Monetary policy | First cut

Awaiting a better handle

April 5, 2024

MPC stays put as growth-inflation mix evolves well

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) kept the repo rate unchanged for the seventh straight time in today's meeting. The MPC is focussing on reducing inflation towards its 4% target, comforted by high gross domestic product (GDP) growth.

Given the uneven inflation trends, the MPC is awaiting clearer signs of easing towards the 4% target. Strong domestic growth momentum has provided it space to do so.

Food, the pain point for inflation last year, could ease if monsoon turns normal this year, as early weather forecasts suggest. Easing food inflation and benign non-food inflation should bring the headline inflation closer to the RBI's target of 4%. That said, any unusual weather events and sustained uptick in crude oil prices will remain monitorable.

The transmission impact of past rate hikes since May 2022 and regulatory measures on risky lending are still playing out. We expect GDP growth and inflation in fiscal 2025 at 6.8% and 4.5%, respectively.

Overall, the macroeconomic environment is turning favourable for a rate cut in mid-2024, under our base case, lest weather and crude prices play spoilsport.

Highlights from April monetary policy review

- The MPC voted to keep the policy rates unchanged, with a 5-1 majority. The repo rate remains at 6.50%, standing deposit facility (SDF) at 6.25% and marginal standing facility (MSF) at 6.75%
- Status quo on the 'withdrawal of accommodation' stance, with a 5-1 majority vote
- The MPC's retained its forecasts for Consumer Price Index (CPI)-based inflation (4.5%) and GDP growth (7.0%) for this fiscal

What kept the MPC on pause

- **Awaiting further easing in inflation**: CPI inflation has been within the MPC's tolerance band of 2-6% in the past six months, coming at 5.1% in the most recent reading for February 2024. However, it stayed above the 4% mid-point, which the RBI has communicated to be targeting

  The MPC stated that high food inflation has been interrupting disinflation in its last mile. While non-food inflation has fallen below 4% in the past six months, food inflation has remained above 8%. Core inflation – a clearer measure of demand pressures in the economy – has been below 4% since December 2023

  The MPC noted encouraging signs for easing of food inflation from an expected record rabi output in the current season and a normal-monsoon prediction. However, it will remain vigilant about any unpredictable weather events, whose frequency has risen in recent years

The decline in fuel prices will get further relief from the cut in liquefied petroleum gas (LPG) prices. However, the recent rise in crude oil prices is a monitorable.

Overall, the MPC kept its CPI inflation forecast unchanged at 4.5% for fiscal 2025. It expects CPI inflation to ease from 4.9% in the first quarter of this fiscal to 3.8% in the second quarter, but inch up to 4.6% in the third quarter and 4.5% the in fourth quarter.

- **Sustaining strong growth**: GDP growth has not shown any signs of a slowdown so far. It rose to 8.4% in the third quarter of fiscal 2024, from 8.1% in the previous quarter. Growth for fiscal 2024 is estimated to be higher at 7.6% than 7% in the previous year.

  The MPC expects GDP growth to remain strong but moderate to 7% in fiscal 2025, from 7.6% in the previous year. Growth is expected at 7.1% in the first quarter, 6.9% in the second quarter, 7% in the third quarter and 7% in the fourth quarter. The MPC takes heart from strong growth to continue its focus on reducing inflation.

  While investments drove the surge in growth last year, the MPC expects private consumption – the weak link in GDP growth – to pick up in fiscal 2025. Rural demand, which was hit by weak agricultural output and high food inflation last year, is expected to improve with a normal monsoon this year. The RBI's latest survey points to a rise in consumer confidence, which it said augurs well for discretionary consumption.

  Conditions remain bright for fixed investment due to the improving capacity utilisation, healthy corporate balance sheets, and supportive government capital expenditure. These are expected to sustain the momentum in manufacturing and services. However, geopolitical tensions and extreme weather events remain the key downside risks.

- **Supportive external conditions**: The RBI governor noted that global growth has shown signs of resilience. While inflation is moving closer to the targets in advanced economies, the last mile of disinflation has been challenging, keeping central banks cautious in their communication. The governor pointed to the persisting risks from geopolitical tensions and elevated global debt level.

  That said, he emphasised that India stands out with stronger GDP growth, move to fiscal consolidation, and rising foreign exchange reserves. The rupee has been stable relative to its emerging market peers, with falling volatility.

RBI maintains a nimble approach to manage liquidity

- The RBI maintained its 'withdrawal of accommodation' stance. The governor stated that the central bank will remain nimble and proactive in managing liquidity.

- The central bank has acted both ways in its liquidity management – conducting both repo and reverse-repo operations since February. While the RBI net-injected funds under the liquidity adjustment facility (LAF) in February and March, it has been absorbing excess liquidity in April so far.[1] Overall liquidity remains close to neutral, at 0.2% of NDTL deficit in March, and 0.6% surplus in the first week of April.

Our view

The MPC's inaction was expected, as food inflation has been stubbornly high so far, even as core inflation – a better indicator of demand pressures – continues to trend down.

Yet food outlook looks better for the current fiscal, as early weather forecasts suggest a normal monsoon this year. The US National Oceanic and Atmospheric Administration (NOAA) expects La Niña conditions to develop by June-August, which augurs well for the southwest monsoon. Last year, El Niño and weak rains curtailed food output.

[1] Until April 5

To be sure, vegetable prices also impart significant volatility and are vulnerable to erratic weather events. Yet, their crop cycles are typically shorter than those of cereals and can correct prices fairly quickly.

We expect easing food inflation, coupled with benign non-food inflation, to bring headline CPI inflation to 4.5% in this fiscal, under our base case – this is close to the RBI's target of 4%. That said, any weather disruptions and sustained uptick in crude oil prices will remain monitorable.

The transmission impact of rate hikes since May 2022 and regulatory measures on risky lending are still playing out. This, coupled with fiscal consolidation, could lead to some moderation in GDP growth this fiscal.

External conditions are turning supportive for easing. S&P Global expects the US and European central banks to begin cutting rates in June. India is poised to attract a significant chunk of inflows from the foreign portfolio investors (FPIs), with the inclusion of India in the bond indices this year, while the current account deficit is well within the comfort zone.

Overall, the macroeconomic environment is likely to turn favourable for a rate cut by mid-2024, under our base case, lest oil prices and monsoons play a spoilsport.

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