Monetary policy | First cut

Focus steadfast on risks

June 7, 2024

MPC keeps rates unchanged, cautious of inflation amid firm growth

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept policy rates unchanged for the eighth straight time in today's meeting. Amid domestic economic growth exceeding expectations, the MPC remains focused on inflation risks and any external shocks. The committee also maintained its stance of 'withdrawal of accommodation'.

Owing to strong economic growth momentum, the MPC has the policy space to keep rates high for longer to rein in Consumer Price Index (CPI)-based inflation to its stated goal of ~4%. It expects the last stage of disinflation to be slow amid strong economic growth. Hence, the MPC is in the league of majority of central banks that have opted to keep rates unchanged in the first half of this year.

We now see the RBI cutting rates starting October 2024 at the earliest, and have lowered our expectation to two rate cuts this fiscal against three foreseen earlier. The expectation of an above-normal monsoon this year paves the way for cooling of inflation, though its distribution will be monitored over the next three months. Moderation in economic growth may also cap inflationary pressures. That said, any weather and geopolitical shocks will remain monitorables.

Highlights from June monetary policy review

- The MPC voted to keep policy rates unchanged. However, the members in favour of this pause reduced to four from five earlier, with two members voting for a rate cut
- The repo rate remains at 6.50%, standing deposit facility at 6.25% and marginal standing facility at 6.75%
- There was also status quo on 'withdrawal of accommodation' stance, with a 4-2 majority vote vs. 5-1 previously
- The MPC retained its forecasts for CPI-based inflation at 4.5%, as the previous meeting
- Gross domestic product (GDP) growth was revised up 20 basis points (bps) to 7.2% for this fiscal

Why the MPC did not tinker with rates

- **Ensuring durable easing of inflation**: Since the last monetary policy meeting, CPI inflation has eased further, and has trended within the MPC's target of 2-6%. In fact, it moved closer to the mid-point of the target, at 4.8% in April 2024 compared with 4.9% in the previous month.

  The MPC noted the role of monetary policy and government interventions in lowering inflation. However, it believes that repeated food shocks have disrupted the progress of disinflation.

  The recent easing was primarily because of non-food inflation, which stood at 2.4% in April. In contrast, food inflation was much higher, at 8.7%. And a recent heatwave and low water reservoir levels have continued to keep the MPC vigilant of risks to food prices.

Nevertheless, the MPC noted the India Meteorological Department's above-normal monsoon forecast to ease food price pressures. However, there is uncertainty on the crude oil price front amid geopolitical uncertainities. It is also monitoring the recent uptick in global commodity prices, as an upside risk for rising cost pressures for companies could be passed on to retail prices.

Owing to these factors, the MPC kept its CPI inflation forecast unchanged at 4.5% for fiscal 2025, with risks evenly balanced. It expects CPI inflation to ease from 4.9% in the first quarter of this fiscal to 3.8% in the second quarter, but rise again to 4.6% in the third quarter and trend at 4.5% in the fourth quarter.

- **Growth surpassing expectations**: Economic growth in the fourth quarter of fiscal 2024 at 7.8% was much stronger than expected, which prompted the National Statistics Office to revise its fiscal 2024 growth by a significant 60 bps to 8.2%.

  The MPC also believes domestic demand is strengthening. Private consumption, which lagged last fiscal, is seen to be improving, driven by urban discretionary spending and revival in rural demand. Investment activity remains strong as well, and external demand is turning supportive of exports.

  The MPC expects growth to remain strong in the current fiscal, driven by (1) a normal monsoon driving up agriculture and rural consumption, (2) services supporting urban consumption, (3) conducive investment conditions *(high capacity utilisation, healthy corporate balance sheets and government's capex thrust)*, and (4) improving global trade.

  Assuming the growth momentum sustains, the RBI has revised up GDP growth for fiscal 2025 to 7.2% from 7.0, with 7.3% projected in the first quarter, 7.2% in the second quarter, 7.3% in the third quarter and 7.2% in the fourth quarter.

- **External resilience**: The RBI governor noted that global growth momentum is also sustaining, with rebounding global trade. But major global central banks remain data-dependent in their inflation fight, and market expectations of rate cuts is evolving.

  The governor, though, reiterated that the MPC focusses more on domestic growth-inflation developments than rate actions of the US Federal Reserve. It stated that it is well positioned to do so, given low external vulnerability of the Indian economy. This is reflected in the rupee being broadly stable, current account deficit remaining benign, and foreign exchange reserves continuing to breach records.

MPC stance unchanged to ensure fuller monetary policy transmission

- The MPC voted with a majority to keep the stance of 'withdrawal of accommodation' to ensure monetary policy transmission progresses further, and work towards anchoring inflation expectations
- The MPC sees transmission of past monetary policy actions still in progress, as bank lending and deposit rates have not increased to the same extent as repo rate after 2022
- Bank credit growth has been moderating, particularly in risky segments such as unsecured lending, which was targeted by RBI's regulatory measures. Yet, bank credit growth continues to outpace deposit growth. The RBI flagged this elevated credit-deposit gap and urged banks to maintain prudent balance between assets and liabilities
- Liquidity conditions tightened after the last monetary policy meeting. It turned from a surplus of Rs 0.20 lakh crore in April to a deficit of Rs 1.38 lakh crore in May. Elevated credit-deposit ratio and lower government spending relative to last year have contributed to this. The RBI continues to be active in its two-way liquidity operations under the liquidity adjustment facility to broadly keep liquidity close to neutral. Liquidity deficit at ~0.3% of net demand and time liabilities in current fiscal so far remains benign relative to previous period (fiscals 2011 to 2016) of deficit liquidity

Our view

The MPC's decision to hold rates at this juncture was expected in an environment of strong growth and little change in inflation trends.

Food inflation has been stubbornly high so far, even as core inflation – a firmer measure of demand pressures – stands at a record low.

As GDP growth momentum remains strong, the MPC sees space to keep monetary policy tight to ensure a durable decline in inflation towards its 4% target. The cooling of food inflation is also crucial to anchor inflation expectations, given it accounts for a sizeable 39% of an average Indian consumer basket, the share being higher for the poorer segments of society.

Yet, we expect the macroeconomic environment to gradually turn favourable for a rate cuts owing to the following factors:

- The forecast of an above-normal monsoon augurs well for easing of food inflation. However, the spatial and temporal distribution of rains in the coming three months will determine the actual impact on crop production and prices. Also, the impact of any unusual weather events will remain a monitorable

- GDP growth is expected to moderate this fiscal. Government spending is likely to slow this year as it pursues fiscal consolidation, though the picture will get clearer in the Union Budget 2024-25. The RBI's past measures to tighten credit growth are also gradually reducing credit growth in targeted segments. This is likely to moderate demand in the current fiscal as well. Global growth remains uneven, and geopolitical risks-driven supply disruptions a risk for exports

- Also, global financial conditions are expected to gradually turn supportive for easing of rates. The European Central Bank has been the first among advanced economies to cut rates. However, the rate cut by the US Federal Reserve will take longer, with S&P Global expecting the first rate cut in December 2024

Based on these factors, we now see the RBI cutting rates starting October 2024 at the earliest, and have lowered our expectation to two rate cuts this fiscal against three foreseen earlier.

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