RBI MPC likely to hold policy stance and rate at August meeting

TRUST
In Partnership. With Trust.

August 7, 2024

RBI MPC likely to hold policy stance and rate at August meeting

- In its policy decision due tomorrow, the RBI MPC is likely to maintain its policy stance at 'withdrawal of accommodation' and benchmark repo rate at 6.50%. At the previous meeting held in June, there was a change in the voting pattern, with two of the six members voting for a change in stance to 'neutral' and easing of the policy rate by 25bps. Prior to the June meeting, only one MPC member was a dissenter.

- Domestic growth momentum has remained solid since the last MPC meeting. The government's adherence to fiscal consolidation, laid out in the Union Budget, signaled policy continuity and sprung no surprises to account for in monetary policy formulation.

- In Q1, headline CPI inflation was in line with the MPC's forecast. However, upside risks to food inflation remain, as rainfall distribution has been skewed so far, and could impact farm output.

- Liquidity conditions have turned surplus since end-June due to government spending post elections and investment flows post bond index inclusion. In addition to main and fine-tuning VRRR operations, the RBI also conducted OMO sales in July to absorb excess liquidity.

- Global uncertainties have increased, with looming US recession fears, and unwinding of yen-funded carry trade post Bank of Japan policy rate hike that triggered financial market volatility in early August. Escalating geopolitical tensions in the Middle East pose upside risks to commodity prices.

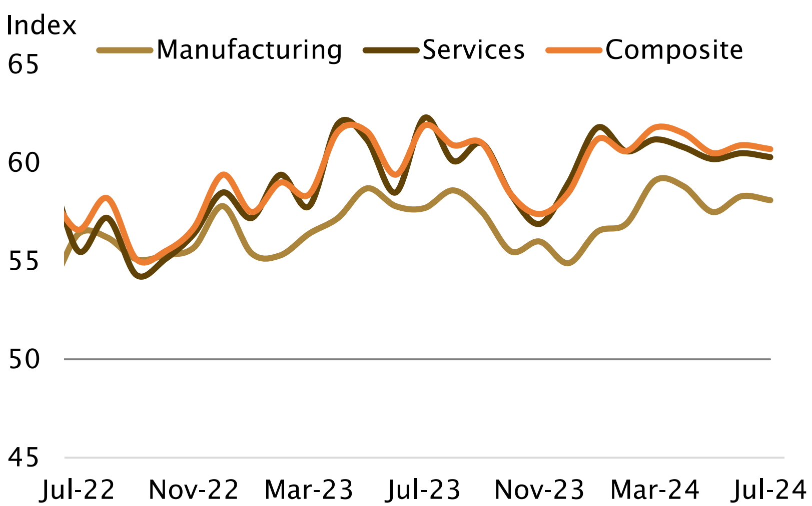
- Financial markets are currently pricing a shallow rate cut cycle by the RBI of 50bps in a year's time, with 25bp cut in six months. This is in line with the upward revision to the neutral rate of interest for the economy, as per a recent RBI study. Since the last policy meeting, Governor Das has reiterated on multiple occasions that with the headline inflation away from RBI's target, it would be premature to change policy stance.

- There are some key upcoming changes in the composition of the MPC. The three external members will exit the committee after the August meeting, and a new set of members will be appointed. Governor Das will complete his second term in December. Deputy governor Dr. Michael Patra, head of the monetary policy department, will complete his extended term in January.

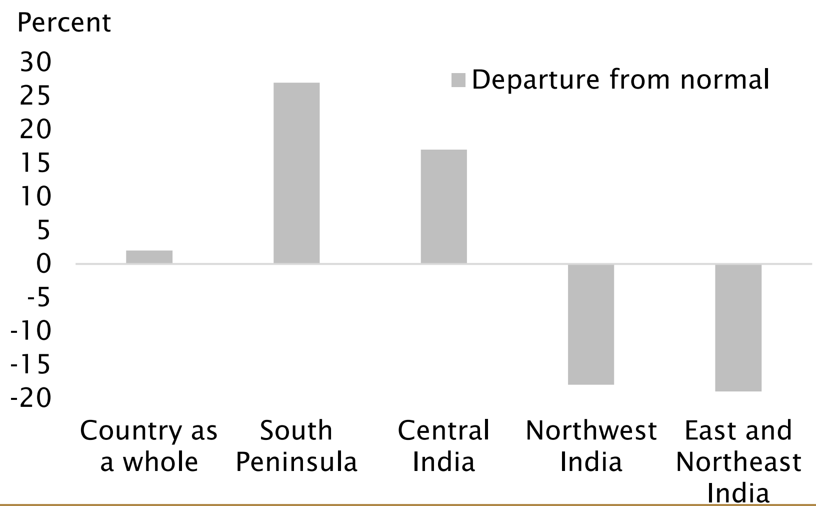
Growth momentum firm; food inflation remains a concern

- The RBI's monthly bulletin for July is tracking GDP growth at 7.4% for Q1-FY25, marginally higher than the latest MPC estimate of 7.3%. PMI indicators showed a slight moderation in momentum in July, though both manufacturing and services indices continued to remain solid. The strength in activity was supported by external sector demand, though there were notable increases in both input prices that were passed on to consumers, and reflected in higher output charges. This could add to domestic price pressures, though the ongoing disinflation in the core component and an expected bottoming out is largely accounted for in the current fiscal. On the other hand, food prices continue to remain a cause of concern.
- The outlook for food inflation largely hinges on the monsoon outturn, particularly after an El Nino year that hit agriculture output in FY24. The expected formation of La Nina and the forecast of an above normal monsoon bodes well for farm sector outlook and food inflation. Kharif sowing is progressing well and (as on August 2), above last year's level, though marginally lower than the comparable period in 2022.
- As of end-July, rainfall for the country as a whole was 2% above normal. However, spatial distribution was uneven with central and southern parts receiving excess rainfall; and rest of the regions recording deficient rainfall. This has also skewed the reservoir levels across regions. The distribution of rainfall and climate-related disturbances will need to be watched out for to gauge the impact on domestic inflation trajectory. In Q1-FY25, headline CPI inflation averaged 4.9%, which was in line with the latest RBI MPC forecast.

PMI indices eased in July but remained firmly in expansion



Skewed spatial distribution of rainfall (as of end-July)



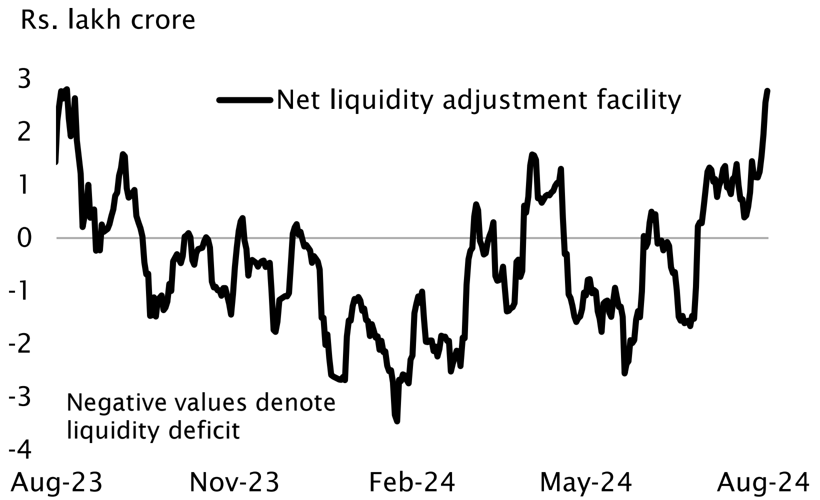
Liquidity turned surplus in end-June; overnight rates softened

- Liquidity conditions turned surplus in end-June after remaining in deficit post the last RBI MPC meeting that concluded on June 7. Since mid-June, the RBI conducted one main VRR operation and four fine-tuning ones, and injected liquidity to the tune of Rs.3.5 lakh crore. In July and until August 6, the RBI conducted two main VRRR operations and 23 fine-tuning ones to absorb liquidity amounting to Rs.7.1 lakh crore. After a gap of around nine months, the central bank also conducted OMO sales in July of Rs.10,125 crore to mop up excess liquidity. As of August 3, liquidity surplus of Rs. 2.78 lakh crore was the highest in almost a year.

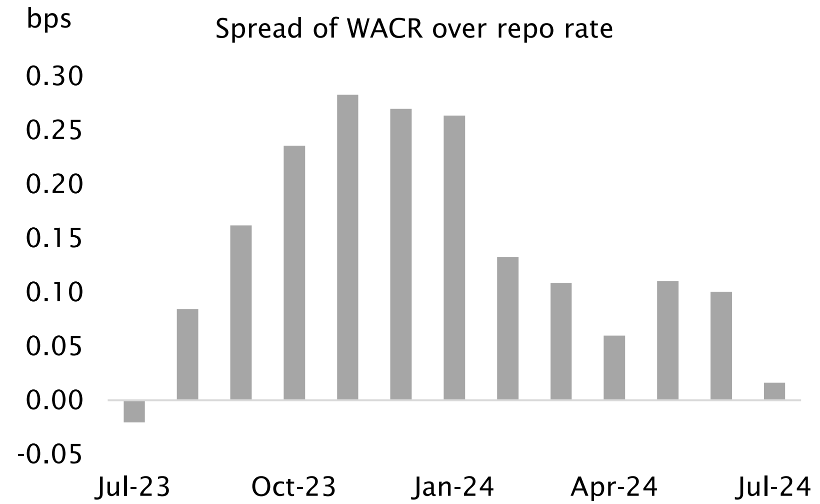
- Government cash balances with the central bank eased from the peak in June as the government started to spend post general elections, which could have contributed to easing liquidity conditions, in addition to the inflows due to JPMorgan bond index inclusion in June.

- As a result of excess liquidity, interest rates have softened with the differential between the overnight weighted average call rate and the repo rate narrowing in July. Yields have eased across the curve, and some of the money market rates have slipped below the repo rate . In this regard, even of the MPC holds the policy unchanged, easing is currently in place to an extent in terms of liquidity and money market conditions.

System liquidity in surplus



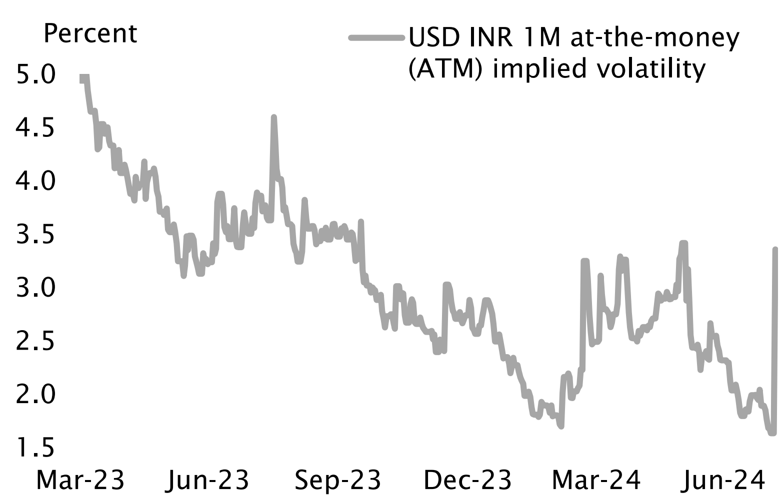
Differential between WACR and repo rate narrowed in July



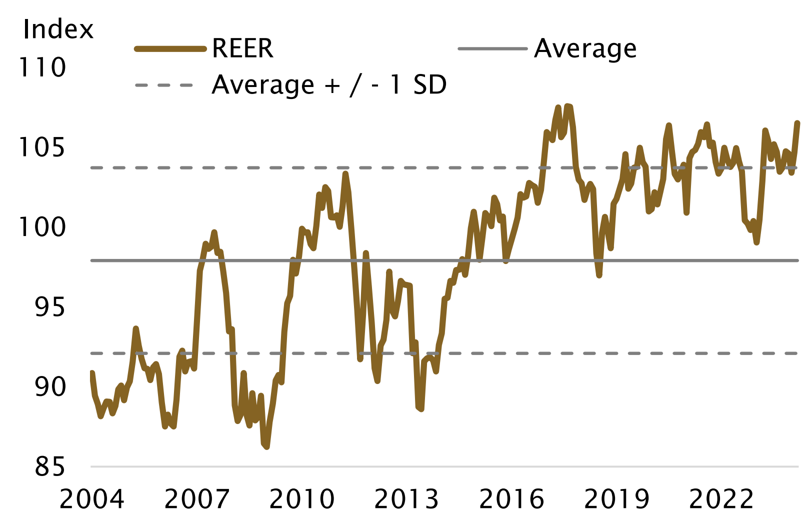
INR overvalued in REER terms; allows scope for depreciation

- The INR continues to remain among the least volatile currencies compared to peers. However, there was a spike in volatility on August 5, similar to the levels seen ahead of the general elections outcome in June. This was driven by turmoil in global financial markets in early August, as weak employment data in the US incited recession fears, and an unexpected interest rate hike by the Bank of Japan with a hawkish forward guidance triggered unwinding of yen-funded carry trade.
- In the first six months of CY2024, the USDINR traded in a range of 82.76-83.65 (Source: Bloomberg BGN). In July, this range trended lower to 83.45-83.74. Data until June indicates that the INR is slightly overvalued, with the real effective exchange rate higher than one standard deviation above its long term average. This allows scope for depreciation to align the real exchange rate to its long term trend.
- As of July 26, foreign exchange reserves were at USD667bn, amounting to more than 11 months of import cover. The reserves were higher than USD656bn in early June, but lower than the recent peak of USD671bn in the week ended July 19.
- As per the latest monthly data available, the central bank bought USD in the spot and the forward market to the tune of USD4.2bn and USD5.9bn in May after selling in April. The outstanding forward book stood at (-)USD10.4bn at the end of May, indicating net forward sales.

USDINR volatility spiked on global financial market turmoil



INR overvalued in REER terms (as of June)

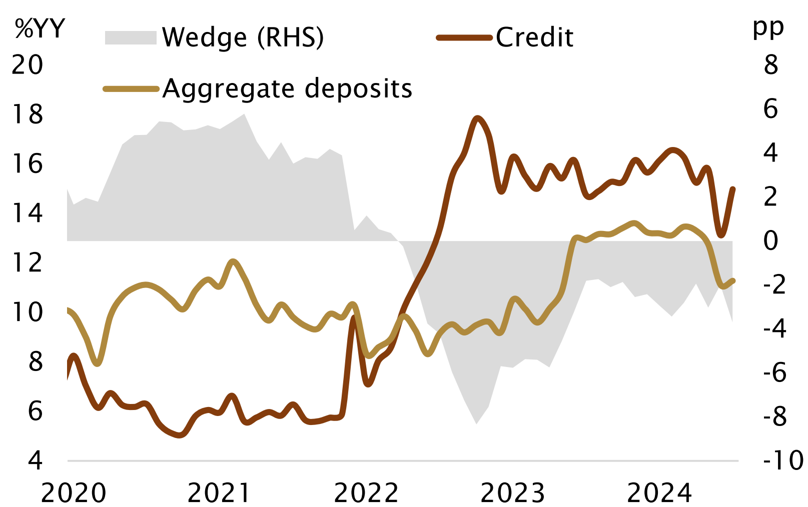


Revised draft liquidity norms could ease credit-deposit gap

- The transmission of policy rate hikes in the current tightening cycle has been higher in case deposit rates compared to lending rates, which also rose but not by the same extent. While credit growth has picked up, deposit growth remains comparatively tepid. The central bank move to raise risk weights for unsecured consumer loans in Nov-2023 has been effective, but the gap between credit and deposit growth continues to persist. This concern was highlighted by the RBI at its June policy meeting and the central bank alluded that the Boards of banks rethink their business plans to maintain a balance between assets and liabilities.

- At its April policy meeting, the RBI announced review of liquidity coverage ratio (LCR) framework to increase banks' liquidity resilience amid increased ability of the depositors to quickly withdraw or transfer deposits using digital banking channels. In July, the RBI released a draft circular (effective April 2025) that calls for additional 5% run-off factor for retail deposits enabled with internet and mobile banking facilities. This could require banks to add to their high quality liquid assets by attracting more deposits/investing more in G-Secs/reducing their loans and advances.

Credit-deposit gap continues to persist



Transmission of policy rate hikes higher in case of deposits

	Variation in basis points	Easing phase (Feb-19 to Mar-22)	Tightening period (May-22 to Jun-24)
	Repo rate	-250	250
Term deposit rates	WADTDR fresh deposits	-259	243
	WADTDR o/s deposits	-188	188
Lending rates	EBLR		250
	1Y MCLR* (median)	-155	160
	WALR fresh loans	-232	181
	WALR o/s loans	-150	119

Note: MCLR data is till Jul-2024

Foreign investment flows strengthened post index inclusion

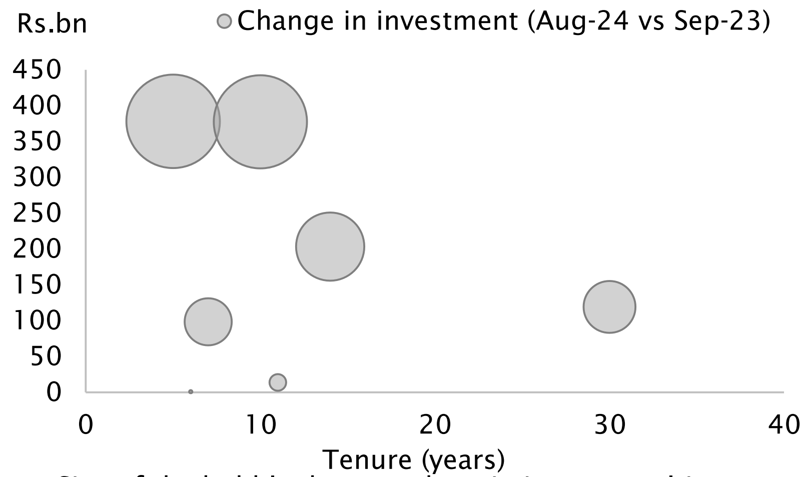
- With the inclusion of Indian government bonds in the JPMorgan Government Bond Index – Emerging Market (GBI-EM) effective June 28, FII investment in debt remained strong in the months of June and July, amounting to around USD4.7bn. Flows into equity were also high at around USD6.5bn for the two months.

- Between Sep-2023, when the index inclusion was announced, and until early Aug-2024, FPI investment in G-sec dated securities under the Fully Accessible Route (FAR) increased by around Rs.1.1trillion, with the largest increments in 5- and 10-year bonds, followed by 14- and 30-year tenors.

- The share of FPI in G-sec dated securities increased to 2.3% as of Mar-2024, up from 1.6% in Sep-2023, and has surpassed the share of state government holdings. However, the share of FPI remains lower than and half of the recent peak of 4.6% in Sep-2017.

- On July 29, the RBI, in consultation with the government, announced exclusion of new securities of 14- and 30-year tenors from FAR. Existing stocks of G-Secs of these tenors already included under FAR will remain available for investments by non-residents in the secondary market.

FPI investment in FAR securities



Note: Size of the bubble denotes share in incremental investment

Ownership pattern of government of India dated securities

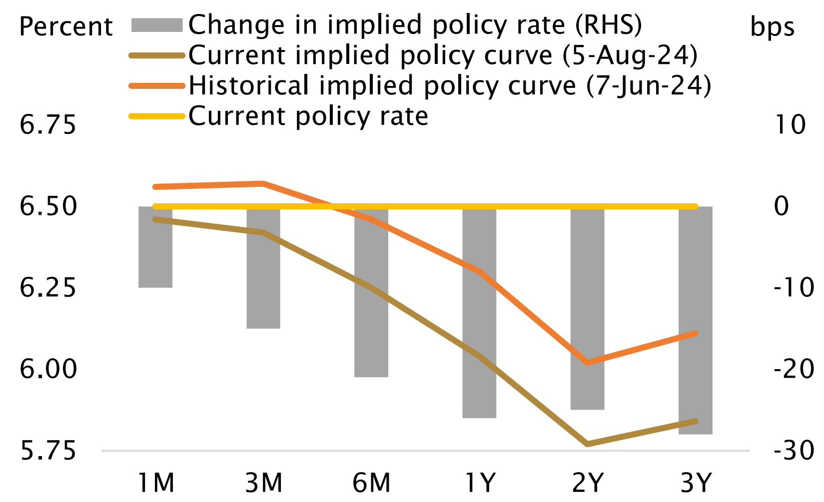
Percent share in total	Sep-23	Mar-24
Commercial Banks	38.0	37.7
Insurance Companies	26.0	26.0
RBI	13.1	12.3
Others	5.6	5.8
Pension Funds	4.3	4.5
Provident Funds	4.4	4.5
Mutual Funds	3.0	2.9
FPI	1.6	2.3
State Govts.	2.0	2.0
Co-operative Banks	1.5	1.5
Corporates	1.2	1.3
Non-Bank PDs	0.7	0.7
Financial Institutions	0.5	0.6

Higher neutral rate of interest narrows scope for policy easing

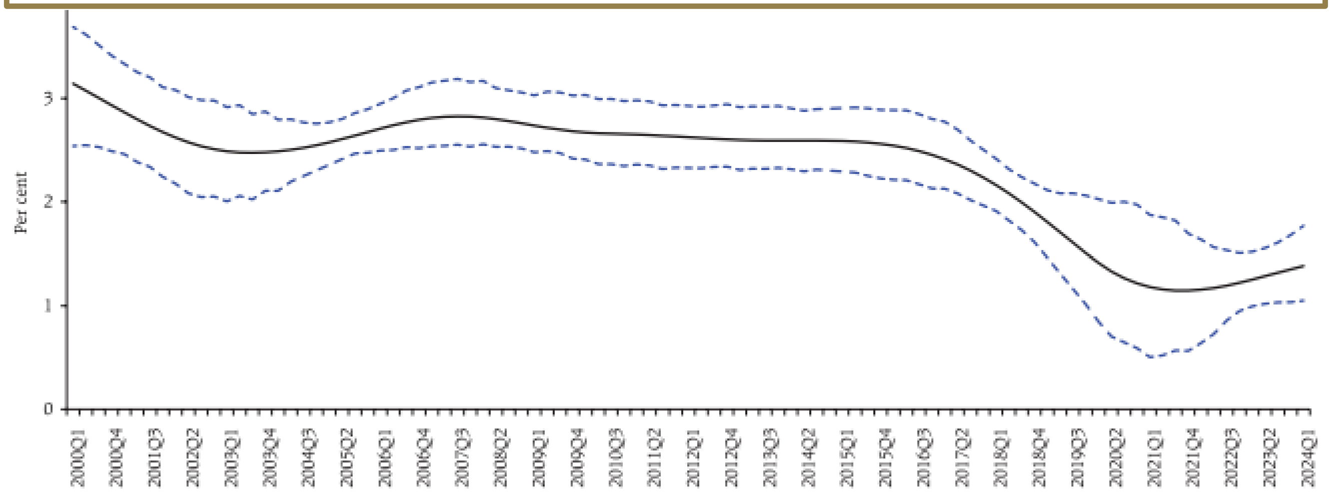
- An article in the RBI's monthly bulletin for July provided updated estimates of the natural rate of interest for the economy in the post-pandemic period. The neutral rate of interest for India stands revised at 1.4-1.9% for Q4-FY24 from the estimate of 1.1-1.3% for Q3-FY22 (revised higher from earlier estimate of 0.8-1.0%).

- The upward revision to the neutral rate suggests that the MPC has less space for easing. Considering CPI forecast of 4.5% for FY25 and current policy rate of 6.5%, this leaves room for 10-60bps cut for the MPC to shift policy towards a neutral setting. This is also reflected in current market pricing of shallow policy easing cycle, with 25bp cut expected after six months, and another 25bp easing after a year. However, this pricing is steeper than at the time of previous policy meeting in June, probably accounting for the policy easing that has started in most major advanced economies.

Market pricing of policy rate path



Natural rate of interest

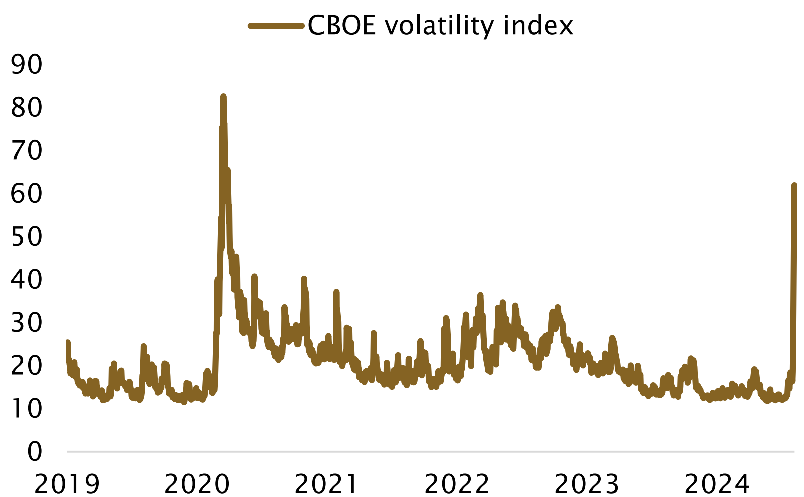


Note: Dashed line in blue represents 90 per cent credible bands.

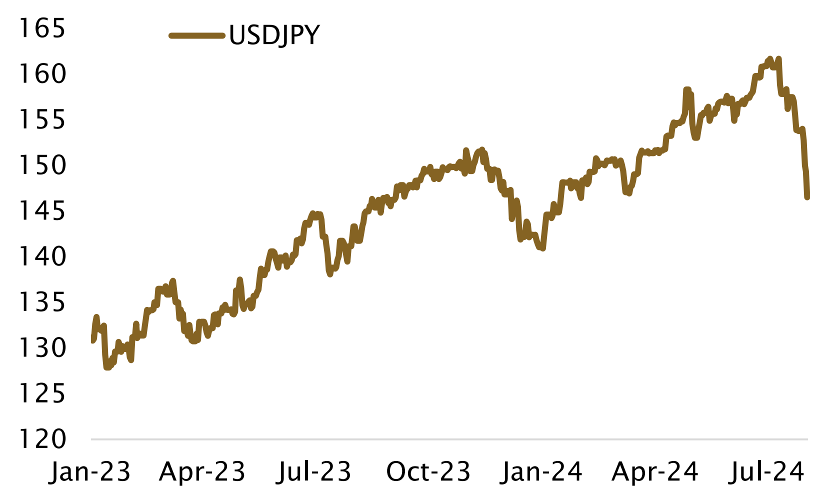
Global uncertainties have increased since last MPC meet in June

- At its latest monetary policy meeting that concluded on July 31, the US Fed FOMC kept its policy rate unchanged, with the Fed Chair Powell putting September rate cut on the table in the post policy conference. However, within a couple of days post the Fed meeting, weak labor market data spooked financial markets, as an increase in the unemployment rate triggered the Sahm rule, a recession indicator. This prompted markets to price in earlier, steeper and/or more number of cuts.
- In the same week, the Bank of Japan surprised markets by raising its benchmark rate to 0.25% from 0-0.1% at its monetary policy meeting held on July 31. The BoJ provided a hawkish forward guidance, signaling further rate hikes if the economy and inflation evolved as per its expectations. This triggered unwinding of yen-funded carry trade positions that also added to financial market turmoil.
- The Bank of England delivered a cautious cut of 25bp this month, bringing its Bank rate to 5% in a narrow 5-4 vote decision. The MPC remained wary of the risks to persistence of inflation in the medium term, but dialed down on the degree of policy restriction due to reduced impact from external shocks and normalization in inflation expectations.
- In terms of global risks, the escalation of geopolitical tensions in the Middle East need to be watched out for because of their impact on commodity prices, including crude oil and gold, and the subsequent effect on domestic inflation.

US recession fears triggered sell-off in global equities



Yen carry trade unwind added to financial market volatility



DISCLAIMER:

We are committed to providing completely independent views to help our clients reach a better decision. This document is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. Nothing in this document should be construed as investment or financial advice, and nothing in this document should be construed as an advice to buy or sell or solicitation to buy or sell the securities of companies referred to in this document. The intent of this document is not in recommendary nature. The recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. Trust Group has not independently verified all the information given in this document. Accordingly, no representation or warranty, express or implied, is made as to the accuracy, completeness or fairness of the information and opinions contained in this document. The Company reserves the right to make modifications and alternations to this statement as may be required from time to time without any prior approval. Trust Group, its affiliates, their directors and the employees may from time to time, effect or have effected an own account transaction in, or deal as principal or agent in or for the securities mentioned in this document. They may perform or seek to perform investment banking or other services for, or solicit investment banking or other business from, any company referred to in this report. Each of these entities functions as a separate, distinct and independent of each other. The recipient should take this into account before interpreting the document. This report has been prepared on the basis of information, which is already available in publicly accessible media or developed through analysis of Trust Group. The views expressed are those of analyst and the Company may or may not subscribe to all the views expressed therein. Neither the Firm, not its directors, employees, agents or representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. This document is being supplied to you solely for your information and may not be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, copied, in whole or in part, for any purpose.

Trust Group

1101, Naman Centre, Bandra Kurla Complex, Bandra (E), Mumbai -400 051, Maharashtra.

Ph: +91 22 4084 5000 • Fax: +91 22 4084 5052 • www.trustgroup.co.in