Monetary policy | First cut

More elbow room to cut

October 9, 2024

MPC changes stance to ‘neutral’, signalling a less restrictive monetary policy

- **Policy rates remain unchanged**: The revamped Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept the repo rate unchanged during its review meeting today. However, it changed the policy stance to ‘neutral’ from ‘withdrawal of accommodation’

- **What the neutral stance implies:** The MPC could change the repo rate in either direction in future, depending on economic data. That way, ‘neutral’ is less restrictive than ‘withdrawal of accommodation’, which would have signalled maintaining tight monetary conditions. Progress on disinflation and a good monsoon have encouraged the MPC to change tack. That said, a ‘neutral’ stance also affords the MPC the flexibility to respond to unexpected disruptions in the disinflation process from exogenous sources

- **Why the MPC stopped short of cutting rates**: The RBI remains wary of supply shocks upending the durable decline in inflation. Geopolitical uncertainties and a rise in international prices of some commodities have added to the upside risks. As for food prices, unseasonal weather shocks bear watching

- **The likely next move:** We anticipate a 25-basis-point reduction in the repo rate during the MPC’s policy review meeting in December, given food inflation is expected to ease after a healthy monsoon. We also expect gross domestic product (GDP) growth to moderate to 6.8% this fiscal compared with RBI’s forecast of 7.2%

Highlights from the October monetary policy review

- The MPC voted 5-1 to keep the policy rate unchanged
- The repo rate was kept unchanged at 6.50%, the standing deposit facility at 6.25% and the marginal standing facility at 6.75% for the 19th month in a row
- The MPC changed its stance — unanimously — to ‘neutral’ from ‘withdrawal of accommodation’
- The MPC retained its forecast for consumer price index (CPI)-based inflation at 4.5%, and GDP at 7.2% for the current fiscal

Improving growth-inflation mix prompts MPC to shift policy stance

- **Inflation showing signs of easing**: CPI inflation has been within RBI’s target range of 2-6% since the past 12 months. The gauge slipped below 4% in July-August compared with 4.9% in Q1.

  While food inflation remained elevated in this period (5.5%), it eased relative to 8.9% in Q1. Non-food inflation remained was a lot lower (2.3%) and stable relative to the previous quarter.

  The MPC was encouraged by a good monsoon this year (8% above the long period average), which has led to a 1.9% on-year rise in kharif sowing. Rabi production is also expected to improve this fiscal due to sufficient water reservoir levels. The MPC expects these factors to contribute to the easing of food inflation later this fiscal.

However, it foresees base effect cranking up CPI inflation in Q3. It remains cautious of volatility in food prices, especially vegetables, due to weather shocks. The MPC also underlined the recent rise in international food prices.

The MPC expects core inflation (i.e., CPI, excluding food and fuel) to stay leashed driven by the transmission of previous monetary policy actions. It remains cognisant of increasing geopolitical uncertainties, which had lifted crude oil prices to ~$80 per barrel levels in early October. Rising international crude and metal prices, if sustained, can create upside risks to domestic inflation.

Overall, the MPC kept its CPI inflation forecast unchanged at 4.5% for fiscal 2025, with risks evenly balanced. The barometer is expected to ease from 4.9% in Q1 to 4.1% in Q2 , rise temporarily to 4.8% in Q3 but ease to 4.2% in Q4. It is expected at 4.3% in Q1 of the next fiscal.

- **Healthy growth expectation**: At 6.7%, GDP growth in Q1 this fiscal was lower than the RBI's projection of 7.1%. However, the MPC noted the improvement in private consumption and investment — the main demand drivers that quarter. While the governor noted softening in some high frequency indicators in Q2, he saw overall growth momentum staying healthy.

  The MPC expects consumption to improve this fiscal given improving rural demand. Healthy monsoon and the onset of the festival season augur well for consumer spending. The MPC said consumer and business confidence has improved. Continued capital expenditure by the government and a pick-up in private investment is expected to sustain the investment momentum. Externally, improving global trade is expected to support export growth.

  Due to these factors, the central bank kept its GDP growth forecast for fiscal 2025 unchanged at 7.2%, with growth picking up from 6.7% in Q1 to 7.0% in Q2, 7.4% in Q3 and 7.4% in Q4. It expects growth to be stable at 7.3% in Q1 next fiscal as well. Risks to growth are seen evenly balanced.

- **Mixed global signals**: The MPC believed global growth momentum has been resilient, but the recent escalation in geopolitical tensions has added to the downside risks. Recent rate cuts by major central banks particularly the United States (US) Federal Reserve (Fed) has supported foreign portfolio investor (FPI) flows to India. While global market conditions remain volatile, the rupee has remained stable, driven by benign current account deficit and robust foreign exchange reserves.

Our view

The shift in the MPC's policy stance is the first step of a policy pivot. While the MPC remains cautious given prevailing uncertainties, it has increased the elbow room for rate cuts.

Easing food inflation coupled with benign non-food inflation, is expected to move the MPC to cut the repo rate in December. Kharif arrivals from this month, along with prospects of healthy rabi production, are expected to soften food prices in the second half of this fiscal. That said, any volatility in food prices due to weather shocks (such as excess rains), and international commodity price movements will be monitorable.

The global environment remains uncertain. The upcoming US presidential elections could also have a bearing on global trade flows and market volatility. The RBI may like to get clarity on how these risks play out, before going for a rate cut.

Yet, monetary easing by major global central banks will give the RBI space to ease its policy. After the Fed's 50 basis points (bps) rate cut in September, S&P Global expects another 50 bps cut in 2024, and 125 bps cuts in 2025.

Moderating domestic growth this year would strengthen the case for a rate cut. We expect GDP growth to print at 6.8% this fiscal compared with 7.2% forecast by the RBI. While healthy agricultural production is expected to support rural demand, the lagged impact of previous rate hikes is also playing out.

Transmission of past rate hikes continuing: Even as the repo rate has stayed unchanged for the past 19 months, interest rates are rising gradually across most financial market segments. The notable exception is government bond yields which are responding to other factors such as fiscal consolidation and inclusion of domestic gilts in global bond indices. The past few months have seen a rise in bank lending as well as deposit rates. Deposit growth is also catching up with credit growth[1]. While overall credit remains strong it is softening gradually. Slowdown in also being seen in risky segments like credit cards where abnormally high growth had concerned RBI.

Elevated interest rates could weigh on discretionary consumption, especially in the urban areas.

We now expect a 25-bps reduction in the repo rate in December policy.

[1] Deposit growth is rising (11.5% in September vs 10.8% previous month) while credit growth is softening (13% vs 13.6%)

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