08 August 2024

Status quo on rates; RBI remains watchful of food inflation risks

- In today's monetary policy meeting, the RBI kept its policy rate, the repo rate, unchanged at 6.5% for the ninth consecutive monetary policy meeting while retaining the stance of withdrawal of accommodation.

- As in the June policy meeting, two external members (Dr. Ashima Goyal and Prof. Varma) voted for a 25 bps cut and change in stance to neutral.

- The overall tone of the policy remained hawkish amidst the uncertainty on food inflation. The governor noted that food price pressures cannot be ignored, and the persistently high food inflation could unanchor inflation expectations and lead to spillovers to core inflation.

- With no softening in the tone of the policy and an upward revision of the Q2 inflation forecast we now assign a higher likelihood of a rate cut in December as opposed to October. Moreover, the RBI will have a better understanding of the Fed's rate trajectory by then.

- We also believe that the room for substantial cuts will be limited in FY25 given that inflation is expected to edge higher in Q3 as the base effect wanes.

- On the inflation front, the RBI retained its FY25 inflation forecast at 4.5%. While it acknowledged the softening in the core inflation, the elevated level of food inflation has led to the revision of the Q2 forecast upwards by 60 bps.

- We expect food inflation to ease ahead getting support from the improved spatial distribution of rainfall in the second half of the monsoon season. However, we expect core inflation to edge up on account of fading of the favourable base effect, the passing on of higher input costs to consumers, and the recent telecom tariff hikes.

- The central bank's growth outlook for FY25 remains bright, supported by improving agriculture performance, robust manufacturing and services, and a favourable environment for pick-up in investments. Meanwhile, geopolitical tensions and global market volatility pose risks.

- Regarding liquidity, we expect it to remain in surplus due to potential pick-up in government spending post elections, rising foreign capital inflows amidst India's bond inclusion in global index and RBI's intervention in forex market.

Bhawna Sachdeva
Economist
bhawna.sachdeva@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 ninth consecutive time

In line with the broader 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 today's monetary policy meeting. 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***%. As in the June meeting, the Monetary Policy Committee (MPC) was divided on both the interest rate and policy stance. ***Two external members, Dr. Ashima Goyal and Prof. Jayanth Varma dissented, advocating for a 25 bps rate reduction and a neutral stance.***

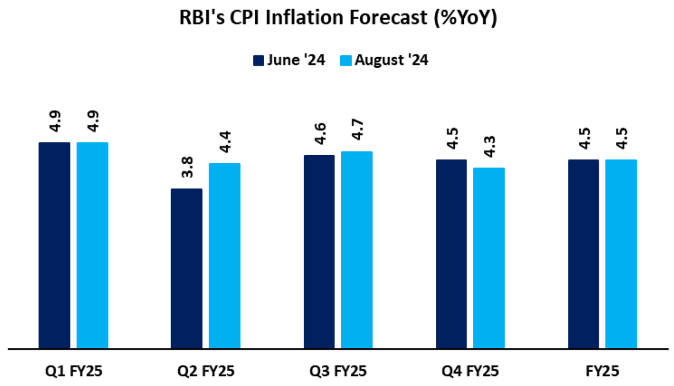
Tone remains hawkish amidst the uncertainty on food inflation

While the market was anticipating some dovish signals from today's policy, especially amidst the higher likelihood of a rate cut in the US in September, the tone of the policy displayed no signs of softening. ***The overall tone of the policy remained hawkish amidst elevated food prices***. In fact, given the momentum of food prices, the inflation projection for Q2 is revised upward by 60 bps to 4.4%. ***In his statement***, ***the governor noted that while core inflation is moderating the risks from food inflation cannot be ignored given the high share of food in the consumption basket. Further, the persistently high food inflation could unanchor inflation expectations and lead to spillovers to core inflation***. Therefore, there is a need for the monetary policy to remain disinflationary to prevent any second-round impact of food inflation. ***Strong domestic growth provides policy space for the RBI to focus on achieving price stability***. Given there was no major surprise in the monetary policy decision, the 10Y G-Sec yield barely budged after the announcement and was trading at 6.87% at the time of writing.

Rate cut not expected before December

We had earlier communicated a likelihood of a rate cut in Q3 FY25 contingent on monsoon completion and a clearer picture of the food inflation trajectory. ***We continue to retain our view however gauging the tone of the policy to be hawkish and an upward revision of the Q2 inflation forecast we now assign a higher likelihood of a rate cut in December as opposed to October.*** Moreover, the RBI will have a better understanding of the Fed's rate trajectory by then. Further, we continue to believe that the room for substantial cuts will be limited in FY25 given that inflation is expected to edge higher in Q3 as the base effect wanes.

Inflation projection for FY25 retained with tweaks in the quarterly profile

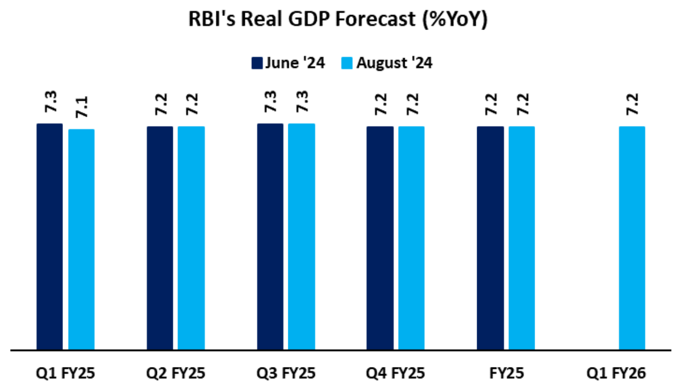


Source: RBI; Note: June '24 and August '24 refer to projections given by the RBI in its June 2024 and August 2024 MPC updates respectively.

The RBI retained its inflation forecast for FY25 at 4.5% but adjusted its quarterly profile. While it acknowledged the softening in core inflation, the elevated level of food inflation has led to the revision of the Q2 forecast upwards by 60 bps. Meanwhile, the Q3 and Q4 projections were fine-tuned a little from 4.6% and 4.5% earlier to 4.7% and 4.3% respectively. For Q1 FY26, the RBI projects inflation at around 4.4%.

Food inflation was tracking closer to 8% in Q1 FY25 but is expected to moderate ahead getting some support from the above-normal rainfall, more specifically in the second half of the monsoon season with IMD projecting a normal rainfall in Kharif sowing states of North-west and East India which have received deficient rainfall in June-July. However, we do expect some edging up of the core inflation on account of fading of the favourable base effect, producers reporting passing on the higher input cost to the consumer (based on PMI surveys) and the recent telecom tariff hikes. Overall, we expect inflation to print slightly above the RBI's forecast at ~4.6%.

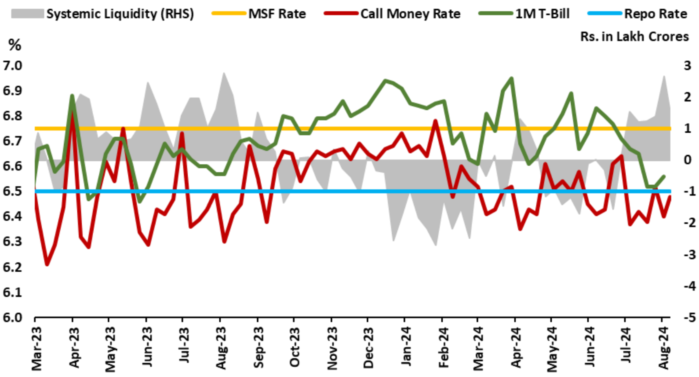
Growth forecast remained unchanged at 7.2% with adjustments in quarterly forecasts



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

The RBI remained upbeat on economic growth in FY25. In the agriculture sector, sowing has improved with the progress of the southwest monsoon, although the spatial distribution continues to pose a concern. This is likely to improve in the second half of the monsoon season. This in turn should bode well for the rural demand which is indeed showing some signs of recovery with improvement in non-durable output, and declining employment demanded under MNREGA etc. Furthermore, momentum in the manufacturing and services sector (in July both manufacturing and services PMI readings indicate robust expansion) is expected to sustain. Robust government capital expenditure, healthy corporates' and banks' balance sheets and rising capacity utilisation are all positive signs for investment activity. External demand for goods and services is also expected to improve with improving global trade prospects. On the flip side, geopolitical tensions and volatile global financial markets are likely to pose downside risks to growth. Overall, the RBI retained the growth forecast for FY25 at 7.2% (lower than our estimate of 6.9%-7.0%) with a marginal downward revision to the Q1 projection due to moderation observed in select high-frequency indicators including government expenditure and corporate profitability indicators. For Q1 FY26, the growth is projected at 7.2%.

The RBI will remain flexible and nimble in managing evolving liquidity dynamics to align overnight rates to policy rate



Source: CMIE Note: Data till 7th August.

Regarding the liquidity management approach, there were no changes in the governor's statement as it stated that the central bank will continue to remain flexible and nimble in managing evolving liquidity conditions to ensure that money market interest rates evolve in an orderly manner. Liquidity conditions eased significantly in July with average liquidity turning into a surplus of Rs. 1.1 lakh crores from a deficit of Rs. 0.5 lakh crore with a pick-up in the government expenditure and the RBI's intervention in the forex market (visible in the US dollar purchases by the RBI). The surplus intensified in August with average banking liquidity increasing to Rs. 2.5 lakh crores. Consequently, the RBI has been conducting VRRRs (Variable Reverse Repo Rate auctions) to mop up excess liquidity and to align the overnight rate closer to the policy rate. Indeed, the weighted average call rate was tracking at around 6.48% yesterday. Looking ahead, we expect the liquidity surplus to increase further given the foreign capital inflows due to India's ongoing inclusion in the global bond index, a potential pick-up in government spending post elections and the RBI's intervention to contain any sharp volatility in the rupee.

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

Regulations

- **Public Repository of Digital Lending Apps:**
  The RBI proposed creating a public repository for digital lending apps (DLAs) deployed by its regulated entities. These entities will be required to report and update their DLAs in this repository, helping consumers identify unauthorized lending apps and supporting the orderly development of the digital lending ecosystem in India.

- **Frequency of Reporting of Credit Information to Credit Information Companies:**
  The RBI proposed increasing the frequency of reporting credit information to credit information companies (CICs) from monthly to fortnightly or shorter intervals. This will ensure faster updates of borrowers' credit information, particularly upon loan repayment, and enable lenders to better assess borrower risk.

Payment and FinTech

- **Enhancing Transaction Limit for Tax Payments through UPI:**
  The RBI proposes enhancing the transaction limit for tax payments through UPI from ₹1 lakh to ₹5 lakh per transaction. This increase will ease tax payments for consumers using UPI.

- **Introduction of 'Delegated Payments' through UPI:**
  The RBI proposes introducing a "Delegated Payments" facility in UPI, allowing a primary user to authorize another individual (secondary user) to make UPI transactions up to a limit from the primary user's bank account without needing a separate UPI-linked bank account. This will enhance the reach and usage of digital payments.

- **Continuous Clearing of Cheques:**
  The RBI proposes reducing the cheque clearing cycle by introducing continuous clearing with 'on-realisation-settlement' in the Cheque Truncation System (CTS). This change will enable cheques to

be cleared within a few hours on the day of presentation, speeding up cheque payments and benefiting both the payer and the payee.