RBI's MPC maintains its hawkish pause; to curb excess liquidity via OMO sales

Key takeaways from October RBI MPC meeting

At its bi-monthly meeting held in October, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) held the policy repo rate at 6.50% percent, while also maintaining its stance of 'withdrawal of accommodation'. The MPC re-emphasized its objective of aligning headline inflation to its 4% target on a durable basis. The hawkish tone was underscored by its willingness to wield open market operation (OMO) sales to curb excess liquidity in the banking system. The MPC was optimistic about the economy's growth prospects, but sounded caution over the likely risks emanating from excessive credit growth in certain segments of personal loans.

Summary: The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in its bi-monthly meeting held in October, unanimously kept the key policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.50% for the fourth consecutive meeting. Accordingly, the standing deposit facility (SDF) remained unchanged at 6.25%, and the marginal standing facility (MSF) and the bank rate at 6.75%. The MPC also retained its policy stance of 'withdrawal of accommodation' by a vote of 5:1 to ensure that inflation progressively aligns to its target of 4%, while supporting growth. The status quo was also driven by the fact that the transmission of the 250 basis point hike since May 2022 is still incomplete.

Amid various external and domestic headwinds, the MPC sounded optimistic about the economy's growth prospects and made no changes to its forecasts for the upcoming quarters and the entire financial year FY24 (Figure 1). The MPC remained vigilant about the upside risks to CPI inflation and held its forecast for the full year FY24, but tweaked the quarterly numbers due to food price shocks that drove headline inflation higher in Q2-FY24. The committee maintained both GDP and inflation forecasts for Q1:FY25.

To manage liquidity and curtail any excesses, the MPC noted that it might have to consider open market operation (OMO) sales to ensure that liquidity remained consistent with its policy stance. However, this soured the sentiment in the bond market and pushed up yields.

Figure 1. No changes in latest growth and inflation forecasts (F) for FY24; but minor tweaks to quarterly CPI numbers

Real GDP growth (%YY)	Q2:FY24 F	Q3:FY24 F	Q4:FY24 F	FY24 F	Q1:FY25 F
October 2023	6.5%	6.0%	5.7%	6.5%	6.6%
August 2023	6.5%	6.0%	5.7%	6.5%	6.6%
CPI Inflation (%YY)	Q2:FY24	Q3:FY24	Q4:FY24	FY24	Q1:FY25 F
October 2023	6.4% (+0.2pp)	5.6% (-0.1pp)	5.2%	5.4%	5.2%
August 2023	6.2%	5.7%	5.2%	5.4%	5.2%

Growth to remain resilient despite external and domestic headwinds. The MPC stayed optimistic about the economy's present and future performance, alluding to it as the new growth engine of the world. In the midst of external headwinds, economic activity remains resilient due to strong domestic demand. In Q1:FY24, India's real GDP grew 7.8%YY, higher than 6.1%YY growth in the previous quarter. Private consumption remains the cornerstone of growth, though in recent years, investment has also been supportive due to the government's push for capital expenditure. On the production side, the services sector remains buoyant, and manufacturing activity continues to recover. The high frequency indicators in recent months indicate that growth is likely to remain resilient in Q2, though not without pockets of weakness.

An uneven and muted monsoon could keep the pressure high on food inflation, adding to central bank woes, with likely repercussions for growth. Additionally, in the backdrop of muted global growth, the external sector is likely to remain a pain point for policymakers. The MPC noted that global growth is slowing due to tighter financial conditions, geopolitical tensions and growing geo-economic fragmentation. Global trade is expected to further dwindle. Across major economies, inflation is easing at a lower-than-expected pace, undermining central bank efforts and creating an environment where interest rates are likely to remain higher for longer. Financial markets are reeling under the impact of these conditions, imparting volatility to capital flows and exchange rates. This is corroborated by recent data on net exports weighing on domestic growth, and an influx of portfolio investment flows amid waning direct investments. However, the MPC is confident of facing these challenges due to the India's lower external vulnerability in comparison with other emerging market peers, accentuated by a strong buffer of foreign exchange reserves.

The latest results (September 2023) from some of the RBI's forward-looking surveys also exude the MPC's confidence in the domestic economy. Consumer confidence continued to recover with both the current situation and future expectations indices reaching a four-year high. As per the industrial outlook survey, manufacturers were optimistic about business conditions in Q3:FY24. However, the services and infrastructure firms noted lesser optimism compared to the previous round of survey, though they expect business conditions to remain strong. In addition to these factors, healthy balance sheets of banks and corporates and supply chain normalization will support the economy's growth prospects.

In its bi-annual Monetary Policy Report, the RBI kept the growth forecast for FY25 unchanged from the previous report at 6.5% (Figure 2). Apart from the factors noted earlier, the report also cited double-digit credit growth as a tailwind for domestic demand. The report noted the structural change in the composition of bank credit over the years, with an increasing proportion of credit now going to services and retail loans relative to industry. The MPC, however, preferred to err on the side of caution by noting that certain components of personal loans with very high growth were being monitored for any signs of incipient stress.

Figure 2: RBI's baseline structural model estimates for real GDP growth (%YY)

MPR edition	FY25	Quarterly forecast range
April 2023	6.5%	5.5%-7.0%
October 2023	6.5%	6.3%-6.6%
Upside risks: 1) stronger-than-expected rebound in services sector 2) more vigorous boost to private investment from government's capex push 3) healthier corporate balance sheets 4) more resilient global growth 5) an early resolution of the geopolitical conflict.		
Downside risks: 1) an escalation in geopolitical tensions 2) further hardening of international crude oil, food and commodity prices 3) sharper loss of momentum in global trade and demand 4) frequent weather-related disturbances due to climate change.		

Source: RBI's Monetary Policy Reports for April and October 2023.

High inflation remains a key risk to macroeconomic stability and sustainable growth. The MPC reiterated its commitment to align inflation to its target of 4% on a durable basis. It noted that high inflation in July and August was driven by food price shocks, particularly vegetables, which is expected to be transient. However, inflation remains elevated in other pockets of the food basket such as cereals, pulses and spices, which is a cause of concern. Despite supply side management and government intervention, food price pressures are unlikely to fade away in a sustained way in Q3:FY24. The MPC noted the risk that these recurring instances of overlapping food price shocks could translate into generalized price pressures. A patchy and muted monsoon, low reservoir levels, below normal kharif sowing of certain crops, and El Nino conditions are among the many factors that continue to cloud the outlook for food inflation. Additionally, the volatility in international commodity prices, particularly food and crude oil, adds to the existing uncertainties for future inflation trajectory.

Recent survey-based soft data on inflation is mixed. In the RBI's latest round of industrial outlook survey (September 2023), manufacturers expect input cost pressures to persist but the pricing power to pass on the rise in selling prices to emerge only after Q3:FY24. Services firms expect both input costs and selling price pressures to ease in Q3, while infrastructure firms expect selling prices to rise. Latest PMI data indicated receding price pressures in case of the services sector but rising output charges (due to demand pressures) amid lower input costs for the manufacturing sector.

However, there are bright spots. Various measures of core inflation continue to moderate. In the RBI's latest survey, households' inflation expectations slipped to single digit for the first time since the pandemic, suggesting anchoring of inflation expectations. Based on these assessments, the

MPC retained the full year FY24 CPI inflation forecast at 5.4%, while raising Q2:FY24 estimate by 0.2 percentage points (pp) to 6.4% and clipping Q3:FY24 projection by 0.1pp to 5.6% (Figure 1).

In its latest bi-annual monetary policy report, the RBI maintained its full year FY25 forecast from the previous edition at 4.5% (Figure 3). Among the alternative scenarios to assess the balance of risks, the report noted that the largest upside risk to its baseline inflation projection was from food prices, followed by INR depreciation, international crude oil prices, and global growth uncertainties (Figure A in the appendix).

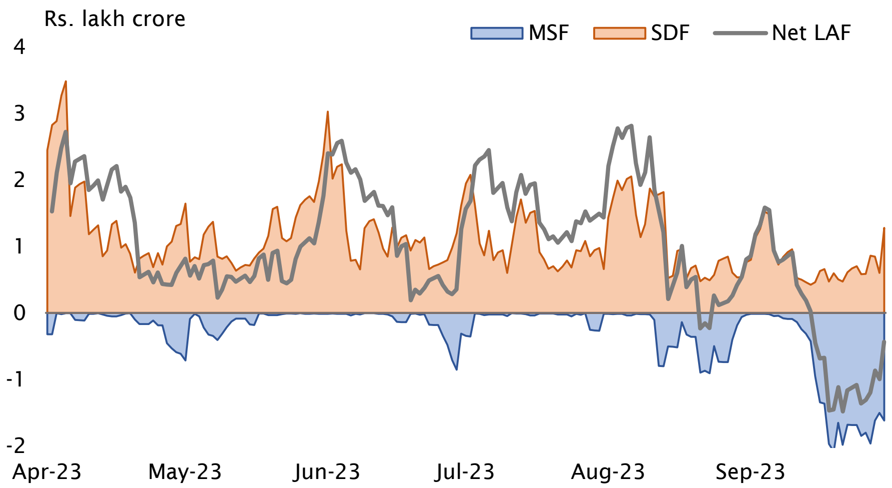
Figure 3: RBI's baseline structural model estimates for CPI inflation (%YY)

Period	MPR edition	Forecast	Quarterly forecast range
FY25	October 2023	4.5%	3.8%-5.2%
	April 2023	4.5%	-
Q4:FY25	October 2023	4.3% (-0.1pp)	3.0%–5.6% (50% C.I.)
			2.3%–6.3% (70% C.I.)
	April 2023	4.4%	3.0%-5.8% (50% C.I.)
			2.2%-6.5% (70% C.I.)
Upside risks: 1) more persistent food price increases due to weather-related events feeding into inflation expectations 2) further hardening of global commodity prices amidst an escalation of geopolitical tensions 3) larger pass-through of input costs to output prices.			
Downside risks: 1) early resolution of geopolitical tensions 2) steep correction in global crude and commodity prices in the event of a sharp slowdown in global growth 3) further improvement in supply conditions.			

Note: C.I. refers to confidence interval implying the percent probability that the actual outcome will be within the range mentioned.
Source: RBI's Monetary Policy Reports for April and October 2023.

RBI to consider OMO sales for liquidity management. In its August meeting, the MPC had introduced an incremental cash reserve ratio (I-CRR) as a temporary measure to absorb excess liquidity in the banking system. The I-CRR impounded around Rs.1.1 lakh crore and has been discontinued in phased manner. The excess liquidity in the system was a result of 1) return of Rs.2000 notes to the banking system 2) RBI's surplus transfer to the government 3) increase in government spending, and 4) capital inflows.

Figure 4: Data on standing facilities suggests skewed distribution of banking system liquidity



Source: RBI

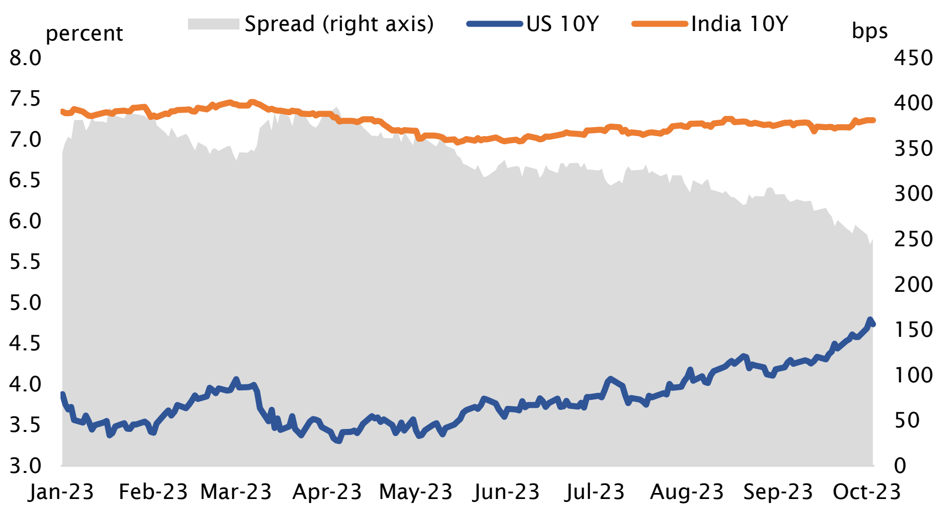
Due to the I-CRR and advance tax outflows, banking system liquidity slipped into deficit by mid-September. As a result, banks increasingly resorted to borrowing at the marginal standing facility (MSF). At the same time, substantial funds were parked at the standing deposit facility (SDF), suggesting skewed distribution of liquidity (Figure 4). This trend compelled the MPC to urge that banks with surplus funds explore lending opportunities in the inter-bank call market. The liquidity mismatch resulted in firming up of the weighted average call rate (WACR), though the average term spread in the G-sec market remained stable.

Going forward, the withdrawal of I-CRR and an increase in government spending is likely to ease liquidity conditions, though an increase in currency demand ahead of the festive season could offset the easing. To actively manage liquidity and curtail any excesses, the MPC noted that it might have to consider open market operation (OMO) sales to ensure that liquidity remained consistent with its policy stance. The MPC has been reiterating that excessive liquidity could pose risks to price and financial stability.

The announcement of the likely OMO sales sparked speculation that the move could help manage the interest rate spread against developed economies that has narrowed in recent months. For instance, the differential between US-India 10 year benchmark yield has shrunk by about 150 basis points since the beginning of the year (Figure 5). However, at the press conference post the announcement of the policy statement, the RBI Governor denied the OMO move as a yield curve control measure. There is also conjecture that the OMO tool could be used in the future to sterilize foreign exchange operations in case of high foreign debt inflow post the economy's inclusion in the JPMorgan's EM bond index.

To conclude, in the past few meetings, the MPC seems to be increasingly leaning on managing liquidity via various tools to prevent any excesses building up in the system, instead of directly tinkering the policy rates to do so. This trend is quite likely to continue until the headline inflation inches closer to the 4% target in a sustained way. Given the upside risks to inflation and RBI's forecasts until Q1:FY25, the MPC is unlikely to tweak its policy rates and stance until June 2024. The next meeting of the MPC is scheduled during December 6-8, 2023.

Figure 5: US-India 10Y yield differential has narrowed by around 150bps since the start of 2023



Source: investing.com

Appendix

Figure A: Alternative scenarios to assess the balance of risks to baseline projections

Scenario	Baseline assumption	Upside risks to inflation	Downside risks to inflation
1. Global Growth Uncertainties	Global growth at 3% in both 2023 and 2024	Global growth higher by 50 bps than baseline: domestic growth and inflation could edge higher by around 15 bps and 7 bps, respectively.	Global growth 100bps lower than baseline: domestic growth and inflation could be around 30 bps and 15 bps, respectively, below the baseline.
2. International Crude Oil Prices	Crude oil (Indian basket) at US$ 85 per barrel during H2:2023-24	Crude oil price 10% above the baseline, domestic inflation and growth could be higher by 30 bps and weaker by around 15 bps, respectively.	Crude oil prices 10% below the baseline and assuming their full pass-through to domestic product prices, inflation could ease by around 30 bps with a boost of 15 bps to growth.
3. Exchange Rate	Rs.82.5/US$ during H2:2023-24	Should the INR depreciate by 5% over the baseline, inflation could edge up by around 35 bps while GDP growth could be higher by around 25 bps through stimulating exports.	If the INR appreciates by 5% relative to the baseline, inflation and GDP growth could moderate by around 35 bps and 25 bps, respectively.
4. Food Inflation	CPI inflation is projected to average 5.4% in 2023-24. For 2024-25, structural model estimates indicate that inflation will average 4.5%, in a range of 3.8-5.2%.	High food inflation could raise headline inflation by around 100 bps over the baseline.	Easing food inflationary pressures could pull headline inflation 50 bps below the baseline.

Source: RBI Monetary Policy Report for October 2023.