## Monetary policy | First cut

# Standing pat on inflation unease

August 10, 2023

### MPC maintains status quo on rates, preferring to watch the price gauge

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept the repo rate unchanged for the third consecutive time during today's meeting. But it signalled greater upside risks to inflation, and increased its inflation forecast for this fiscal. Given the recent flare-up in food prices, the central bank clearly wishes to see whether they become entrenched in inflation.

*We expect the MPC to hold on policy rates in the next meeting, as it awaits a clearer picture on the inflation path. Uncertainty on the inflation trajectory has increased with the recent flare-up in food prices. Monsoon and weather disruptions, along with government interventions and global food supply trends, will influence the inflation outcome. A 25 bps rate cut in early 2024 is a conditional possibility for now.*

### Highlights from the August monetary policy review

- The MPC voted unanimously to keep policy rates unchanged. So the repo rate remains at 6.50%, the standing deposit facility at 6.25%, and the marginal standing facility at 6.75%
- The committee voted, with a 5-1 majority, to keep the 'withdrawal of accommodation' stance unchanged
- It expects consumer price index (CPI)-based inflation at 5.4% this fiscal, revised up from 5.1% for in the previous meeting
- It maintained its projection for growth in real gross domestic production (GDP) at 6.5% for this fiscal
- The RBI levied incremental cash reserve ratio (I-CRR) temporarily to reduce the liquidity overhang in the banking sector

### Watching how the inflation risks unfold

- **Food threatens to disrupt inflation:** After the June monetary policy review, CPI inflation began rebounding. It rose to 4.8% on-year in June after falling in the preceding four months. While it has been within MPC's target range of 2%-6% so far, recent data points to it crossing the upper bound July-August.

  Fresh risks are from food as major vegetables such as tomatoes have seen prices rise almost 4 times on-month in July. To be sure, vegetables are the most volatile component of inflation. But other food items such as cereals, milk and spices have also seen elevated inflation since the start of this year.

  However, the non-food component of CPI continues to ease till date, driven by falling commodity prices. Easing input costs have reduced pressure on manufacturers to hike retail prices.

  The MPC recognises the growing uncertainties to inflation outlook. While it expects the vegetable price spike to be transitory, it is concerned about impact of weather and global factors. The impact of El Niño and other weather events could impact food output. Geopolitical tensions present a fresh risk to global food prices. Even the recent rise in crude oil prices needs to be monitored.

Consequently, the MPC revised up its CPI inflation forecast by 30 bps to 5.4% for fiscal 2023. Inflation is expected to move from 4.6% in the first quarter (Q1) to 6.2% in Q2 (revised up 100 bps from previous meeting), 5.7% in Q3 (30 bps up), 5.2% in Q4 (no change).

- **Growth holding up well:** The MPC is comforted by continued resilience in economic growth. This is evident in S&P Global's Purchasing Manager's Index staying in expansionary zone for both manufacturing and services, rising Index of Industrial Production, and core sector growth since the last monetary policy review.

  Among demand segments, investment is gaining steam led by government capital expenditure. Private capex, too, is seeing signs of revival, with capacity utilisation in the manufacturing sector at 76.3% in Q1 — above the long-term average of 73.7%. Urban economy continues to lead consumption demand, while rural demand is seeing nascent recovery. The governor noted transmission of past rate hikes is still underway. Exports remain a drag on growth.

  The MPC expects growth to receive support from the upcoming festive season. However, it sees global demand and geopolitical tensions as risks to growth outlook.

  Overall, the MPC maintained its growth projection at 6.5% for this fiscal. 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.

## Staying on top of liquidity conditions and financial stability

- While keeping rates unchanged and maintaining stance of withdrawal of accommodation, the RBI is closely monitoring the liquidity conditions.
- The governor noted various factors contributed to an increase in banking liquidity in past few months, including the return of Rs 2,000 denomination notes, the RBI's surplus transfer to the government, pick-up in fiscal spending and foreign capital inflows. However, banks do not seem to be voluntarily parking corresponding quantum of funds under the liquidity adjustement facility, especially under the variable reverse repo rate operations (VRRRs), which is the main mode of operation. Any liquidity overhang, it believes, can pose a risk to financial stability.
- To facilitate appropriate liquidity conditions, the RBI introduced the I-CRR. This is a temporary measure under which banks need to park 10% of their incremental net demand and time liabilities (NDTL) under the CRR window of RBI. This is estimated to be ~Rs 1 lakh crore. However, the central bank intends to restore similar liquidity back into the system after a review in September.
- This may lead to a reduction in liquidity in the second quarter relative to the previous quarter, and cause a temporary spike in short-term rates. With this rise, it can also facilitate transmission of rate hikes to broader banking sector.

## Our view

Uncertainty on the inflation trajectory has increased with the recent spike in food prices. While a transitory rise in food inflation can be ignored by the RBI, a sustained rise can influence inflation expectations and add pressure.

Surging vegetable prices are not a new phenomenon. However, the current surge in vegetable prices is coming on top of elevated inflation in cereals, pulses, milk and spices.

Going forward, easing of foodgrain inflation will depend on how monsoon and El Niño risks pan out. Swinging from deficit June to excess rains in July, monsoon has normalised, with all-India rainfall at 0% of long period average as of August 9. Spatial distribution has improved, too, with 18 of 28 states having normal rainfall. Sowing is picking up for all food crops, except pulses. Adequate, well-distributed rainfall in August remains critical for kharif production. Additionally, global food supply could weigh on domestic inflation, especially if El Niño impacts major sources of edible oils like Indonesia and Malaysia.

Fiscal policy can play a bigger role in curtailing the present food inflation, which is a supply-driven phenomenon. Indian government's recent interventions such as banning certain rice exports, and release of food stocks with the Food Corporation of India could help ease inflation and the MPC's job.

Fortunately, GDP growth seems to be holding up so far. But the monsoon can still affect prospects by influencing rural demand. Exports are already a drag on growth. Advanced economies, which are growing better than expected so far, could still see a prolonged slowdown ahead under interest rates staying higher for longer.

India remains resilient to volatile global financial conditions, as evident in stable rupee and stable financial conditions. Lower current account deficit relative to last year, coupled with adequate foreign exchange reserves bode well.

Net-net, we expect the MPC to maintain status quo on rates in October meeting, as it awaits a clearer picture on inflation. Given fresh inflation risks, a 25 bps rate cut in early 2024 quarter is a conditional possibility for now.

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