Monetary policy | First cut

Job not over, says Mint Road

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Stays unmoved on rates and stance, eyes durable inflation reduction

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) held rates steady for the sixth straight time at its review meeting on Thursday. It also continued its stance of 'withdrawal of accomodation'. The MPC is steadfastly pursuing two goals; (i) complete transmission of its 250 basis points (bps) rate hike in this cycle; and (ii) aligning headline inflation to its target of 4% on a durable basis.

Our view:

With this decision of 'no change', the entire fiscal 2024 now has seen no movement on the policy rate and no alteration in the stance. Yet, interest rates in the market have risen. The interbank call money rate is 25 basis points (bps) higher than its March 2023 level, and so is the one-year marginal lending facility rate (MCLR).

This fiscal, the central bank leaned on liqudity management (details below) to improve the transmission of its rate hikes to lending rates. The MPC believes this is the way forward for the next few months as well.

We believe slowing inflation despite food price hiccups, a smaller fiscal deficit and an imminent turn in the US Federal Reserve policy rates will create the ground for the MPC to start cutting rates. But the RBI is wary of doing so too early, or even changing its stance as inflation is not yet firmly under control.

We believe more clarity on the path of disinflation – shaped by food prices and the trend in crude oil prices given the tensions around the Red Sea — could push this decision at least to June 2024, if not later. While consumer price inflation (CPI) has remained in the RBI's tolerance band of 2-6% since August, it still is away from its 4% target and that keeps the MPC on watch.

Highlights from February monetary policy review

- The MPC voted with a 5-1 majority to keep policy rates unchanged. The repo rate remains at 6.50%, standing deposit facility (SDF) at 6.25% and marginal standing facility (MSF) at 6.75%
- The monetary policy stance of 'withdrawal of accommodation' was maintained with a 5-1 majority
- The consumer price inflation (CPI) forecast stands at 4.5% for fiscal 2025, down from an estimated 5.4% in the current fiscal. The MPC forecasts inflation to peak at 5% in the first quarter of fiscal 2025 and then moderate to reach 4.7% in the fourth quarter
- India's GDP growth is forecast to slow a tad to 7% for fiscal 2025 from 7.3% this fiscal, with quarterly estimates revised up from the previous forecast.

What is influencing the MPC's decision?

- **Growth exceeded expectations:** GDP growth in fiscal 2024 came in higher-than-expected at 7.3%, and also further up from 7.2% in fiscal 2023. The RBI expects GDP growth to remain strong at 7% in fiscal 2025. The

MPC believes resilient manufacuring and services sectors, improving domestic consumption and capex (both private and government) will be supportive of growth.

CRISIL, however, expects GDP growth of 6.4% in fiscal 2025 due to the impact of somewhat slower growth in key trade partners and high domestic interest rates that should moderate demand. The government's budgetary focus on capex and increased support to rural employment and incomes will provide some support to domestic demand. Escalation of geopolitical strife and weather-related risks remain monitorable.

- **Food, the biggest risk to inflaiton:** Between April and December 2023, although overall inflation softened by ~130 bps on-year, on average, food inflation rose 15 bps and offset the 230 bps drop in non-food inflation. Even the flare-up in the gauge after October has been because of higher food prices. Meanwhile, core inflation below 4% implies easing input price pressure on producers and thereby on consumers. Going into fiscal 2025, the MPC expects CPI inflation to soften to 4.5% average, with risks evenly balanced.

  CRISIL's inflation forecast is also at 4.5% average for fiscal 2025. Stubborn food prices, particularly, of some key food items such as cereals and pulses remain a concern. Also, a mild upside to core inflation needs monitoring as commodity prices are unlikley to come down at the same pace as they did this fiscal. This, coupled with a low-base effect, could mean a slight uptick in non-food inflation. Crude oil prices will also be monitorable given the disturbances along the critical Red Sea trade route.

- **Transmission to lending and deposit rates is work in progress:** The RBI has raised the repo rate by 250 bps since May 2022. However, this has not been completely transmitted to lending and deposit rates. The RBI is using liquidity tools to speed up this process. To be sure, the deposit rate, which was steady for the last 3 months, rose 5 bps in January and vehicle loan rates increased 2 bps.

  On the other hand, money market rates have risen at a faster pace than the repo rate due to tighter systemic liquidity, which has driven up rates over the past few months.

- **Fiscal prudence will support monetary policy:** The Interim Budget has lowered the fiscal deficit target to 5.1% for fiscal 2025 from a revised 5.8% in fiscal 2024 and remains committed to bringing down the fiscal deficit to ~4.5% of GDP by fiscal 2026. A lower fiscal deficit would, create headroom for the central bank to start easing policy rates this year. The budget is also non-inflationary with most of the rural support focused on asset creating and employment generating schemes such as NREGA, and housing and rural road construction.

- **Soon, systemically central banks will begin to move:** Several key central banks including the US Fed, the European Central Bank (ECB) and Bank of England have held interest rates steady at their latest meetings. In fact, the Fed has also hinted at a faster easing path with its dot plot projecting the key interest rate at 4.6% by 2024-end compared with 5.1% previously projected. This implies the Fed will cut rates by a cumulative 75 bps in 2024.

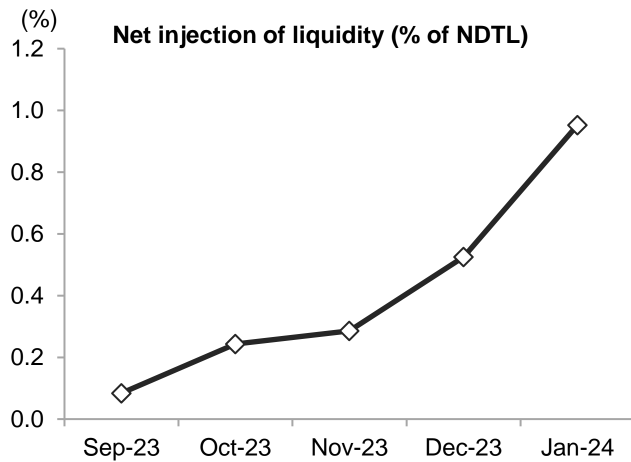
Systemic liquidity remains in deficit for the past 5 months

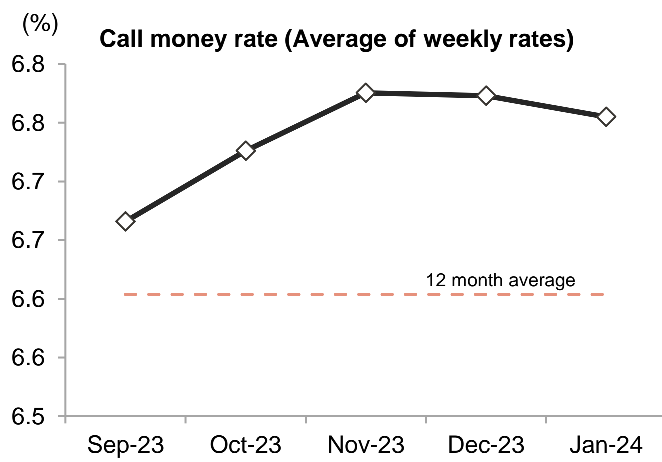
- Systemic liquidity has been in deficit since September and the gap has been consistently widening. The deficit almost doubled in January compared with December. The RBI net-injected an average of Rs. 2.07 lakh crore (1% of NDTL[1]) under the liquidity adjustment facility (LAF) compared with 1.14 lakh crore (0.5% of NDTL) in December. This puts systemic liquidity outside the neutral zone (+/- 0.5% of NDTL).
- Higher currency in circulation during the festive season, rising government cash balances with the RBI and credit growth outpacing deposit growth contributed to lower liquidity. The RBI has almost paused open market operations sales of G-secs since November 2nd. Net sales since then have been nil.

[1] Net demand and time liabilities

- The RBI conducted two variable repo rate auctions between December 15 and Janaury 31 this injected Rs 4.25 lakh crore into the system.
- In his statement, The governor higlighted that "adjusted for government cash balances, potential liquidity in the banking system is still in surplus". Liquidity conditions are expected to ease in the near future as government spending has picked up in the past couple of weeks. Between Februrary 2 and 7, the RBI conducted six fine-tuning variable rate reverse repo auctions to absorb liquidity.

A widening deficit in systemic liquidity keeps interbank rates elevated





Source: RBI, CEIC, CRISIL

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