explicitly addressing liquidity management regarding foreign inflows (post the bond inclusion), it is expected to remain active in managing excess liquidity to keep the overnight rate closer to the policy rate.

Overnight rates mirror the policy rate in April and May



Source: CMIE Note: Data till 6th June.

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

Regulations

- **Review of Limit of Bulk Deposits in Banks:**
  The RBI proposed revising the bulk deposit definition to 'Single Rupee term deposit of ₹3 crore and above' for Scheduled Commercial Banks (SCBs) and Small Finance Banks (SFBs) from 2 crore previously while setting it at '₹1 crore and above' for Local Area Banks, aligning with Regional Rural Banks (RRBs).

- **Rationalisation of Guidelines for Export and Imports under FEMA:**
  The RBI proposed to rationalize the existing FEMA guidelines on exports and imports of goods and services to facilitate international trade and liberalize foreign exchange regulations. This move is intended to promote ease of doing business and provide greater operational flexibility to Authorized Dealer Banks. Draft guidelines on the proposed changes will be issued shortly to seek stakeholder feedback.

- **Setting up a Digital Payments Intelligence Platform:**
  The RBI aims to bolster digital payments' safety and security amidst rising fraud cases. To address this, they propose establishing a Digital Payments Intelligence Platform for real-time data sharing across the ecosystem. A committee has been formed to advance this initiative.

Payment and FinTech

- **Expanding e-Mandate for Auto-Replenishment in Recurring Payments:**
  The RBI proposes expanding the e-Mandate framework to cover recurring payments like Fastag and National Common Mobility Card (NCMC)

balance replenishments, enhancing customer convenience in travel-related transactions. Given these payments do not occur periodically, the replenishment will be triggered when the balance in Fastag or NCMC falls below a certain threshold.

- **Auto-Replenishment of UPI Lite Wallet Added to e-Mandate Framework:**
  The RBI suggests integrating UPI Lite into the e-Mandate framework, allowing customers to refill their wallets when balances dip below preset limits automatically. This move aims to encourage wider adoption of UPI Lite and streamline small value digital payments for enhanced convenience.

RBI initiatives

- **HARBINGER 2024 – Innovation for Transformation:**
  The RBI has spearheaded various initiatives to promote fintech innovation, including the global hackathon "HaRBInger - Innovation for Transformation." Following successful editions in 2022 and 2023, the third edition, "HaRBInger 2024," focusing on 'Zero Financial Frauds' and 'Being Divyang Friendly,' is set to launch soon.