Monetary policy | First cut

Balancing tough inflation-growth mix

December 6, 2024

RBI cuts the cash reserve ratio while standing pat on rates

- **Policy rates unchanged amid high inflation**: The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept the repo rate unchanged at 6.5%, and maintained stance at 'neutral' during its December review meeting. The rise in headline inflation — the RBI's main target — in the past three months is what kept the rate cut away. That said, the MPC noted the sharp slowdown in economic growth during the second quarter. The neutral stance gives it flexibility to change the repo rate in upcoming monetary policy, depending on economic data

- **CRR cut to prevent liquidity drag on growth:** The RBI will cut the cash reserve ratio (CRR) in two tranches of 25 basis points (bps) in December, bringing it to 4% this fiscal — on a par with pre-pandemic rates. These cuts will swiftly boost systemic liquidity — which is seeing signs of pressure — and keep financial conditions conducive for growth

- **Inflation projection revised, growth down**: The MPC raised its forecast for the Consumer Price Index (CPI)-based inflation by 30 bps to 4.8% for fiscal 2025, expecting inflation to stay elevated till the third quarter

- Gross domestic projection (GDP) was revised down a sharp 60 bps to 6.6% after growth in the second quarter came well below expectations. The RBI saw the slowdown in the second quarter as transitory, but underscored its intent to act if growth slowdown is prolonged

Key actions in the December monetary policy

- The MPC voted 4-2 to keep the policy rates 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 21st month in a row
- The stance was unanimously retained at 'neutral'
- The forecast for CPI inflation was raised 30 bps to 4.8% for fiscal 2025
- The RBI revised down its GDP growth forecast for this fiscal by 60 bps to 6.6%
- CRR to be cut 50 bps to 4% of net demand and time liablities (NDTL) in two tranches of 25 bps each in December
- Interest rate ceiling was raised on foreign currency non-resident banks (FCNR) deposits
- Limits for collateral-free agricultural loans revised up

Why the inflation-growth mix has worsened

- **Inflation has risen in the past three months**: CPI inflation rose since the last policy meeting, and crossed RBI's tolerance limit of 6% in October. Food remains the driver of rising inflation.

Food inflation has stayed stickily high, surging to 10.9% in October from 9.2% in September. Non-food inflation saw a milder uptick to 3.1% in October from 3% in September.

The MPC expects headline CPI inflation to remain elevated till the third quarter of current fiscal, driven by food prices. Winter crop arrivals are expected to ease food inflation in the fourth quarter. Healthy monsoon has improved kharif food production this year, and augurs well for rabi production in the second half of this fiscal.

Pressures from global prices, particularly for edible oils, need monitoring. The MPC also noted manufacturing and services firms projecting a rise in their selling prices for fourth quarter of this fiscal, which could add to non-food inflation.

These factors persuaded the MPC to increase its CPI inflation forecast to 4.8% for this fiscal. The barometer is expected to rise from 4.2% in Q2 to 5.7% in Q3 but ease to 4.5% in Q4. Not much relief is seen in the next fiscal as CPI is projected to rise to 4.6% in Q1 of fiscal 2026, and reach 4% in Q2.

The RBI Governor emphasised his primary mandate is maintaining price stability. He also said high food inflation hurts all economic segments, impacting household consumption and thus economic growth. Price stability will help sustain healthy economic growth.

- **Growth slowdown sharper than expected**: GDP growth at 5.4% in the second quarter of this fiscal came well below the MPC's expectations. This is what drove a 60 bps reduction in its GDP growth forecast.

  However, the committee saw the second-quarter growth slowdown as transitory, with the sluggishness localised to a few industry sectors. Agriculture improved and services activity was resilient in their view.

  High frequency indicators hint at a revival in growth in the third quarter. Healthy agricultural output, improving rural demand, rising government consumption and exports are expected to improve GDP growth in the remainder of this fiscal.

  The RBI expects growth to pick up from 5.4% in Q2 to 6.8% in Q3 and 7.2% in Q4. Next fiscal, it expects growth to move from 6.9% in Q1 to 7.3% in Q2.

  The governor maintained that if growth slowdown prolongs, policy support may be needed. The MPC's neutral stance permits it to move on rates in the upcoming policy meetings. For now, it has used the CRR tool to support growth by improving systemic liquidity.

Liquidity pressures prompt CRR cut

- While systemic liquidity under liquidity adjustment facility remains in mild surplus, there was pressure from foreign portfolio investor (FPI) outflows in the past two months. Currency demand has also increased after the festive season, which is draining liquidity from the financial system
- The governor expects liquidity to tighten in the coming months driven by tax outflows in December, high currency demand and volatility in FPI flows. Anticipitating this, the RBI announced the CRR cut
- The CRR cut will quickly infuse liquidity in the banking sector. The RBI estimated Rs. 1.16 lakh crore increase in primary liquidity due to this cut
- FPIs have been net sellers in the past two months, after the rise in United States (US) yields. The increase in interest rate ceiling on FCNR deposits is intended to attract FPIs to India amid global uncertainty

Outlook

We expect conditions to turn favourable for rate cuts with the first one in February. Inflation is expected to ease towards the end of this fiscal given healthy agricultural output. When the rabi, or winter, crop reaches the market, vegetable prices tend to correct sharply. Easing food inflation coupled with benign non-food inflation, is expected bring down headline CPI inflation.

While major global central banks have begun cutting rates, market volatility has increased after the US elections. The US Federal Reserve (Fed) and the European Central Bank (ECB) have cut 75 basis points (bps) each in 2024.

The Fed’s path to further rate cuts is unclear because incoming President Donald Trump has spoken about imposing higher tariffs, which is likely to add to inflationary pressures.

S&P Global sees fewer rate cuts by the Fed in 2025 compared with expectations 3 months ago. Overall, the global environment is conducive to pursuing rate cuts.

Domestic growth is moving closer to pre-pandemic decadal average this fiscal, after posting above-average 8.2% last year. While healthy agricultural production is expected to support rural demand, the lagged impact of previous rate hikes is also playing out in other sectors. Elevated interest rates and high inflation could weigh on discretionary consumption, especially in the urban areas.

Overall, easing domestic inflation will be the main driver of RBI’s rate cuts from February. That said, the cumulative reduction in the upcoming cutting cycle would be less than the 250 bps hiked since May 2022 as domestic growth momentum is projected to remain healthy and global rate cut cycle will also be shallower.

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