RBI's Policy Preview: MPC to Maintain Pause

September 29, 2023 l Economics

Economic Headwinds Intensified Since the August MPC Meeting

The forthcoming Reserve Bank of India's (RBI) monetary policy committee (MPC) meeting, scheduled for the upcoming week, is set against a backdrop of growing domestic as well as external economic challenges. These domestic challenges encompass growing risks to consumption demand amid soaring food inflation, an uneven monsoon adversely affecting kharif crops, higher interest rates and rising global crude oil prices.

The Q1 FY24 GDP figures indicate a robust growth rate of 7.8%, up from the 6.1% recorded in Q4 FY23. Notably, private consumption expenditure has exhibited a strong expansion of 6%, marking a substantial improvement from the modest 2.8% growth observed in the previous quarter. This upswing in consumption expenditure can be attributed primarily to increased discretionary spending by urban consumers, as reflected in healthy air and railway passenger traffic, growth in retail credit, and higher sales figures for passenger vehicles (PV). Additionally, the government's emphasis on capital expenditure (capex) has supported investment activities and is corroborated by the robust growth in steel consumption, capital goods production, and cement production. E-way bill collections touched all time high of 93.4 million in August growing over 19% compared to previous year. The robust growth in E-way bill indicates buoyancy in economic activity, especially ahead of the festive season. Furthermore, the auto sales led by PV continue to display resilience and strength. However, recent developments suggest a potential rise in headwinds affecting consumption demand, particularly in rural areas. It is crucial to monitor these emerging headwinds closely.

As indicated by CMIE's data, consumer confidence has exhibited a concerning decline, with a notable 1.5% drop in the index observed in August. This dip follows a period of sustained recovery since January 2023. Several factors contribute to this decline, including poor rainfall during the crucial month of August which significantly impacts kharif crop cultivation, a slackening labour market, and persistently elevated inflation levels – all of which have collectively dampened consumer sentiment. Additionally, CMIE's consumer survey reveals a sharp decrease in consumers' intentions to purchase durable goods, which is concerning ahead of the festive season. Furthermore, the labour market continues to grapple with challenges, as reflected in the all-India unemployment rate, which rose to 8.1% in August from 7.9% in July. This increase is primarily driven by higher urban unemployment, which rose to 10.1% in August from 8.1% in July. In comparison, rural unemployment has seen a marginal decrease to 7.1% in August from 8.3% in July, owing to a seasonal rise in demand for agricultural labour. However, distress in the rural labour market is evident from the consistent rise in annualised growth in the number of households demanding work under MNREGA, which has surged from 3.2% YoY in May 2023 to a peak of 20% YoY in August.

The downside risks to consumption demand are further substantiated by the underwhelming sales performance of FMCG firms despite their increasing profitability. Nevertheless, the government's persistent commitment to capital expenditure is anticipated to support job creation and sustain economic momentum in the coming months. Additionally, the festive season is expected to bring about a seasonal uptick in consumption demand, even though downside risks to demand remain elevated.

On the global front, the economic momentum remains ambivalent, with increasing anticipation of a 'soft-landing' for the US economy, while growth concerns remain elevated in Europe and China. Major global central banks like the US Federal Reserve (US Fed) and European Central Bank (ECB) are anticipated to keep their borrowing costs higher for an extended period, thereby adversely impacting the capital flows into emerging markets. In September, foreign portfolio investments (FPIs) in India have taken a downturn, registering a net outflow of USD 1.7 billion. This marks a notable shift after experiencing six consecutive months of positive inflows. While there is a positive development to note – the inclusion of Government Securities (G-Secs) under the Fully Accessible Route (FAR) within the JP Morgan bond index (GBI-EM) – its positive impact is expected to be gradual, as the weightage assigned to India will be increased incrementally over a period of time.

On the other hand, the reduction in oil supply from OPEC member countries has driven crude oil prices to touch USD 95 per barrel this week. This development has accentuated headwinds to the external economic scenario, as weakening global demand is poised to negatively affect domestic exports, while the import bill is expected to stay elevated due to higher energy costs. Consequently, the current account deficit (CAD) is now projected to stand at 1.8% of GDP, higher than the prior estimate of 1.6% of GDP. The widening CAD and outflows of foreign portfolio investments have intensified depreciating pressures on the Indian rupee, resulting in a depreciation of approximately 0.5% in September. Furthermore, India's foreign exchange reserves have declined, reaching a near four-month low at USD 593 billion in the last week.

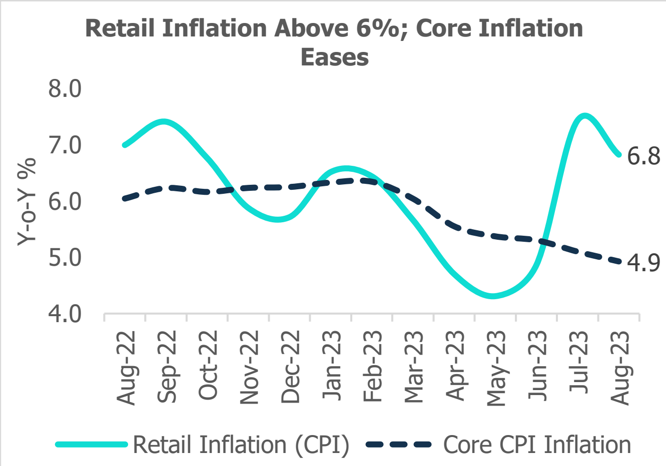
With the prevailing economic headwinds, we expect the RBI to retain its growth projections at 6.5% for FY24 as the RBI will likely adopt a 'wait and watch' approach, seeking better visibility on festive demand trends and estimates of kharif production before making any adjustments.

Inflation Shows Signs of Cooling Despite Staying Above RBI's Tolerance Band

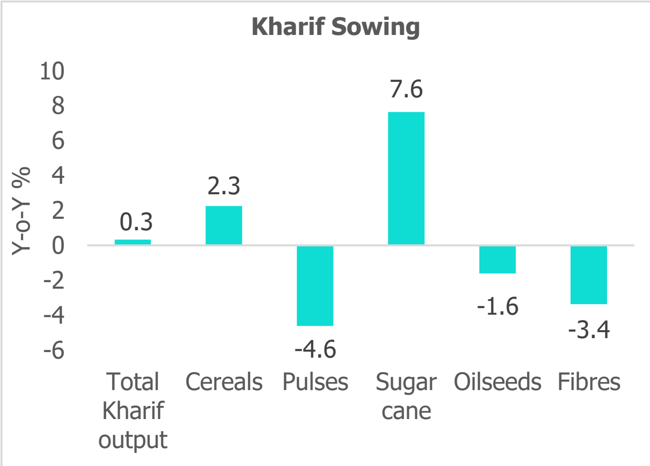
In August, India's retail inflation moderated to 6.8% from a high of 7.4% in July. This moderation was primarily attributed to a decrease in vegetable prices, which had surged in July as an erratic rainfall affected the harvest. The arrival of a fresh harvest, coupled with government interventions, played a role in cooling these prices. Various supply-side measures, such as restrictions on wheat and non-basmati rice exports and the Open Market Sales Scheme (OMSS) utilizing Food Corporation of India (FCI) stocks, along with reductions in import duties on edible oils, have contributed to stabilizing retail food prices. High-frequency retail data indicates a further softening of vegetable prices in September, which is expected to ease headline inflation further. However, it's important to note that while the volatile component of the food basket has cooled significantly, price pressures persist in cereals, spices, and pulses. The sowing of pulses has lagged by approximately 4.6% in this Kharif season, and high-frequency retail prices suggest a sequential uptick in the prices of pulses in September. However, we expect food inflation to moderate going ahead with average inflation in the food basket slowing from 6.9% in Q2 to 5.6% in Q3 and 5.1% in Q4.

Despite the steep rise in global crude oil prices, it is anticipated that this will not significantly impact retail inflation, as there will be pressure on oil marketing companies (OMCs) to refrain from increasing retail prices for petrol and diesel. As we approach the pre-election period, OMCs are expected to absorb a substantial portion of the increased global crude prices. The RBI is also likely to find comfort in the fact that the Wholesale Price Index (WPI) continues to remain in deflationary territory, and core inflation remains relatively benign. In August, core inflation moderated to 4.9%, down from 5.1% in July.

We expect the September inflation print to remain above RBI's upper tolerance limit. As a result, the RBI will miss its Q2 inflation projections by ~60 bps and will consequently revise its whole-year projection to 5.6% from an earlier projection of 5.4%.



Source: CEIC



Source: CEIC; Data as on September 22, 2023

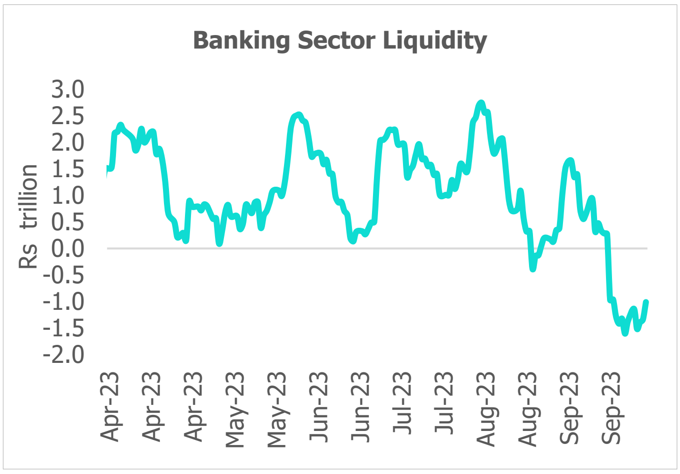
Tighter Liquidity Conditions and Hardening of Bond Yields

Liquidity conditions in the banking system have undergone a significant tightening since the last policy meeting. Systemic liquidity, which had been in surplus at Rs 2.1 trillion during the August MPC meeting, transitioned into a deficit of Rs 1.5 trillion by 27th September. This shift has increased money market rates, with the overnight call money rate rising from 6.4% to 6.8%. The RBI implemented an incremental cash reserve ratio (I-CRR) in the last MPC meeting, resulting in the withdrawal of liquidity amounting to Rs 1.1 trillion from the banking system. Despite the gradual withdrawal of the I-CRR, systemic liquidity continued to stay in the deficit since mid-September due to quarterly tax outflows and GST payments. Additionally, interventions in the foreign exchange market aimed at supporting the rupee may have marginally contributed to some absorption of rupee liquidity.

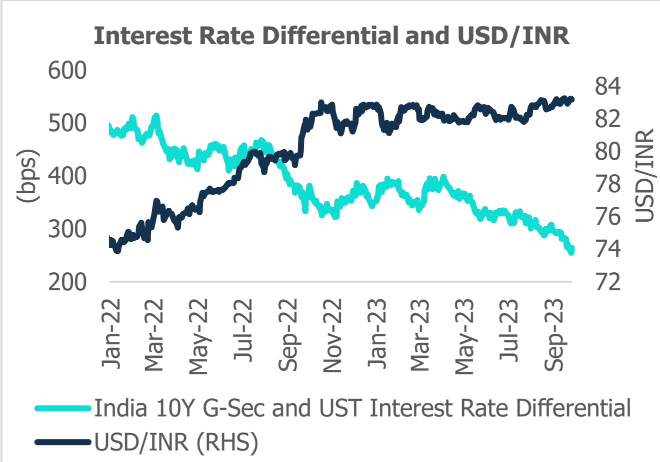
In the short term, liquidity conditions are expected to remain tight as the festive season will keep currency demand high. The government's cash balance with RBI is estimated at around Rs 3 trillion, and a pickup in government spending in the second half will ease the pressures arising from a deficit in systemic liquidity. Furthermore, considering the prevailing inflationary pressures and the growing depreciating pressures on the Indian rupee, the RBI may not be averse to higher short-term interest rates resulting from tighter liquidity conditions.

Meanwhile, despite positive news on FAR bond inclusion in international indices, the 10y benchmark yield continues to harden. The positive news of index inclusion was overshadowed by concerns about higher international crude prices, elevated headline inflation prints, and hawkish commentary from officials of Western central banks. The 10y G-sec benchmark yield stands at 7.24%, higher than 7.17% at the start of the month.

Going ahead RBI may conduct liquidity management operations as and when required to support the money market conditions. Having said, that we expect the overall liquidity situation to remain tight.



Source: CEIC; Data as on September 28, 2023



Source: CEIC; Data as on September 28, 2023

In conclusion, the potential risks to economic growth have heightened since the last policy, owing to a combination of both domestic and global challenges. Despite the persistent rise in inflation, primarily driven by the volatility in food prices, there are initial signs of a slowdown in food inflation. Meanwhile, core inflation remains relatively stable, with some easing observed in August. Liquidity conditions have tightened, and borrowing costs remain elevated.

Given the current circumstances, the RBI is likely to prioritise supporting economic growth, especially during the festive season, while remaining cautious on inflation. Therefore, we anticipate that the RBI will keep its policy rates unchanged, with a unanimous decision, while adhering to its stance of 'withdrawal of accommodation.' We do not anticipate any further rate hikes by the RBI in this fiscal year. The MPC is expected to consider rate cuts after the first quarter of the upcoming fiscal year.

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