RBI MPC likely to hold policy stance and rate at June meeting with a cautious undertone

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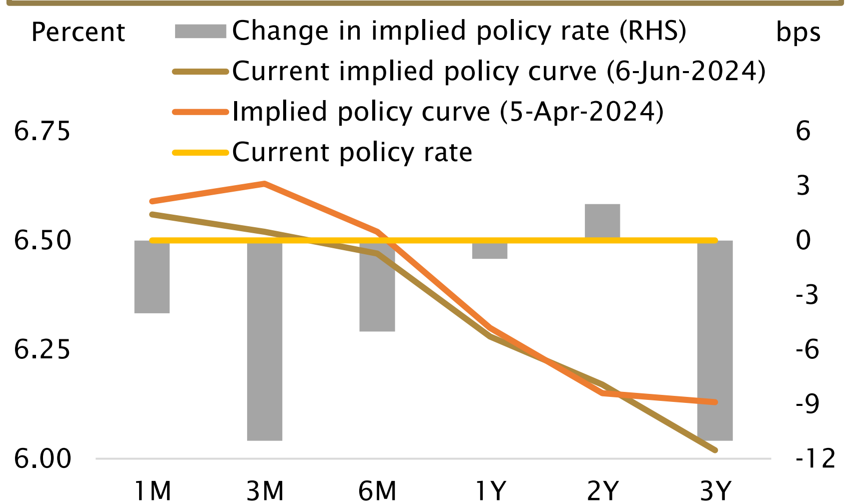
June 6, 2024

RBI MPC likely to hold policy with a cautious undertone

- In its monetary policy decision due tomorrow, the RBI MPC is likely to keep policy stance and rates unchanged. The minutes of its previous meeting indicated that a gradual change in stance could be underway at its August meeting but there have been major developments since its last meeting held in April that could impel the MPC to adopt a wait and watch approach before embarking on any changes.
- On the domestic front, real GDP for FY24 topped 8%, surpassing market expectations and CPI inflation, including core, was stable in the months of March and April. The projection of an above normal monsoon bodes well for both growth and inflation outlook.
- However, general election results declared on June 4 were unexpected, with lack of a single party majority and a narrow victory margin for the incumbent ruling alliance. Financial markets turned volatile on concerns over policy continuity and a populist bias that could impact the government's reform agenda and fiscal consolidation efforts. The RBI MPC might adopt a wait and watch approach ahead of the Union Budget, likely in early July, to understand the impact, if any, of election outcome on the fiscal path.
- Globally, the ECB cut its benchmark interest rates by 25bps today (June 6) citing improvement in inflation outlook. Earlier this month, Bank of Canada and in May, Sweden's Riksbank also lowered interest rates. Despite the start of policy easing, the pace and extent is likely to be uncertain and data dependent. While inflation has eased adequately in economies such as Switzerland , it still remains above target in certain economies where weak growth prompted the start of policy easing. In the US, where another Fed decision is due next week (June 12), data remains mixed amid pockets of weakness in the labor market, though there are no immediate signs of distress and the latest core PCE inflation data was softer but remained above target.
- Domestically, markets are currently not pricing policy easing for at least six months from now. The MPC might wait for clarity on Union Budget and monsoon outcomes, and the start of easing by other systemic banks such as the Fed and BoE before making changes to policy rates or stance.

Market pricing policy easing only after six months



FY24 real GDP growth above expectations; CPI inflation stable

- **Real GDP growth printed above 8% in FY24, exceeding market expectations** and the statistical office's second advance estimate of 7.6%. Real GVA growth was at 7.2%, with the wedge between the two measures of growth remaining a key highlight for the second consecutive quarter in Q4 and for the fiscal year as well. Manufacturing propelled GVA growth, while investment drove GDP growth amid slowing consumption and a drag from net exports.

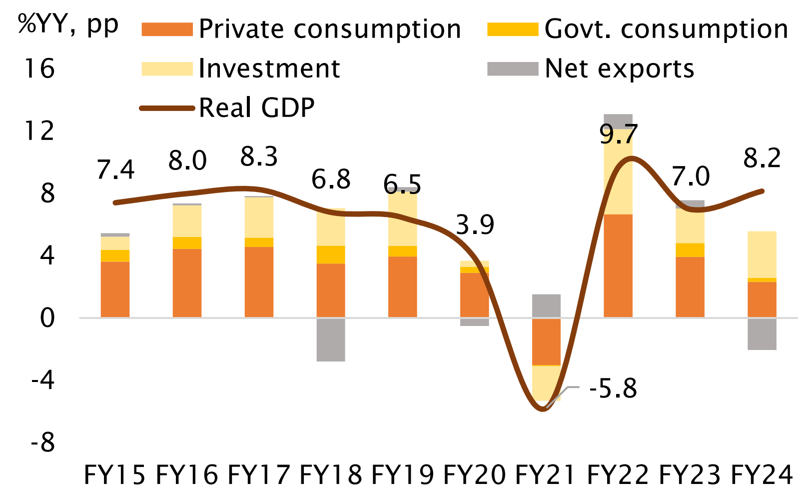
- **Both headline and core CPI inflation have been largely stable for two straight months of March and April.** Though food price inflation remains elevated, internal data is favorable. There are early signs of core inflation bottoming out at current rates.

- The **volatility and rise in global commodity prices pose risks to both growth and inflation outlook. The forecast of an above normal monsoon is a silver lining** that could lift farm output and also ease food prices.

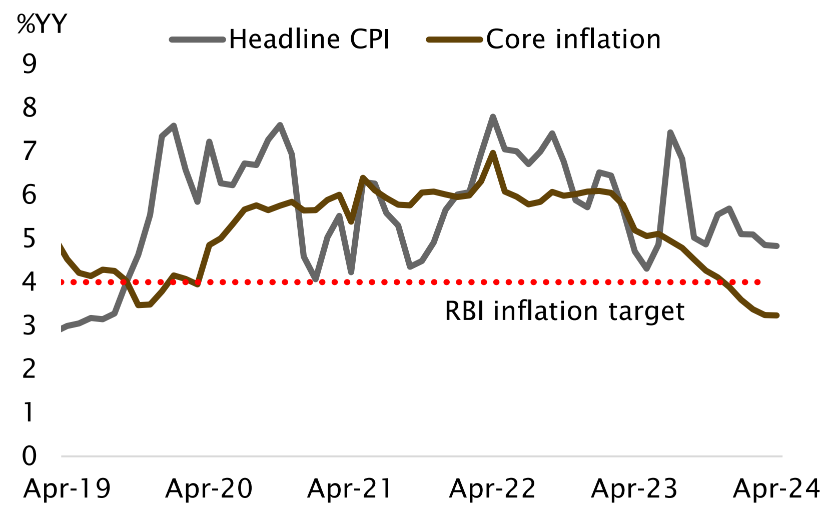
IMD forecasts higher probability of above normal monsoon rains

Category	Rainfall (% of LPA)	Probability (%)
Excess	> 110	29
Above normal	105 - 110	32
Normal	96 - 104	31
Below normal	90 - 95	8
Deficient	< 90	2

Real GDP growth exceeded 8% in FY24



Both headline and core inflation were stable in April

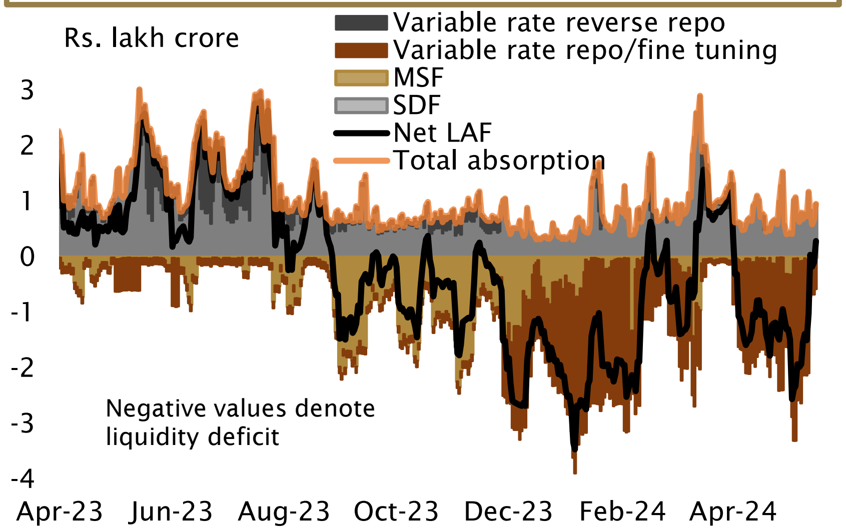


Liquidity in deficit mode since end-April but turning neutral again

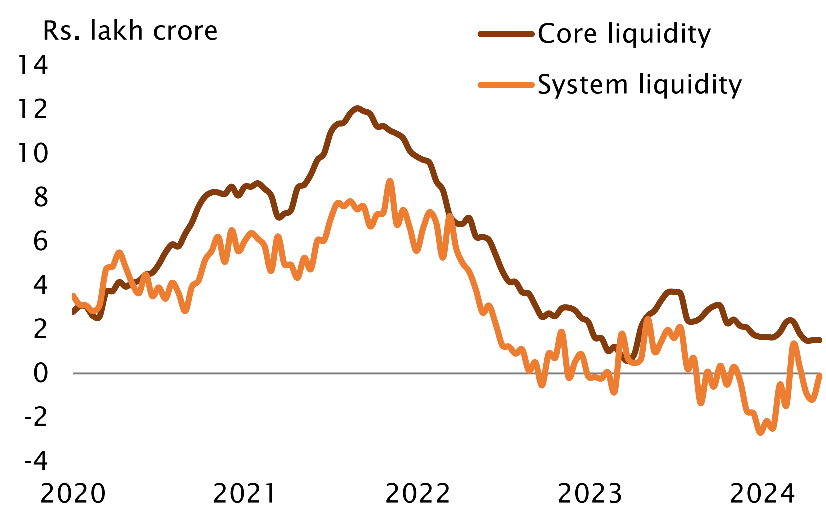
- **Liquidity conditions tightened towards the end of April mostly on account of GST payment outflows and reduced government spending ahead of general elections.** The RBI conducted two-way VRR and VRRR auctions to manage liquidity conditions since its last policy meeting, though the balance was skewed towards liquidity injection. **Liquidity deficit peaked at Rs.2.6 lakh crore on May 21, but improved and has turned somewhat neutral since May 31, so that the central bank started to resort to VRRR auctions at the beginning of June to maintain balance in liquidity conditions. Despite the volatility in system liquidity, core liquidity, net of government cash balances, remains in surplus.**

- Since the last MPC meeting that concluded on April 5 (till June 4), the RBI has conducted four main VRR auctions and 13 fine-tuning operations to inject liquidity amounting to Rs.12 lakh crore against one main VRRR operation and five fine-tuning ones amounting to Rs.1.8 lakh crore to absorb liquidity. The placement of funds under the standing deposit facility (SDF) amounted to ₹0.79 lakh crore (April 6 – June 3), down from Rs.0.93 lakh crore during February 9 – April 4.

System liquidity conditions turning neutral



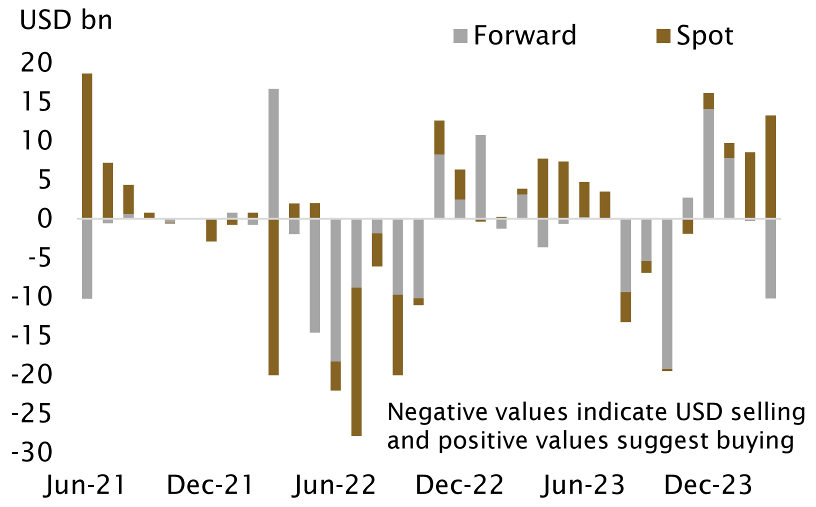
Core liquidity remains in surplus



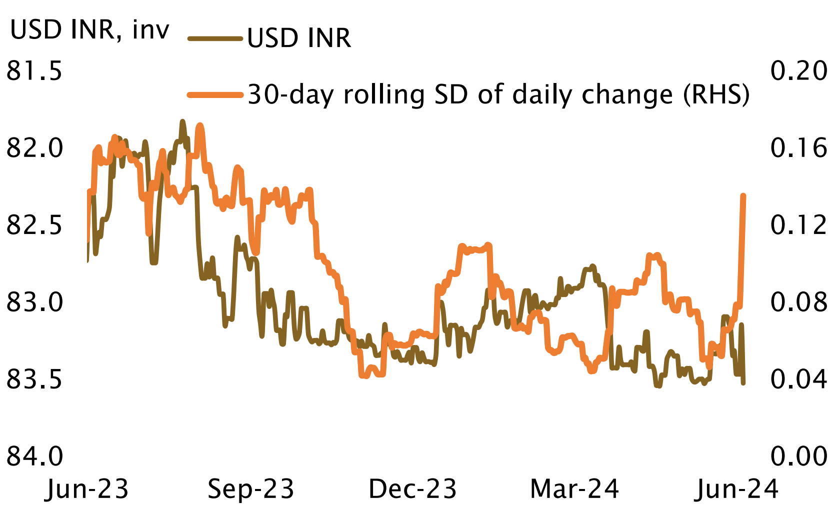
FX volatility muted relative to peer currencies

- Monthly data shows that the central bank bought USD in the spot market worth USD13.2bn in March, the highest since June 2021. The RBI also sold USD in the forwards market to the tune of USD10.2 billion after a gap of three months. On March 22, USDINR had depreciated to the extent that was last seen in Jul-Sep 2023.
- In the months of both March and April, there was a decline in real effective change rate (EER) despite mild increase in nominal EER.
- **FY25 year-to-date volatility in USDINR remains muted relative to peer currencies.**
- **On June 4, there was a spike in USDINR volatility post the general elections outcome** that was in line with reaction in other segments of the financial market.

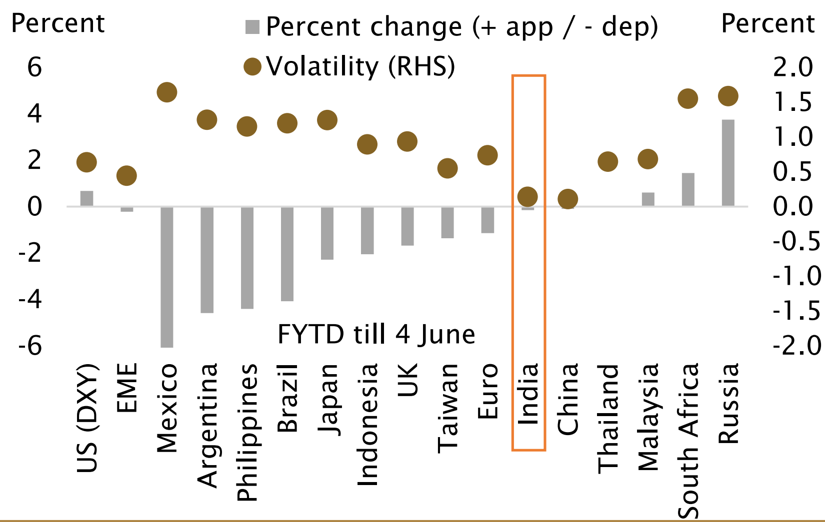
RBI intervention in FX market



Spike in FX volatility post election outcome



INR stable relative to peer currencies

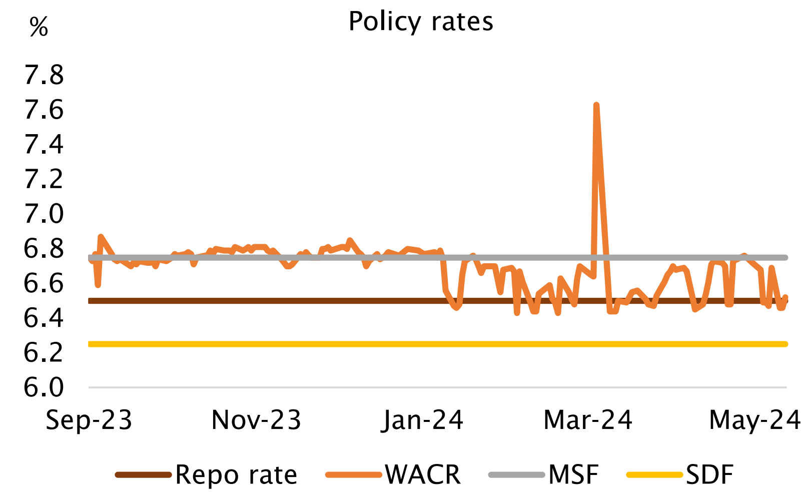


Mixed trends in money market rates since last RBI MPC meet

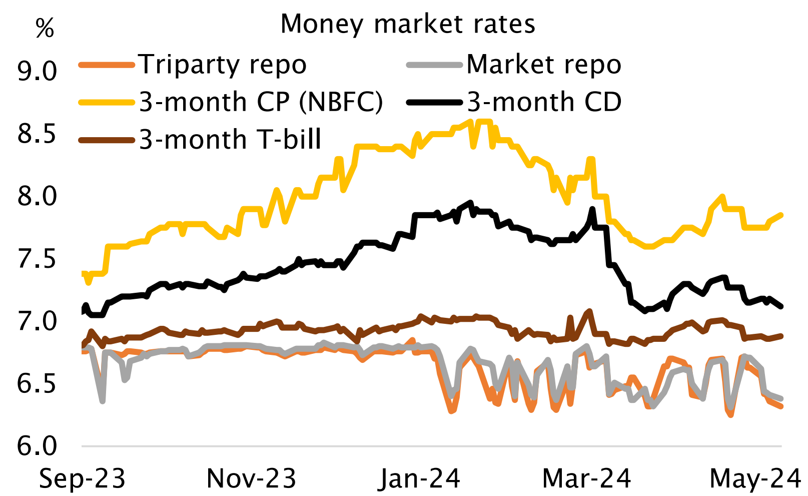
- **Money market rates, including the weighted average call rate, were marked by volatility and mixed trends since the last RBI MPC meeting, reflecting the fluctuations in liquidity conditions around year-end and ahead of general elections.** There was a softening bias in case of 3-month CD, triparty and market repo, and increase in 3-month CP yield.

- Due to tight liquidity conditions for most part of the period since the last MPC meeting, there was an increase in yields at the front end of the curve but an easing in the belly and back end of the curve. However, **post the general elections outcome on June 4, rates jumped across the curve, except for the 3- and 6-month yields that softened.**

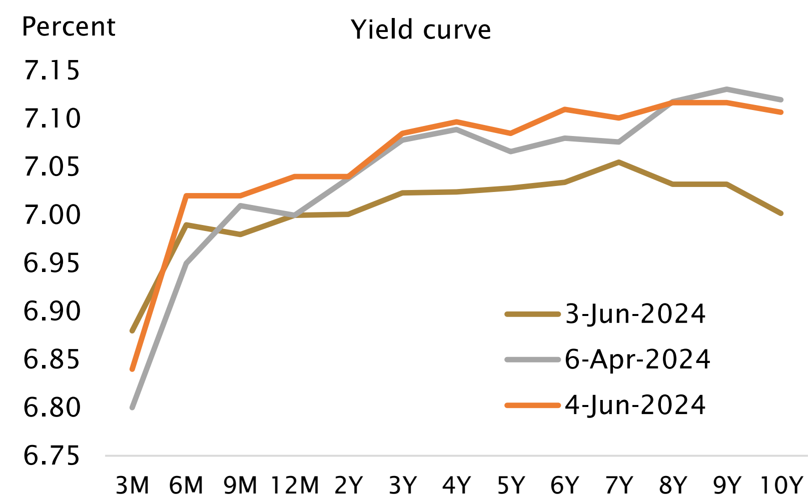
Volatility in weighted average call rate since last MPC meet



Mixed trends in money market rates since last RBI MPC meet



Yields surged post general elections outcome



Lack of single party majority in election results spooked investors

- The outcome of general elections, held once in five years in India, were announced on June 4. The incumbent party that was largely expected to earn majority failed to garner sufficient votes – a feat that it had achieved in the 2014 and 2019 elections – though its alliance led party crossed the 272 mark needed to form a government.

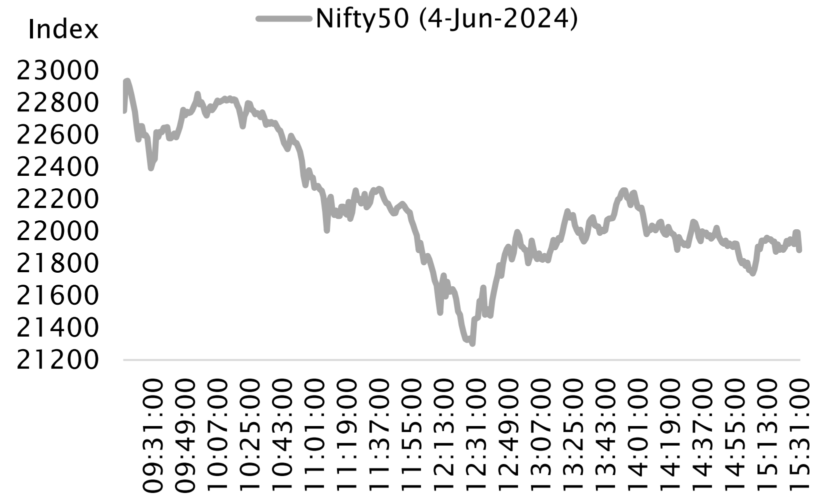
- The lack of single party majority and a smaller victory margin for the incumbent Prime Minister's third term spooked investors and financial markets turned volatile. **There are concerns that to accommodate political support of some of the regional allies, the government's reform agenda might get a pushback or diluted, with likelihood of a populist bias in policymaking and spillovers to fiscal consolidation efforts.**

Financial markets jittery on lack of single party majority

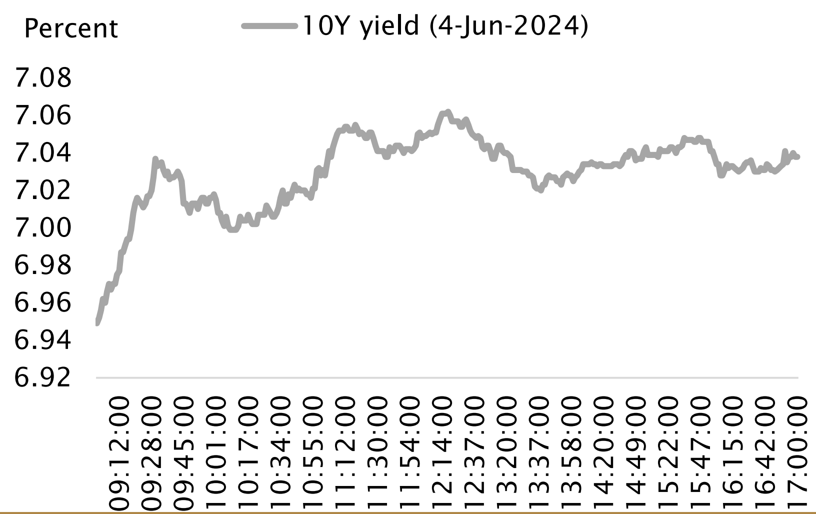
No. of seats won in general elections	2014	2019	2024
Bhartiya Janata Party	282	303	240
BJP-led NDA	336	353	293
Indian National Congress	44	52	99
Congress-led UPA/INDIA	59	91	232
Others	148	98	18

NDA: National Democratic Alliance
UPA: United Progressive Alliance
INDIA: Indian National Developmental Inclusive Alliance

Equites volatile as general election results disappointed



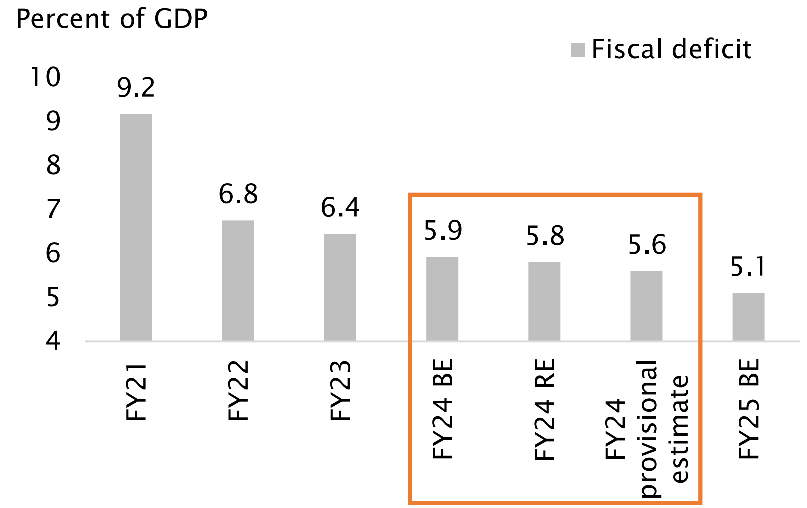
Yields jumped across the curve, including 10Y benchmark



S&P ratings outlook upgrade; lower govt. borrowing and buyback

- **S&P Global Ratings recently upgraded its outlook on India's sovereign rating to 'positive' from 'stable'**, while retaining 'BBB-' rating. The agency cited the country's economic performance and fiscal consolidation efforts among reasons for its move. The government has been adhering to fiscal discipline, with provisional data for FY24 indicating deficit at 5.6% of GDP, lower than the budget estimate of 5.9% and revised estimate of 5.8%.
- To manage liquidity conditions around election time, when lack of government spending builds up cash balances with the RBI, and also perhaps due to higher revenue collections, **the government announced buyback of bonds. However, lukewarm responses to these prompted the government to trim its T-bill borrowing in Q1.**

FY24 fiscal deficit at 5.6% of GDP, lower than budget estimates

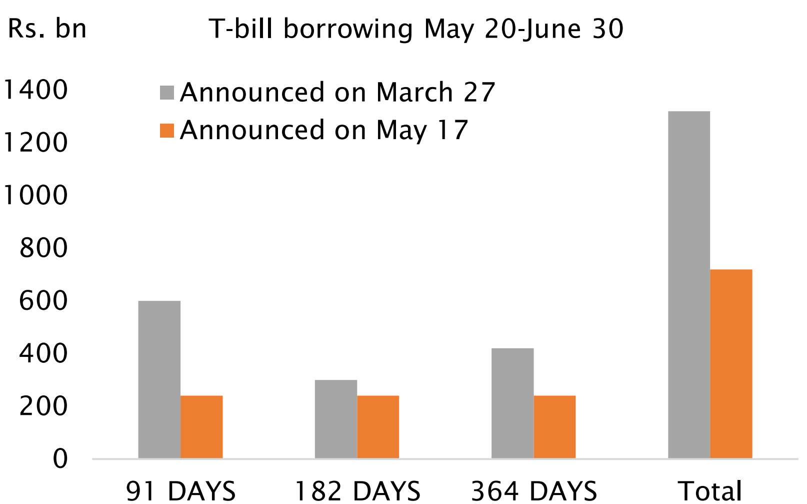


Tepid response to government bond buyback

	Face value (Rs. crore)		
Announcement date	Amount notified by RBI	Amount offered by participants	Amount accepted by RBI
27-May-24	40,000	10,989	5,111
16-May-24	60,000	19,279	5,266
10-May-24	60,000	40,595	2,070
03-May-24	40,000	53,334	10,513
Total	2,00,000	1,24,198	22,960

Note: Additional buyback of Rs. 30,000 crore was announced on June 3, the result of which is due on June 6.

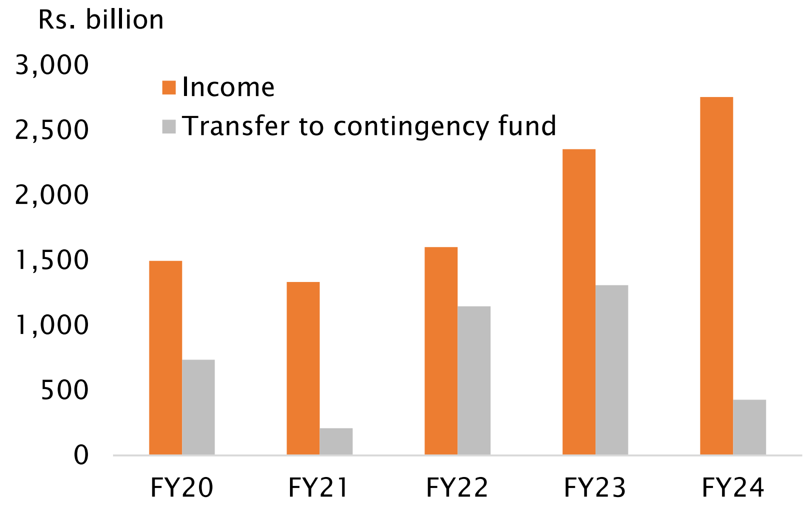
T-bill borrowing lowered by Rs. 600 bn in Q1-FY25



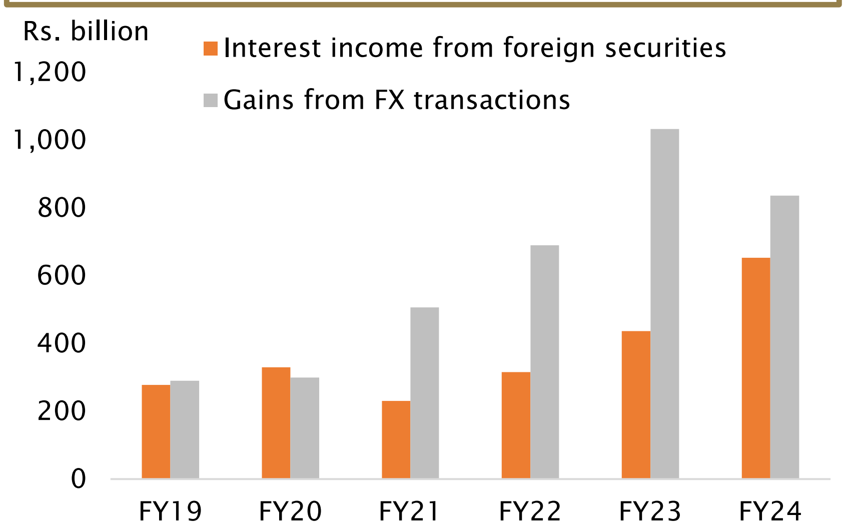
Lower provisions enabled RBI's record dividend transfer to govt.

- **RBI transferred record surplus of Rs. 2.1 lakh crore to the central government in FY24**, higher than market expectations of around Rs.1 lakh crore and revised budget estimate of Rs.1.04 lakh crore expected from RBI, banks, financial institutions, etc.
- The central bank's balance sheet size rose 11.1%YY to Rs.70.5lakh crore. **The surplus transfer was enabled by high interest income from foreign securities amid fall in expenditure** (-56%YY) due to lower transfer to contingency fund (CF). **Investment revaluation gains on foreign and rupee securities enabled lower provisioning towards contingency fund.** Despite the relatively lower transfer to CF fund, balance in the fund rose to 6.5% of the balance sheet, higher than 6% earmarked in FY23.

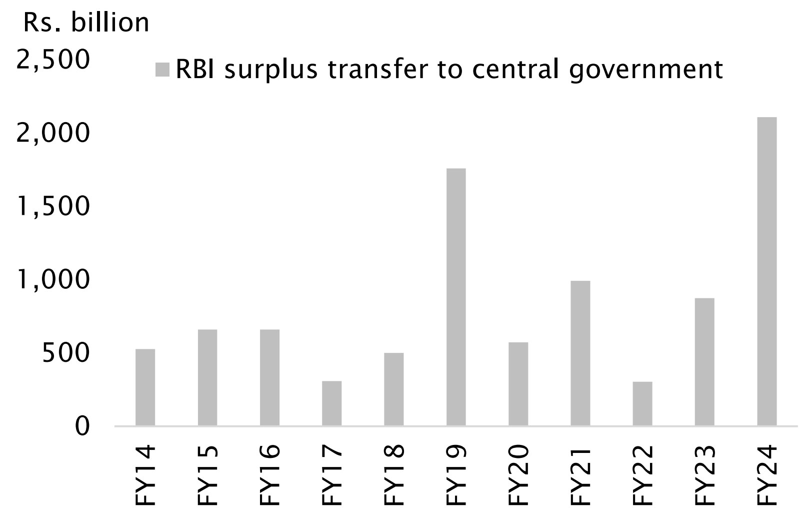
Revaluation gains enabled lower provisioning towards CF



Interest income from foreign securities up by ~50% in FY24



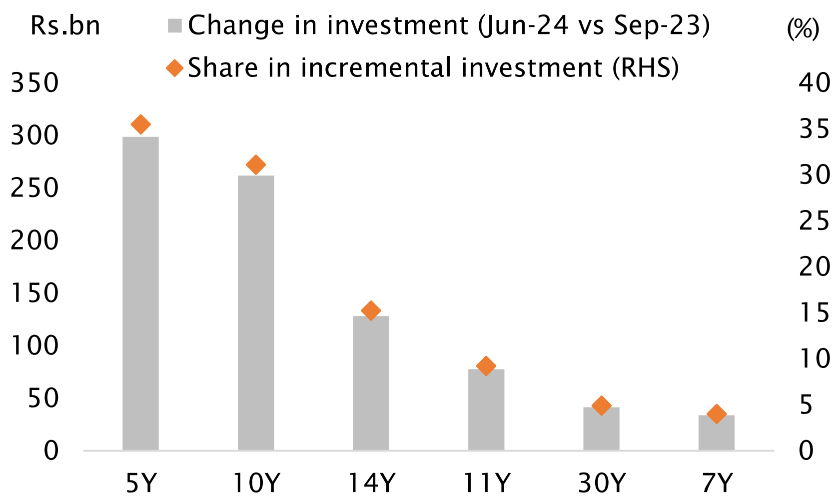
RBI transfers record high dividend to government in FY24



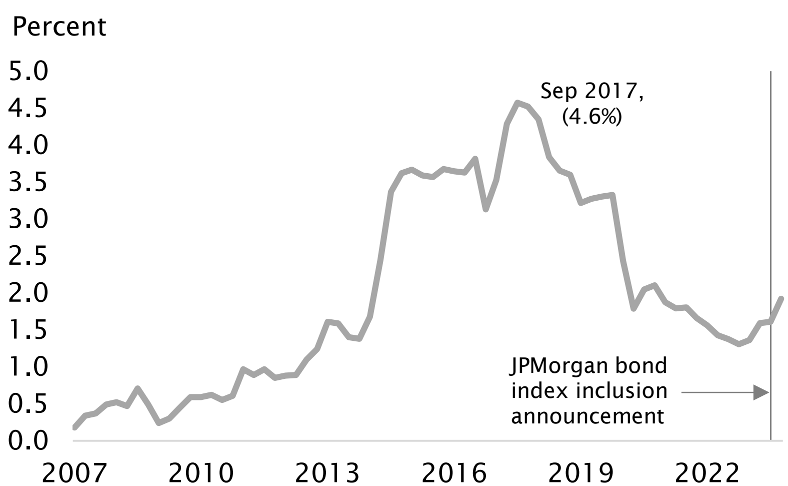
RBI to enhance FX intervention tools; steps for INR internationalization

- In its annual report for FY24, the RBI noted plans to enhance its toolkit for foreign exchange market interventions. The bank noted that the **inclusion of Indian Government Bonds in global bond indices could add to volatility**, though lower outstanding FPI holdings will likely contain risks.
- In its agenda for FY25 for the foreign exchange department, the central bank noted plans for **liberalization of external commercial borrowing (ECB) framework.** As **steps towards internationalization of INR**, some of the agenda items include 1) permitting Indian residents living abroad to open INR account outside the country 2) INR lending by Indian banks to people resident outside India 3) Enabling FPI and FDI through special accounts.

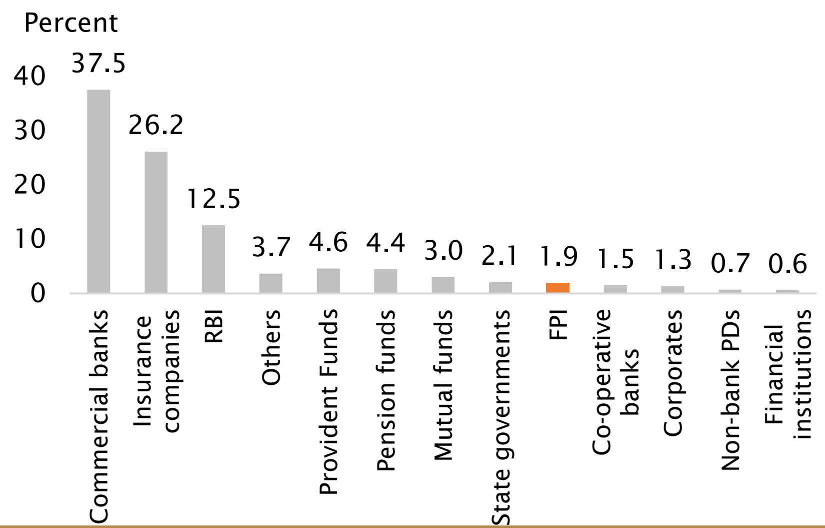
FPI investment in FAR securities



Share of FPI in ownership of Indian g-sec bonds (Dec-2023)



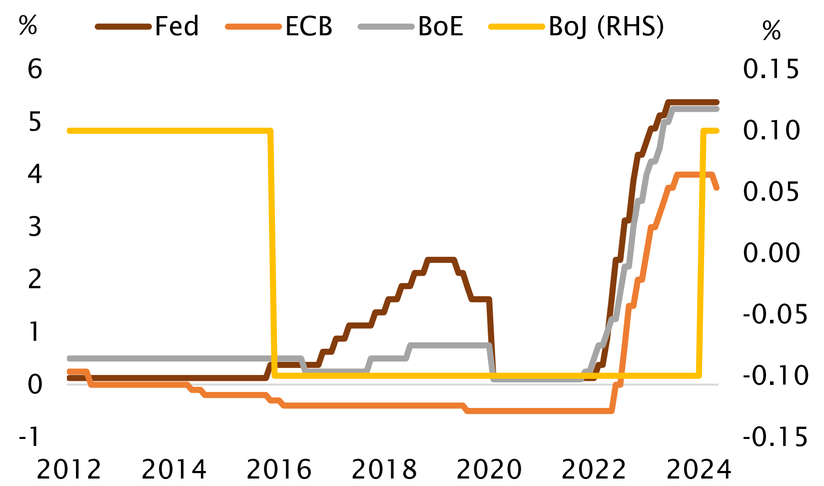
Ownership breakdown of India g-sec bonds (Dec-2023)



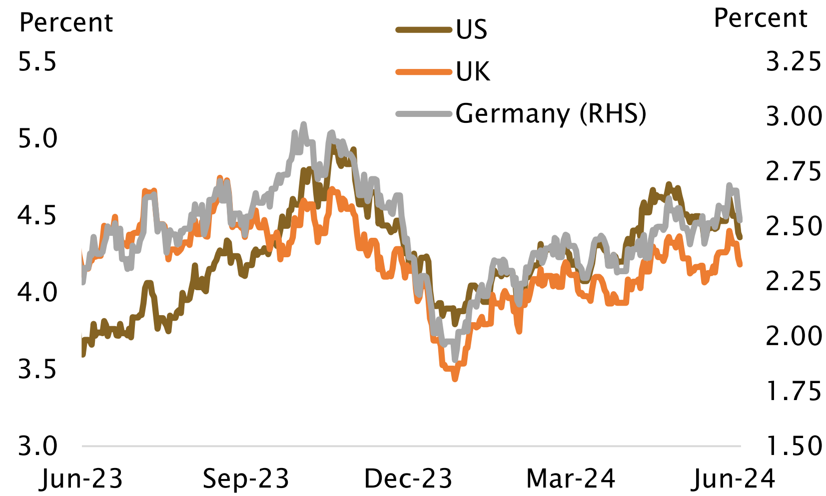
AE central banks start easing; uncertainty looms over extent, pace

- **Central banks in advanced economies have been cautious in dropping their guard against inflation, as the last mile of disinflation process turned out to protracted. Though more banks have started to cut rates, the extent and pace of easing remains uncertain and data dependent.** The idiosyncrasies specific to economies paves the way for policy divergence, not just between advanced and emerging market economies but also within these blocs.
- On June 6, the ECB lowered its key policy rates by 25bps each, citing progress in disinflation. However, upward revision to its inflation forecasts for 2024 and 2025 indicate that the ECB might adopt a cautious, data dependent approach before cutting rates further.
- In March, the Bank of Japan ended its eight-year long negative interest rate regime by hiking rates for the first time in 17 years. On the other hand, the Swiss National Bank surprised markets with a rate cut, as inflation stayed within the bank's target range for months.
- In May, Sweden's Riksbank cut policy rate for the first time since 2015, as inflation neared target in March and GDP fell in 2023. Bank of Canada also cut policy rate as inflation eased and Q1 growth was slower than expected.
- The US Fed kept policy rate unchanged at its last meeting in May and is slated to announce decision next week on June 12. Economic data remains mixed, with pockets of weakness in the labor market, though there are no significant signs of distress yet. Latest PCE print eased in April but remains above the Fed's 2% target.
- Bank of Japan and Bank of England are also scheduled to meet this month on June 14 and 20, respectively.

ECB reduced key policy rates by 25bps



Volatility in yields due to sensitivity to incoming data



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