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The RBI Leaves the Policy Repo Rate Unchanged; Takes Action to Boost Liquidity and Credit Flow

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- As expected, the RBI's Monetary Policy Committee (MPC) left the policy repo rate unchanged at 6.5% and the policy stance at "neutral", to remain unambiguously focused on a durable alignment of inflation with the target, while supporting growth.
- In line with our view, the RBI announced measures to address liquidity challenges and boost sectoral credit, thereby supporting economic growth.
- The RBI announced a reduction in the Cash Reserve Ratio of all banks by 50 basis points (bps) to 4.0% of Net Demand and Time Liabilities, bringing it back to the pre-COVID level. This will inject primary liquidity of ~Rs 1.16 lakh crore into the banking system, potentially supporting credit growth.
- It raised the limit for collateral-free agriculture loans from Rs 1.6 lakh to Rs 2 lakh per borrower, a move aimed at increasing credit access for small and marginal farmers.
- It also announced an increase in the interest rate ceilings on Foreign Currency Non-Resident Bank (FCNR(B)) deposits, which could boost capital inflows and relieve some pressures from the exchange rate.
- Given the recent surprise on inflation and growth prints, the RBI cut the FY25 projections for economic growth by 60bps to 6.6% and revised up the CPI headline inflation forecast by 30bps to 4.8%.
- It expects economic growth to pick up in H2 FY25 and inflation to come down going forward. The central bank noted that it remains committed to restoring the balance between inflation and growth, which has become unsettled recently.
- With the CRR cut in this meeting, we expect the next policy move to be a policy repo rate cut in February'2025, assuming there are no major shocks in the interim and inflation follows the expected trajectory.

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RBI kept the policy rate unchanged but announced a CRR cut and measures to boost sectoral credit

The RBI's MPC met in the backdrop of a sharper-than-anticipated slowdown in India's economic growth, a significant rise in inflationary pressures led by food prices and continued global market volatility. ***Against this backdrop, the RBI decided to keep the repo rate unchanged at 6.50% and retained the policy stance at "neutral".*** Accordingly, 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%. The divergence in views among the MPC members is becoming increasingly clear with two members voting for a rate cut compared to one member in the previous meeting. ***We assess the overall tone of the policy to be balanced.***

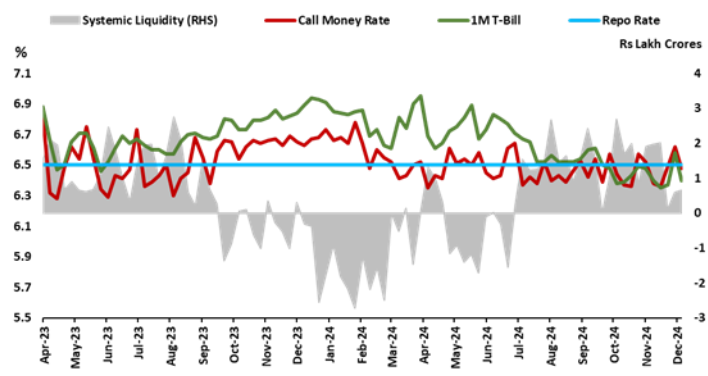
In view of the need for a policy response to support economic growth and address liquidity pressures, ***the RBI announced a cut in the Cash Reserve Ratio (CRR) and measures to stimulate sectoral credit***. It raised the limit for collateral-free agriculture loans from Rs 1.6 lakh to Rs 2 lakh per borrower, to facilitate an increase in credit access for small and marginal farmers. It also announced measures to boost capital inflows, which could relieve some pressures from the exchange rate. As anticipated, it also cut its FY25 projection for economic growth and revised up the CPI headline inflation forecast. It noted that it remains committed to restoring the balance between inflation and growth, which has become unsettled recently. It expects economic growth to pick-up in H2-FY25 and inflation to come down in coming quarters.

The RBI's policy decisions announced today are aimed at boosting liquidity, supporting sectoral credit flow, and stabilizing the currency while keeping the focus on controlling inflation. With the CRR cut in this meeting, ***we expect the next policy move to be a policy repo rate cut in February'2025,*** contingent on no major shocks in the interim and inflation following the expected trajectory. By February, there will also be more clarity on the next US administration's trade policy plans which may potentially weigh on global trade and supply chains with risks of spillover to India. Further, the progress of Rabi sowing by that time will help assess the trajectory of food inflation, which has played a pivotal role in shaping headline inflation.

RBI announced a cut in CRR to resolve the tightening in liquidity and support economic growth

On the liquidity front, the RBI today announced a reduction of 50 bps in CRR, bringing it back to the pre-pandemic level of 4.0% of Net Demand and Time Liabilities (NDTL). This will be implemented in two tranches each of 25 bps, with the first tranche effective from December 14, 2024, and the second from December 28, 2024. The RBI Governor noted that the CRR was last increased in May 2022 as a *"temporary measure"*, and it has *"served its purpose and it was time to normalise it"*. As per the RBI, this measure is expected to infuse liquidity of Rs 1.16 lakh crores in the banking system. The measure was taken in response to the recent tightening in liquidity and to ease the potential liquidity stress. Systemic liquidity may tighten in the coming months due to tax outflows, increase in currency in circulation and volatility in capital flows. In recent months, the RBI's FX intervention to support the rupee has already led to liquidity tightness. Indeed, the systemic liquidity surplus declined from an average of Rs 1.5 lakh crores in October to Rs 0.2 lakh crore in the last week of November. In response to the same, overnight weighted call rates rose above the policy rate at 6.62% in the week ending November 29th. The RBI also announced VRR operations during this period to infuse liquidity. Since then, the liquidity surplus has slightly improved to Rs 0.8 lakh crore in the first week of December with overnight rates hovering closer to the policy rate. The CRR cut announced today will help ease these and any future pressures on the liquidity front. We do not rule out further measures to address any future liquidity challenges, through Open Market Operations and longer-tenor Variable Rate Repo (VRR) operations, etc. Further, the RBI reiterated that it would continue to remain nimble and proactive in managing the evolving liquidity conditions. To attract capital inflows and support the exchange rate, the RBI also increased the interest rate ceilings on FCNR(B) deposits (details shared in the section below). This will also help banks by boosting their deposits and thereby potentially reducing the elevated Loan-Deposit ratio.

Systemic liquidity fell sharply in recent weeks



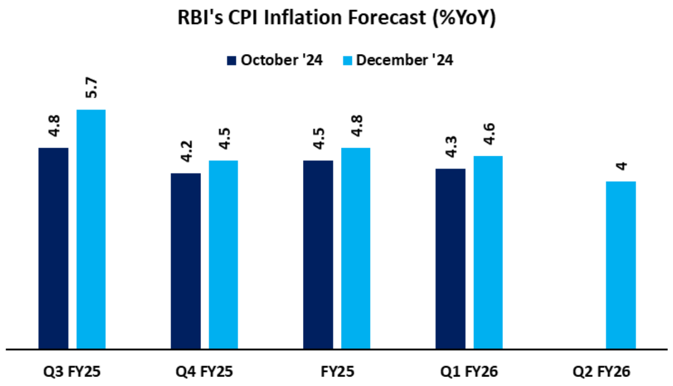
Source: CMIE; Note: Data is till December 5th.

Inflation forecast revised upwards to 4.8% in FY25

The RBI recalibrated its inflation projection for FY25 as food inflation remains elevated and easing is expected only Q4 onwards. Indeed, inflation had surged to 6.2% in October, beyond the upper threshold of the RBI's inflation target. It is expected to decline in November due to moderating vegetable prices but is likely to remain elevated.

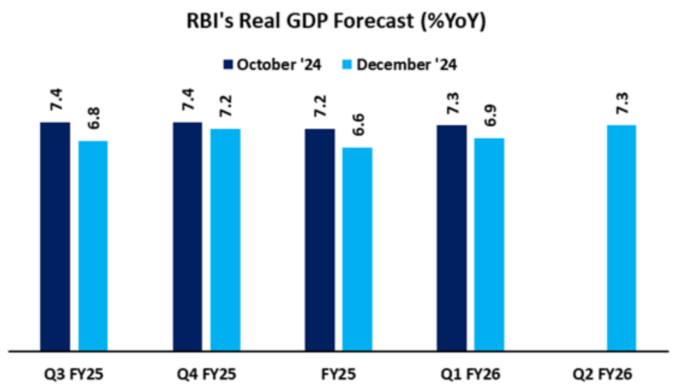
Accordingly, the RBI has revised the inflation projection for FY25 upwards to 4.8% from 4.5% previously, with Q3 and Q4 estimates now at 5.7% and 4.5% respectively compared to 4.8% and 4.2% earlier. The inflation forecast for Q1 FY26 has also been revised upwards to 4.6% from 4.3% in the previous meeting while it is forecasted at 4.0% for Q2. The anticipated easing in inflationary pressures in upcoming quarters is expected to gain support from the seasonal winter correction in vegetable prices, Kharif harvest arrivals and the promising prospect of rabi sowing on the back of healthy reservoir levels which are tracking comfortably above the decadal average. On the other hand, the upside risk to inflation from a hike in import duty for edible oils and passing of the higher input prices to the consumers is expected to persist.

Inflation forecast revised upwards across all quarters



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

Growth forecast for FY25 is revised downwards to 6.6%



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

The RBI downgraded its real GDP growth projection for FY25 by 60 bps from 7.2% previously to 6.6% due to the larger-than-expected deceleration in Q2 FY25 when economic growth fell to a seven-quarter low of 5.4%. This was led by a disappointing performance of the industrial sector with growth faltering in all three segments i.e. manufacturing, mining and electricity. The RBI assessed that economic growth has likely bottomed out in Q2 with improvement expected in H2 FY25. Demand is expected to be aided by the continued rebound in rural demand supported by the pick-up in the agricultural sector. Government expenditure is expected to improve. Meanwhile, investment will be led by the revival in government capital spending and tentative signs of improvement in private sector investments. That said, we continue to note the risks from softer domestic conditions and heightened global uncertainty acting as a deterrent to the broader pick-up in private investment. On the supply side, industrial activity will gather momentum with the fading of the extended monsoon which had disproportionately impacted the mining and electricity sectors. Overall, the RBI has estimated economic growth for Q3 and Q4 at 6.8% and 7.2% respectively lower than the previous estimate of 7.4% in both quarters. For FY26, the growth for Q1 and Q2 is projected at 6.9% and 7.3% respectively.

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

Liquidity & Financial Markets

- **Foreign Currency Non-Resident Bank (FCNR(B)) Deposits:** To attract capital inflows, the RBI increased the interest rate ceilings on FCNR(B) deposits. For fresh deposits with maturities between 1 and 3 years, banks can now offer rates up to the Annual Rate of Return (ARR) plus 400 bps (previously 250 bps). For fresh deposits with maturities between 3 and 5 years, the rate cap is raised to ARR plus 500 bps (previously 350 bps). This relaxation, available until March 31, 2025, aims to enhance foreign capital inflows, which can support the Indian currency.

- **Expanding the reach of the FX-Retail Platform through linkages with Bharat Connect:** To expand the reach of the FX-Retail platform, the RBI decided to link the FX-Retail platform with Bharat Connect operated by NPCI (National Payment Corporation of India) Bharat Connect. The first phase will allow users (individuals and sole proprietors) to purchase US dollars against the rupee through bank and payment apps integrated with Bharat Connect. The platform's scope will later expand to include other FX transactions including the sale of US Dollars against the Rupee and other categories of users.

- **Introduction of the Secured Overnight Rupee Rate (SORR) – a benchmark based on the secured money markets:** The RBI had set up the

Committee on the MIBOR Benchmark to review the Rupee interest rate benchmarks in the country, including the usage of Mumbai Interbank Outright Rate (MIBOR). In line with the recommendations of the committee, the RBI today proposed to develop a benchmark based on the secured money markets (both basket repo and TREP) – the Secured Overnight Rupee Rate (SORR).

Regulation & Communication

- **'Connect 2 Regulate' – An Initiative for Open Regulation:** The RBI will launch the 'Connect 2 Regulate' initiative which will allow stakeholders to contribute ideas and inputs on regulatory topics through case studies and concept notes via a dedicated section on the RBI website.

- **Introduction of podcast facility as an additional medium of communication:** The RBI will launch podcasts for wider dissemination of information that is of interest to the general public.

Payment Systems

- **Pre-sanctioned Credit Lines through UPI – Extending the scope to SFBs:** To expand the reach of credit on UPI, the RBI has now allowed Small Finance Banks (SFBs) to extend pre-sanctioned credit lines through the UPI. In September 2023, the scope of UPI was expanded by enabling pre-sanctioned credit lines to be linked through UPI and used as a funding account by Scheduled Commercial Banks excluding Payments Banks, SFBs and Regional Rural Banks.

Fintech

- **Framework for Responsible and Ethical Enablement of Artificial Intelligence (FREE-AI) in the Financial Sector – Setting up of a committee:** The RBI has proposed forming a committee of experts from diverse fields to recommend a framework for the responsible and ethical use of AI (FREE-AI) in the financial sector to leverage transformative technologies while addressing key risks.

- **AI solutions to identify mule bank accounts - MuleHunter.AI™:** The central bank continues to take steps to combat digital fraud, including guidelines for strengthening cybersecurity and transaction monitoring. It is running a "Zero Financial Frauds" hackathon to address the issue of mule accounts and piloting an AI/ML-based model, MuleHunter.AITM, to detect these accounts. It encouraged banks to collaborate with RBIH to further develop the MuleHunter.AITM initiative to deal with the issue of mule bank accounts.

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