RBI Delivers Hawkish Pause Again, Raises Inflation Projection

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As anticipated, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) has unanimously chosen to maintain the benchmark repo rate at 6.5% during the August bi-monthly policy meeting, marking the third consecutive instance of this decision. Concurrently, the Central Bank has upheld its stance at 'withdrawal of accommodation' (5:1) due to mounting apprehensions about inflationary pressures. Notably, the policy's tone displayed a more hawkish inclination compared to the preceding two meetings, accentuated by a substantial revision in inflation projections for the next two quarters.

The decision to maintain the status quo is judicious considering the prevailing circumstances. The surge in inflationary pressures is primarily attributed to elevated vegetable prices, a phenomenon inherently tied to seasonal variations and thus expected to be transitory. Nonetheless, the RBI remains cautious about latent inflationary factors stemming from skewed distribution of monsoon, lagged cultivation of Kharif pulses, and the rise of global food and crude oil prices. Hence, the RBI has adopted a prudent wait-and-watch approach to systematically assess the evolving inflation trends. The RBI is expected to look through any transient surge in inflationary pressures in the immediate future while ensuring a comprehensive analysis of the situation.

RBI to Keep a Tight Leash on Inflation

While the CPI inflation for June remained within the RBI's designated target range, the prevailing risks exhibit a tendency towards the upside, underpinned by expectations of elevated inflationary figures in the immediate future. Of notable concern is the persistence of heightened food inflation, marked by the escalation in prices of essential commodities including cereals, pulses, milk, and vegetables. Although the seasonal nature of increased vegetable prices during this period is acknowledged, the noteworthy 12% sequential surge in the CPI vegetable index for June was nearly double the long-term trend. Additionally, the augmented prices of cereals and pulses can be attributed to constricted supply conditions, a situation expected to ameliorate with the onset of the Kharif harvest from October onward.

As of now, Kharif crop sowing has exhibited robust progress, yet the inadequate sowing of pulses remains a cause of concern. This factor could potentially introduce an upward risk to the CPI figures, particularly given the anticipated weakening of the monsoon in the second half of the season due to the intensification of El Nino conditions. Furthermore, the ongoing upward trajectory of global food prices, particularly in the domain of edible oils, and the surge in crude oil prices necessitate diligent monitoring for their potential direct or indirect impacts on the domestic inflation trajectory.

Increase in Average Retail Price (%) (Since the last policy meet in June)	
Tomato	385.2
Onion	24.0
Potato	15.1
Tur Daal	10.3
Rice	5.0

Source: DCA; Note: % increase as on August 9, 2023

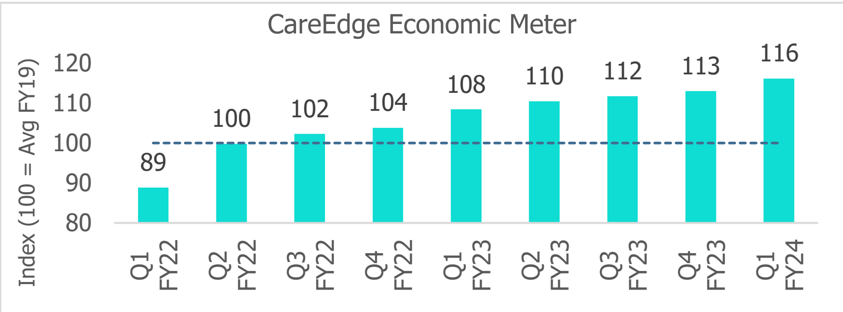
In response to these dynamics, the government has initiated several supply-side measures aimed at mitigating food price escalation. These include measures such as the concessional sale of tomatoes, the release of Tur Daal from buffer stock, and the embargo on non-basmati rice exports. However, the efficacy of these interventions will manifest over time. Given that food contributes approximately 45% to the CPI basket, the overall inflation outlook has deteriorated compared to the preceding MPC meeting. Consequently, the RBI has revised its inflation projection for FY24 upwards to 5.4% from the previous 5.1%, with a substantial revision of 100 basis points in the second quarter and 30 basis points in the third quarter of the fiscal year. The anticipation of heightened near-term inflation has consequently shifted the expectation of rate cuts to the subsequent fiscal year.

RBI's Inflation Outlook (%)					
	FY24	Q2 FY24	Q3 FY24	Q4 FY24	Q1 FY25
August 2023	**5.4**	6.2	5.7	5.2	5.2
Earlier (June 2023)	**5.1**	5.2	5.4	5.2	--

Growth Continues to be Resilient

The central bank remains optimistic on the growth front and maintains the GDP projection at 6.5%, which is in line with our expectations. Domestically, growth signals are expected to hold up well, supported by healthy urban demand and government expenditure. The rebound in manufacturing sector output seen in the last quarter of FY23 is likely to continue in the coming quarters, with IIP-manufacturing growth averaging 5.5% in April-May. Deleveraged corporate balance sheets, rising capacity utilisation in the manufacturing sector, and higher business optimism lay the ground for a pick-up in private investment. From the consumption perspective, healthy expansion in the output of consumer non-durables is encouraging. Also, the output of consumer durables expanded in May after a gap of six months. These trends are expected to strengthen further with the upcoming festival season.

So far this fiscal, the high-frequency growth indicators such as PMI manufacturing, PMI services, GST collections, and credit growth have maintained momentum and have largely shielded the economy from the impact of the global slowdown. However, from the rural demand perspective, healthy Kharif sowing will be critical. Overall, the risks on the growth front are balanced, supporting the case for an extended pause.



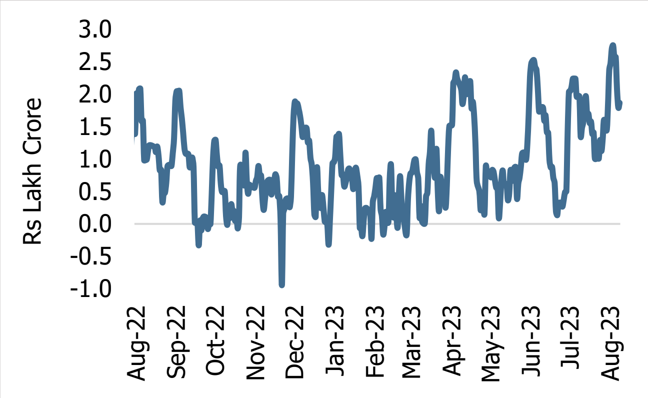
Note: CareEdge Economic Meter (CEM) is a composite index covering 18 high-frequency economic indicators to track the state of the economy on a real-time basis.

RBI Introduces I-CRR to Mop up Excess Liquidity

The systemic liquidity averaged Rs 2.3 lakh crore in August 2023, which is Rs 1.6 lakh crore higher than the average systemic liquidity in May 2023. The recent accretion in liquidity was aided by a pickup in government spending, sustained foreign inflows, and the lingering effect of high-valued currency withdrawal. RBI's FX purchases in response to a higher-than-expected Balance of Payments (BoP) surplus have also added to the rupee liquidity. RBI now estimates the surplus in BoP to improve from USD 5.6 billion in Q4 FY23 to USD 24.4 billion in Q1 FY24.

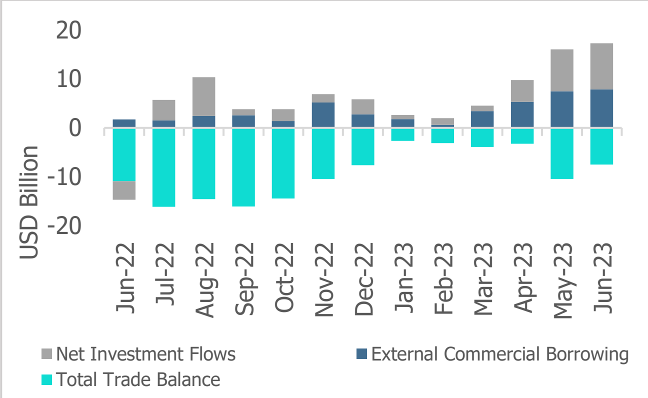
Since June, the RBI has conducted 15 variable rate reverse repo (VRRR) auctions amounting to nearly Rs 7.2 lakh crore. Consequently, the weighted average call money rate has been hovering around the repo rate of 6.5%. Along with the ongoing regular fine-tuning operations, RBI has introduced a temporary provision of incremental cash reserve ratio (I-CRR) for scheduled commercial banks (SCBs) to remove the build-up of excess liquidity in the system. Under the I-CRR framework, SCBs will have to park additional cash reserves with RBI equal to 10% of the increase in their net demand and time liabilities (NDTL) between May 19, 2023, and July 28, 2023. We expect this new measure to absorb liquidity worth ~Rs 1 trillion from the system. RBI will review this new measure on September 8, 2023. Due to seasonal growth in currency demand during the festive season, RBI may discontinue the I-CRR going ahead. However, with the new measure, a lower level of systemic liquidity will push up money market rates and help stem inflationary pressures. Nevertheless, systemic liquidity is expected to remain in surplus despite the additional cash reserve requirement under I-CRR

Banking System Liquidity in Surplus



Source: RBI; Note: Positive is surplus and negative is deficit

BoP Situation Improves



Source: RBI; Note: Net investment flows are sum of net FPI and net FDI flows

Way Forward

While the moderation observed in core inflation provides a certain degree of reassurance, the escalating food inflation presents a notable challenge. The persisting uncertainties stemming from weather-related factors coupled with the surge in global food prices contribute to the continued presence of elevated upside risks to food inflation. Given the significant role that food prices play in shaping inflationary expectations, the RBI is poised to maintain vigilance over the evolving scenarios.

Presently, the RBI is set to adopt a data-driven strategy in order to assess the evolving dynamics of inflation. It is likely to look through any short-term transient surges in inflationary pressures. As inflation is projected to remain near the upper boundary of the target range in the forthcoming months, it seems plausible that the RBI is preparing for an extended pause accompanied by a hawkish stance. Consequently, the likelihood of a rate cut has been deferred to the subsequent fiscal year.

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