Monetary policy | First cut

Watching the aftereffects and risks

June 2023

RBI maintains status quo on monetary policy; remains vigilant on inflation

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept its policy rates unchanged for the second consecutive time in June. It also maintained its stance of ‘withdrawal of accommodation’ to progressively align inflation to 4%, the mid-point of the RBI’s target range. The central bank is currently evaluating the impact of past rate hikes on growth and inflation while remaining cautious of the upside risks on the latter.

We expect the MPC to continue its pause on policy rates in the next meeting, too, as it evaluates the inflation trajectory. Retail inflation has been within the RBI’s tolerance band for the past two months. That said, risks from El Nino and an uneven monsoon can shore up food prices. The RBI will likely initiate rate cuts in January-March 2024 as growth moderates.

Highlights from the June monetary policy

- The MPC voted unanimously to keep policy rates unchanged, with the repo rate at 6.50%, standing deposit facility at 6.25%, and marginal standing facility at 6.75%
- The committee voted, with a 5-1 majority, to keep the ‘withdrawal of accommodation’ stance unchanged
- It slashed its projection for consumer price index (CPI)-based inflation to 5.1% for this fiscal from 5.2% estimated in the previous meeting
- It maintained its projection for growth in real gross domestic production (GDP) at 6.5% for this fiscal

Factors that kept the RBI on hold

Cautious watch on inflation: CPI inflation fell below 6%, the upper threshold of the RBI’s target range of 2-6%, – since March 2023. A favourable base effect and falling commodity prices drove this fall.

Core inflation — that is, inflation excluding food and fuel — has been easing as well and could be reflecting some impact from past rate hikes on demand and the government’s supply-side measures. The RBI governor also noted a fall in consumer inflation expectations since September 2022.

In line with its continued measures to fight inflation, the RBI aims to align inflation to its target of 4% and ensure related expectations remain well anchored.

The MPC sees inflation facing upside as well as downside risks over the medium term. On the bright side, rabi production turned out to be better than expected, having dodged the weather vagaries towards the end of the season. This could help lower food inflation through fall in wheat prices.

However, El Nino remains a risk for kharif output this season, and progress on monsoons will need to be continously monitored. While lower input costs should help ease inflation in goods, services could continue facing upside amid robust demand conditions, maintaining pressure on core inflation.

Overall, the MPC expects CPI inflation to average 5.1%, 10 bps lower than the previous forecast. The downward revision was largely driven by better-than-expected rabi production, which made the RBI revise the inflation forecast for the first half of this fiscal. The MPC expects inflation at 4.6% in the first quarter (Q1), 5.2% in Q2, 5.4% in Q3, and 5.2% in Q4.

Watching the impact on growth: The MPC expects the impact of its past rate hikes to be seen this year. Overall, GDP growth has been resilient so far, with a sharp uptick to 6.1% in the last quarter of fiscal 2023. However, recovery remained uneven, with private consumption being more subdued than other demand segments in the second half. Urban demand and services have been leading the recovery so far. Meanwhile, investment remains robust and net exports have become less of a drag on growth.

Robust rabi production augurs well for rural prospects. Services and investments are expected to remain robust. However, according to the MPC, weakening external demand and geopolitical risks are key downside risks to growth outlook.

Overall, the MPC maintained its growth projection at 6.5%. After peaking at 8% in the first quarter, it expects growth to slow to 6.5% in the second quarter, 6.0% in the third, and 5.7% in the fourth.

Proactive stance on financial conditions: While noting the resilience of India's financial conditions, the governor stressed the need to remain vigilant of volatility in the global market.

Central banks of major advanced economies such as the United States (US) and Eurozone have reduced the pace of rate hikes. This has led to some revival of risk appetite and return of capital inflows to emerging markets such as India. Yet, the governor highlighted the need to remain vigilant as elevated inflation keeps central banks on the edge. Tight labour markets in countries such as the US could also have a bearing on their inflation and interest rate outlook, and affect global risk sentiments.

Europe and UK will continue with rates hikes as inflation has stayed uncomfortably high. Interestingly, Bank of Canada and Reserve Bank of Australia have raised interest rates in June.

Among emerging markets, while Bank of Thailand raised rates by 25 bps last month most other markets have seen the peak of the rate hiking cycle.

In such a dynamic scenario, the RBI will continue with its agile approach to managing liquidity conditions and maintaining financial stability.

Our view

The MPC status-quo today was on expected lines as the lagged effects of past rate hikes are yet to fully play out. It also highlighted the central bank's caution on inflation amid prevailing risks.

Inflation faces risks primarily from the impact of weather on food inflation. While the India Meteorological Department has predicted a normal monsoon this season, its spatial and temporal distribution will have a critical bearing on kharif production. El Nino remains a significant risk this year.

Meanwhile, growth will inevitably slow this year due to higher borrowing costs, among other factors. Bank lending rates have crossed pre-pandemic 5-year average with the transmission of past rate hikes. Private consumption has already begun showing signs of a slowdown in the past two quarters. External demand will be a bigger drag as major advanced economies face the highest rates in a decade. As growth slows, it could help ease core inflation as well by the end of this fiscal.

India is expected to remain resilient to global shocks as current account deficit eases further on falling crude oil prices. RBI's foreign exchange reserves remain adequate to tackle any global volatility.

Net-net, we expect RBI to maintain status quo on rates in the next few meetings. We expect it to initiate cuts in the January-March quarter of 2024 as growth slows and puts a downside on inflation.

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