Preview – RBI Monetary Policy Meeting – October 2023

Summary: In its monetary policy decision due tomorrow (October 6, 2023), the Monetary Policy Committee (MPC) of the RBI is expected to hold repo rate at 6.50% for the fourth consecutive meeting, and retain its policy stance of withdrawal of accommodation. Since the last MPC meeting, economic activity has remained strong, and inflation is showing signs of cooling, though pockets of concern remain within these variables and new headwinds have emerged. Banking system liquidity turned into deficit in mid-September after the introduction of incremental cash reserve ratio (I-CRR) at the previous MPC meeting and four variable reverse repo rate operations (VRRR) thereafter.

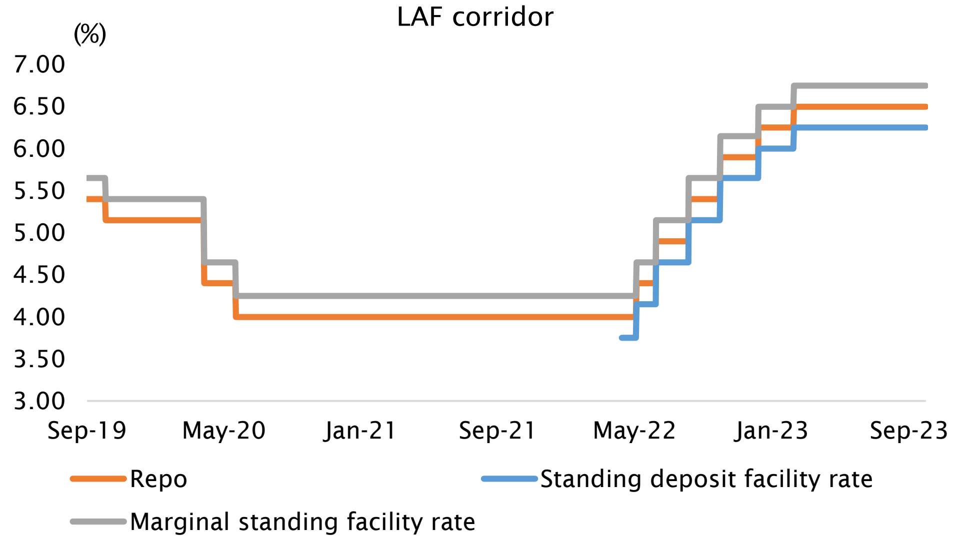
At its previous meeting, the MPC raised CPI inflation forecast for FY24, and it is likely that it could tweak its growth forecasts and/or modify its policy stance in the upcoming meetings. The plausible reasons for these changes include weakness in soft data indicators in the rural sector, muted global growth prospects that could continue to hurt the economy's external balances, and policy concerns around excess liquidity in the banking system. However, the committee is expected to hold key policy rate(s) constant in FY24 to gauge the full impact of the 250 basis point hike since May 2022 (Figures 1 and 2).

Figure 1: RBI's MPC has kept key rates unchanged in three consecutive meetings.

Date	Change in repo rate	Repo	SDF	MSF	Voting pattern Policy rate	Policy stance	Voting pattern Policy stance
10-Feb-22		4.00	-	4.25	6:0	Accommodative	5:1
08-Apr-22	0.00	4.00	3.75	4.25	6:0	Accommodative: focus on WoA	6:0
04-May-22	0.40	4.40	4.15	4.65	6:0	Accommodative: focus on WoA	6:0
08-Jun-22	0.50	4.90	4.65	5.15	6:0	WoA	6:0
05-Aug-22	0.50	5.40	5.15	5.65	6:0	WoA	5:1
30-Sep-22	0.50	5.90	5.65	6.15	5:1*	WoA	5:1
07-Dec-22	0.35	6.25	6.00	6.50	5:1**	WoA	4:2
08-Feb-23	0.25	6.50	6.25	6.75	4:2***	WoA	4:2
06-Apr-23	0.00	6.50	6.25	6.75	6:0	WoA	5:1
08-Jun-23	0.00	6.50	6.25	6.75	6:0	WoA	5:1
10-Aug-23	0.00	6.50	6.25	6.75	6:0	WoA	5:1

WoA: Withdrawal of accommodation
* One MPC member voted for hike by 35bps
** One MPC member voted against hike
*** Two MPC members voted against hike
Effective April 2022, floor of the LAF corridor was changed to SDF from reverse repo

Figure 2: Cumulatively, RBI's MPC has hiked key policy rate(s) by 250bps since May 2022.



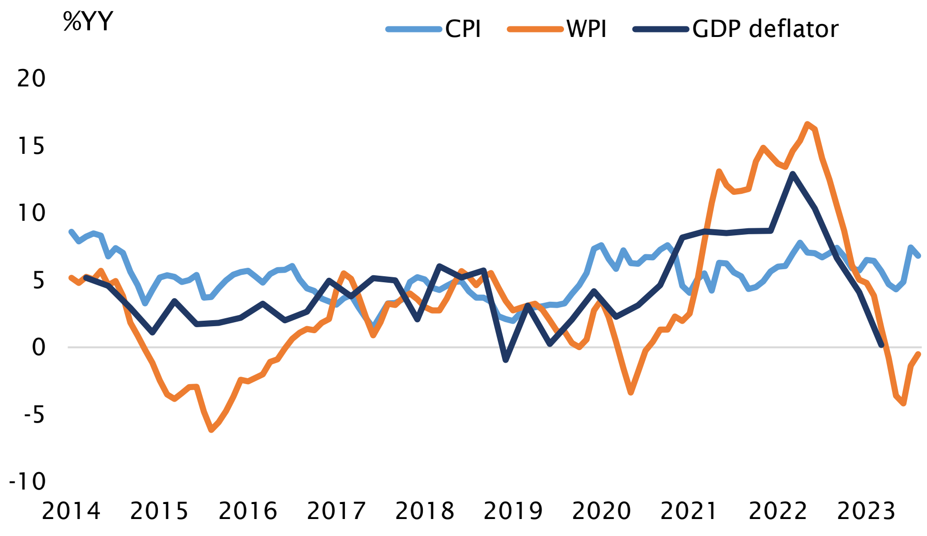
Source: RBI

Inflation: Headline CPI remained above the RBI's upper tolerance band for the second straight month in August, though it moderated to 6.8%YY from the 15-month high of 7.4% in July. The recent inflation prints have been driven higher by prices of vegetables (6% weight in CPI), which is seasonal in nature, and therefore, expected to be transient. However, within the food basket itself, inflation in certain items such as cereals, pulses and spices remains high. While government intervention has and will continue to be effective in arresting some of these price pressures, data on rainfall, sowing and reservoir levels paint a mixed picture.

During the monsoon season this year, the country as a whole received below normal rainfall at 94% of its long period average (LPA). The uneven spatial and temporal distribution of rainfall amid the conflux of El Nino conditions and a positive Indian Ocean Dipole (IOD) continues to cloud the outlook for both kharif and rabi output. The silver lining is that rainfall over the monsoon core zone, which consists of most of the rainfed agriculture regions in the country, received 101% of LPA, which was normal (94-106% of LPA). Latest sowing data (as on 29 September) suggests that the area under rice and cereals remains above last year's coverage but is deficient in case of pulses. Major reservoirs in the country were at 73% of their storage capacity (as of September 29), compared to 89% in the corresponding period last year and 79% of LPA (last 10 years).

On the bright side, various core measures of inflation have been moderating and inching closer to RBI's comfort zone of 4% +/- 2%. As per the latest round (July 2023) of RBI's household survey of inflation expectations, the 3-month and one-year ahead inflation expectations seem to have peaked in September 2022 and have been either declining or have remained stable thereafter. Also, wholesale prices have remained in deflation for five straight months now, which could ease pressures in consumer prices, albeit with a lag. However, wholesale prices could increase if international crude oil prices continue to rise or stay high for longer after breaching the $90/barrel mark in September. Globally, the UN FAO food price index remained in contraction for the tenth consecutive month in August, but in terms of levels, the index remains above the pre-pandemic numbers.

Figure 3: GDP deflator further moderated in Q1-FY24

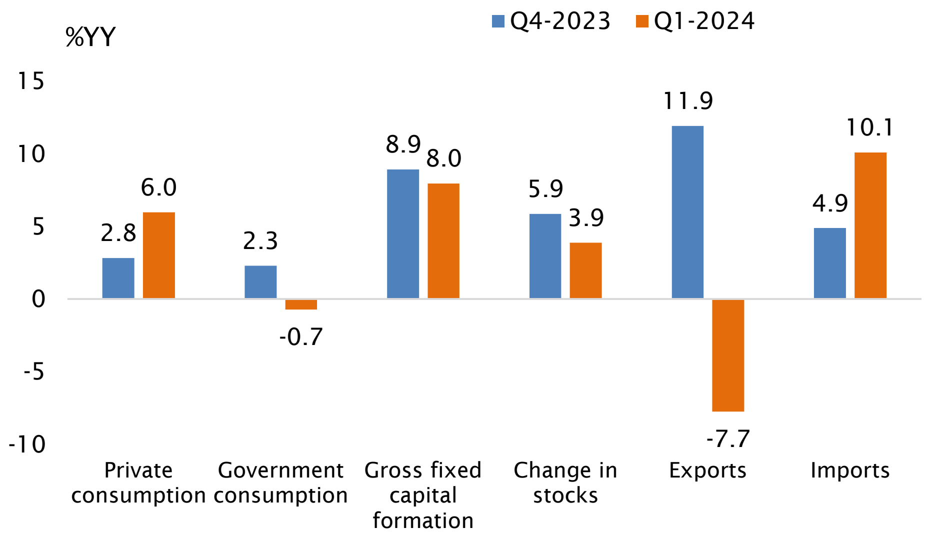


Source: MoSPI, Office of Economic Advisor

Among other measures of inflation, the GDP deflator recently came into focus post the release of GDP data for Q1-FY24. The GDP deflator seems to have peaked in Q1-FY23 and has been moderating thereafter, reaching a 17-quarter low of 0.2% in the latest print for Q1-FY24. This easing has raised concerns that the deflator could be inflating real GDP data, and has revived one of the long-standing debates on the deflator methodology used for arriving at real GDP numbers from nominal values. In India, the Central Statistical Office (CSO) uses single deflation method that uses various combinations of consumer and wholesale prices to deflate corresponding categories of industries in gross value added (GVA). Critics note that the GDP deflator in India closely tracks trends in WPI, which is not representative of the heavyweight services sector in GVA. On the other hand, the double deflation method, used extensively by other nations, uses input and output prices for deflating respective values, and therefore, could better measure economic activity.

Economic activity: Brushing aside the deflator debate, India's real GDP grew 7.8%YY in Q1-FY24, higher than 6.1%YY growth in the previous quarter and a tad lower than the RBI's forecast of 8.0%. Robust increase in private consumption supported higher GDP growth. Growth in gross fixed capital formation moderated but remained strong, boosted by government's thrust on capital expenditure. Net exports deteriorated from the previous quarter due to decline in exports. The latest balance of payments also reflected weakness in the external sector. The current account deficit (CAD) in Q1-FY24 widened to US$9.2 billion (1.1% of GDP) from US$1.3 billion (0.2% of GDP) in the previous quarter.

Figure 4: Key components of GDP by expenditure approach



Source: MoSPI

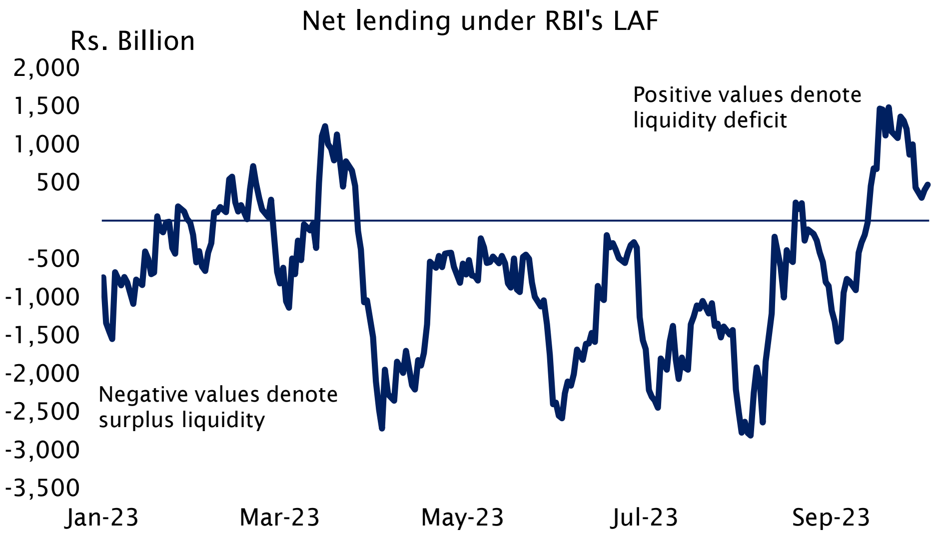
The weakness in external sector is on expected lines, given the sluggish growth in some of the major global economies such as Europe and China. For India, though, the domestic growth story remains intact, but not without hiccups. Most of the high frequency indicators of economic activity remain strong. The latest print on industrial production was robust, with the core sector year-on-year growth reaching a 14-month high. The services sector PMI data for September indicated the sharpest growth in around 13 years. However, signs of distress due to high inflation are emerging in certain data points. Even as the services PMI was robust in September, manufacturing PMI eased from the previous month, as strong demand and high labor costs weighed on output charges. Headwinds are also evident in some of the rural sector data. Domestic tractor sales fell 0.3%YY in April-August this year compared to an increase of 7.2% in the corresponding period in 2022. CMIE's measure of rural consumer sentiment moderated by 255 bps in August to a 3-month low, marking the first decline since December 2022, even as urban consumer sentiment remained largely intact.

As the full impact of policy rate hikes finds its way into the economy, private consumption, which has been the cornerstone of economic activity in the country, could take a hit, so the high growth in Q1 could fade in the remaining quarters of FY24. This is also reflected in RBI's GDP growth forecasts. For the entire financial year FY24, RBI has penciled in a growth forecast of 6.5%, with 6.5% in Q2, 6.0% in Q3 and 5.7% in Q4. In its latest biannual update for India, the World Bank retained its earlier projection of 6.3% growth in FY24, supported by strong investment due to a continued increase in public investment in infrastructure.

Liquidity conditions: As a result of the I-CRR introduced by RBI's MPC in its August meeting, and four VRRR operations, banking system liquidity slipped into a deficit in mid-September and remained so as per the latest data for October 4 (Rs. 471.5 billion).

In Q1-FY24, the narrowing of current account deficit on a year-on-year basis was driven by strong foreign portfolio investment (FPI) inflows of $15.7 billion versus an outflow of $14.6 billion in Q1-FY23. On the other hand, while foreign direct investment (FDI) was strong at $13.4 billion in Q1-FY23, it shrunk to $5.1 billion in Q1-FY14. Among other factors, this influx of hot money, could impart volatility to the exchange rate and complicate RBI's task of managing foreign exchange reserves, and therefore, liquidity.

Figure 5: Banking system liquidity slipped into deficit in mid-September



Source: RBI

In addition to signs of slowing economic activity and headline inflation that continues to hover above RBI's upper tolerance band, deteriorating external and fiscal balances could compel the MPC to keep its policy status quo, albeit with a hawkish tone.