

Monetary policy | **First cut**

Focus on inflation

October 6, 2023

MPC maintains rates on inflation risk

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept the repo rate unchanged for the fourth straight time in today's meeting. The MPC remained cautious on inflation, which is facing supply-side risks from elevated food prices. It also highlighted the need to be vigilant on global financial market volatility. Resilient domestic growth and incomplete transmission of past rate hikes compelled the MPC to retain its 'withdrawal of accommodation' stance as well.

Uneven distribution of rainfall during the monsoon season, rising crude oil prices and tight global food supplies continue to pose upside risks to inflation this fiscal. Hence, we do not expect a rate cut this fiscal. In fact, we foresee a rate cut only in the first quarter of next fiscal, assuming normalising inflation and slowing growth.

To be sure, the MPC remains focused on aligning inflation to 4.0%. It sees this as key for macroeconomic stability amid a challenging global environment. External developments, such as rising global interest rates, a stronger dollar, tightening global financial conditions and volatile foreign capital inflows, require continued vigilance and tilt the balance towards the stance of withdrawing accommodation.

Highlights from October monetary policy review

- The MPC voted unanimously to keep policy rates unchanged. The repo rate remains at 6.50%, standing deposit facility at 6.25%, and marginal standing facility at 6.75%
 - The committee also voted, with a 5-1 majority, to keep the 'withdrawal of accommodation' stance
 - It maintained a forecast of Consumer Price Index (CPI)-based inflation at 5.4% this fiscal as well
 - Also, it maintained its real gross domestic production (GDP) growth projection at 6.5% for this fiscal
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MPC stays vigilant on inflation and global headwinds

- **Inflation fight tested by supply shocks:** Since August's monetary policy, CPI inflation breached the MPC's upper tolerance band of 6.0%, averaging 7.1% in July-August.

This was because of food inflation rising a sharp 10.7% during the two months, and within the basket, volatile vegetables, which rose 31.8%. However, the rise in non-food inflation was much slower, at 4.8%. Core inflation (inflation excluding food and fuel) – which reflects more of demand-side pressures – eased to 4.9% in July-August compared with 5.2% in the previous quarter.

While the MPC expects inflation to cool with the abating of seasonal spike in vegetable prices, it sees other food items, such as cereals, pulses and spices, remaining under pressure. The prices of spices are also expected to be elevated on demand-supply mismatch. The impact of uneven monsoon is a risk for kharif production as well, especially for pulses and oilseeds, wherein sowing was lower on-year. Rabi production faces risk from low reservoir levels, too. Finally, global food supplies face headwinds from ongoing El Niño,

with India dependent on palm oil supplies from Indonesia and Malaysia.

However, non-food inflation is expected to cool, as lower commodity prices on-year reduce pressure on manufacturers to hike retail prices.

The MPC is looking for further easing of core inflation for anchoring inflation expectations.

That said, the MPC was encouraged by inflation expectations falling to single digits for the first time since the outbreak of Covid-19. In its September survey, household inflation expectations for three months ahead was 9% vs. 10% in July.

Given the recent bulge in inflation, the MPC revised up second quarter inflation forecast by 20 bps to 6.4% (compared with August estimate). However, it lowered its third quarter forecast by 10 bps to 5.6%, and kept the fourth quarter forecast unchanged at 5.2%. Overall, CPI forecast for fiscal 2024 was kept unchanged at 5.4%.

- **Rising crude oil prices and global interest rates risk:** The price of Brent Crude rose in the past three months. In September, it averaged \$94 per barrel, 9.1% higher on-month and 4.3% higher on-year. While prices trended below \$90 per barrel in the first week of October, and is currently below \$84, it remains vulnerable to supply disruptions.

Also, global bond markets are factoring in a prolonged period of tight monetary policy by major central banks. While the US Federal Reserve kept policy rate unchanged in September, it reduced the number of rate cuts expected next year. However, the European Central Bank hiked it by 25 bps in September. The 10-year US Treasury yield crossed 4.8% in October for the first time since 2007, and the US dollar index reached a 12-month high in September.

Adverse global developments caused short-term capital outflows by foreign portfolio investors since September. However, the rupee only depreciated 0.3% on-month on average, supported by the RBI's intervention in the foreign exchange market.

The RBI governor stressed that risks and vulnerabilities can emerge from unanticipated corners, even in good times. This reinforced the central bank's monetary policy stance, and its vigilance on evolving global risks.

- **Growth staying resilient:** India's GDP print after the last MPC meeting came in at 7.8% for the first quarter, marking the second consecutive quarter of rising growth. However, this was slightly below the RBI's projection of 8% for the quarter.

Nevertheless, the MPC believes growth will stay resilient on account of domestic demand. Also, the industrial sector extended its recovery in the second quarter, with the services sector remaining buoyant. Investment maintained momentum, supported by government spending. Rising capacity utilisation augurs well for private sector investment as well. However, slowing global growth has been a drag through weaker goods exports.

The MPC also highlighted that the transmission of past rate hikes via bank lending rates was incomplete. Chart 1 shows that the cumulative rise in bank lending rates was less than the 250 bps repo rate hike. This reinforced MPC's narrative to continue its stance of withdrawal of accommodation.

Overall, the MPC maintained its GDP growth projection at 6.5% for this fiscal. After peaking at 7.8% 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. Headwinds are expected from global slowdown, geopolitical tensions and uneven monsoon. However, domestic demand conditions may stay healthy on services buoyancy, government's capex focus, healthy bank and corporate balance sheets, and supply chain normalisation.

RBI's dynamic liquidity management keeping it close to neutral

- Systemic liquidity reduced after the August policy meeting, when the RBI imposed an incremental cash reserve ratio (I-CRR). The governor noted Rs. 1.1 lakh crore was impounded because of the I-CRR.

- Liquidity was in mild deficit in September, as reflected in the RBI net-injecting Rs 0.1 lakh crore (0.1% of net demand and time liabilities, or NDTL¹) on average. In comparison, the RBI net-absorbed Rs 1.2 lakh crore (0.6% of NDTL) in August, indicating surplus liquidity that month.
- Besides the I-CRR, the RBI's other interventions are contributing to liquidity reduction: (1) open market sales of Government Securities in September, and (2) buying rupees in forex market to limit currency depreciation. Other macro factors, such as rising credit-deposit ratio, advance tax outflows, and moderating government spending, had roles in recent liquidity reduction as well.
- Consequently, the RBI began withdrawing the I-CRR in September, with the scheme ending on October 7. The governor, though, stated that the apex bank will continue to manage liquidity in line with the MPC's monetary policy stance, considering open market operation-sales as well. In fact, liquidity has stayed in the neutral zone till date (+/-0.5% of NDTL).

Our view

The MPC is understandably staying on the sidelines as it awaits signals on inflation from noisy food prices. While monetary policy cannot control supply-side shocks to food inflation, it needs to watch out for risks from persistently elevated food prices, which can generalise inflation pressures. Food, which comprises 39% of the CPI basket, has a significant bearing on the purchasing power and inflation expectations of consumers in India.

The impact of monsoon on kharif production is keenly awaited, amid double-digit inflation in cereals and pulses. With the monsoon highly uneven this year, ending 6% below the long period average, kharif sowing has been mixed across crops, with rice, sugarcane and coarse cereals higher and pulses and oilseeds lower. Rabi output also faces risks from low reservoir levels. Tight global food supply, too, could affect India through rising edible oil prices.

Further, rising crude oil prices are a risk to inflation expectations. While global slowdown in the second half this year is likely to soften crude oil prices, supply decisions by major oil producers will be a monitorable. In India, the government's crude oil price management and passthrough by oil marketing companies to consumers will influence inflation.

Crude oil prices will have a bigger impact on India's current account deficit, as it is a major import item. At the same time, rising global interest rates and tighter global financial conditions are risks to foreign capital flows. These developments could put some pressure on the rupee. However, the RBI has adequate forex reserves to control excessive rupee depreciation.

Global slowdown will moderately hit India's GDP through falling export growth. Domestic interest rates have risen to a lesser extent vs. advanced economies. The RBI's rate hikes since April 2022 have not significantly affected domestic demand so far, as credit offtake remains at decadal highs. We expect domestic demand to be mildly impacted by lagged transmission of rate hikes in the second half of this fiscal.

Overall, we expect the RBI to keep rates unchanged for the remainder of this fiscal. Assuming supply shocks dissipate for inflation and growth slows, we expect the first rate cut in the first quarter of 2024.

¹ Net demand and time liabilities

Chart 1: Transmission of past RBI rate hikes remains incomplete

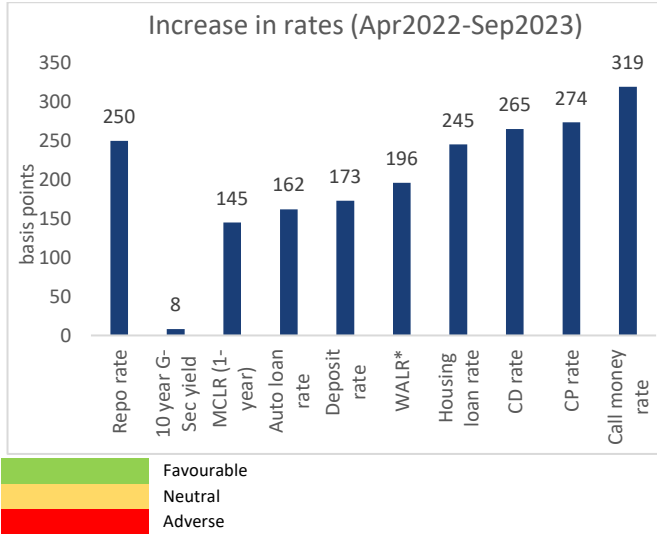


Chart 2: Inflation and global shocks are the key macro risks at present

		Q4 FY23	Q1 FY24	Q2 FY24
Domestic macros	CPI Inflation	6.2	4.6	7.1*
	GDP growth	6.1	7.8	N/A
	CAD (% of GDP)	0.2	1.1	N/A
	INR/USD (q-o-q %)	-0.4	0.4	0.5
	Liquidity (% of NDTL)	-0.1	-0.6	-0.4
	10 year G-Sec yield (%)	7.36	7.08	7.16
Global factors	Brent crude (US\$/bbl)	81.4	78.2	86.8
	Fed rate hike (bps)	50	25	25
	US 10-year yield (%)	3.65	3.59	4.15

* Until August 2023

Source: Reserve Bank of India, CCIL, National Statistics Office, World Bank, US Department of Treasury, CRISIL

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