RBI's Policy: A Lesser Hawkish Pause with Cautious Undertone

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In alignment with prevailing market expectations, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) has unanimously opted to maintain the policy repo rate at 6.5% during the bi-monthly policy meeting in December. Concurrently, the MPC has upheld its stance at 'withdrawal of accommodation,' with a 5:1 majority. Notably, the policy wording exhibited a lesser hawkish tone compared to the preceding October statement. However, the governor struck a note of caution, emphasizing the need for additional economic data to decide future trajectory of the monetary policy. The governor underscored the RBI's commitment to striking a balance in monetary policy, navigating between optimism fuelled by a few months of positive data and the risk of policy over-tightening. Additionally, the statement indicated the RBI's comfort with the existing liquidity conditions.

In light of the current circumstances, the decision to maintain the status quo in both policy rates and stance appears justified. A string of favourable developments has positively influenced the broader economic landscape: Q2 GDP growth has surpassed market expectations, core inflation has eased to levels closer to the RBI's target of 4%, the interest differential has narrowed owing to the softening of UST yields, and Brent crude oil prices have moderated to ~ USD 75 per barrel. However, it is crucial to remain attentive to certain underlying factors that can increase economic headwinds. Following the projected contraction in Kharif production, close scrutiny of the progress in rabi sowing is imperative, particularly in light of lower reservoir levels in certain regions. Lower agricultural output not only poses a risk to the growth of the agriculture sector but may also contribute to food inflation. Furthermore, the fragile state of the global economy and the contraction in global trade can potentially have spillover effects on the domestic economy. Consequently, the governor's statement carried a cautious tone, acknowledging these considerations.

The RBI Raised FY24 Growth Projection to 7%

The RBI expressed a sense of optimism regarding the growth momentum, evident in its upward revision of the FY24 growth forecast to 7%, up from the earlier projection of 6.5%. Building on the positive surprise observed in Q2 GDP growth, the RBI now anticipates a stronger growth in the second half of FY24, with the revised average growth rate at 6.25% in H2, compared to the October estimate of 5.85%.

High-frequency data underscores a robust acceleration in economic momentum, supported by the impressive performance of eight core sectors, capacity utilization levels exceeding long-term averages, resilient GST collections, heightened festive demand, and substantial growth in investments in fixed assets by listed private manufacturing companies. Monthly services exports have sustained above USD 27 billion, demonstrating resilience despite a slowdown in global growth. The surge in festive demand is reflected across various high-frequency indicators, including the expansion of retail credit, robust GST collections, increased air passenger traffic, and elevated sales figures for passenger vehicles (PV). The government's steadfast commitment to productive capital expenditure remains evident. The central government's capex registered a remarkable growth of 43.1%, while state capital expenditure exceeded a 50% increase compared to the previous year.

RBI's Growth Outlook (%)						
	FY24	**Q3 FY24**	**Q4 FY24**	**Q1 FY25**	**Q2 FY25**	**Q3 FY25**
Dec-23	**7**	6.5	6	6.7	6.5	6.4
Earlier (Oct 2023)	**6.5**	6	5.7	6.6	--	--

Nevertheless, the RBI tempered its optimism on growth with a cautious acknowledgment of underlying risks, particularly arising from the contraction in Kharif production and potential threats to rabi output due to lower reservoir levels. The governor acknowledged that a contracting global trade amid a somewhat fragile recovery in the global economy, geopolitical turmoils and geo-economic fragmentations could have potential spillover effects on domestic growth. Despite these concerns, the RBI expressed confidence in India's resilience, emphasizing that the country is well-positioned to navigate volatility, given comfortable levels of foreign exchange reserves.

RBI Remains Cautious about Inflation

The RBI has maintained its inflation projections for FY24 at 5.4%, foreseeing a gradual alignment of quarterly headline inflation towards its 4% target by Q2 FY25. This projection assumes significance in terms of timing of potential future policy rate cuts.

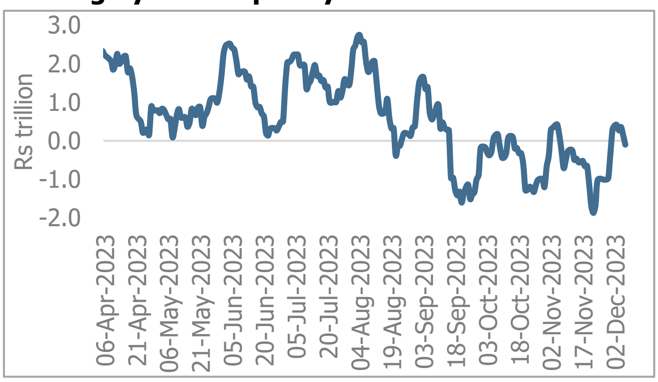
The governor found reassurance in the benign nature of core inflation, which has inched closer to the RBI's 4% target. However, the governor acknowledged the risks from volatility in food prices. The recent sequential increase in prices of key vegetables is noted as a factor that could elevate headline inflation in the short term. Global concerns persist with the uptick in sugar prices. Although the MPC is inclined to overlook isolated shocks from food price volatility, the governor iterated a need for vigilance regarding the possibility of such shocks evolving into broader trends that could disrupt the ongoing disinflation process. The primary threat to the RBI's endeavour to converge headline inflation with the 4% target primarily stems from the potential volatility in food prices.
Nevertheless, the governor expressed comfort in the softness of international prices for highly import-dependent food items such as edible oils. Proactive supply-side interventions by governments have further alleviated price pressures, contributing to the overall mitigation of inflationary concerns.

RBI's Inflation Outlook (%)						
	FY24	**Q3 FY24**	**Q4 FY24**	**Q1 FY25**	**Q2 FY25**	**Q3 FY25**
Dec-23	**5.4**	5.6	5.2	5.2	4	4.7
Earlier (Oct 2023)	**5.4**	5.6	5.2	5.2		

RBI to Remain Nimble in Liquidity Management

The RBI appears comfortable with the current levels of liquidity. The governor noted that the evolution of liquidity conditions aligns with the current monetary policy stance. Currency leakage during the festive season, robust government cash balances, and the RBI's market operations have collectively contributed to a significant tightening of liquidity conditions, reducing the necessity for Open Market Operations (OMO) sales. The absence of any mention of future OMO sales in the governor's statement provides reassurance to the bond market. However, it's worth noting that the RBI has been conducting small-value

Banking System Liquidity in Deficit



Source: RBI, CEIC

OMO sales in the secondary market. The governor also found reassurance in the fact that the size of the RBI's balance sheet has now moderated to 21.6% of GDP, down from the pandemic-induced peak of 28.6% of GDP when RBI had undertaken significant OMO purchases to manage the yield curve.

Going ahead, we expect the RBI to keep liquidity conditions tight while ensuring ample liquidity is available to support the credit demand. The RBI is expected to be nimble in its approach and implement liquidity management operations as and when necessary to support money market conditions.

RBI Focus Remained on Financial Stability

In the previous policy statement, the governor had raised concerns about the rapid expansion of specific components of personal loans. In response, the RBI has proactively implemented precautionary measures, including a 25-percentage point increase in the risk weightage of consumer credit (excluding housing loans, vehicle loans, education loans, and loans secured by gold exposure).

Building on the continuity from the last policy, the governor has introduced further regulatory measures to shape the lending landscape of the economy. In a bid to enhance transparency and customer-centricity in the digital lending ecosystem, the RBI has articulated its intent to regulate the web aggregation of loan products in digital lending. Moreover, there are plans to introduce a unified framework for connected lending.

In an additional move, the RBI has proposed the establishment of a fintech repository designed to facilitate the sharing of information. This initiative comes in response to a notable surge in retail lending within the country, driven by the growing popularity of digital loans as consumers increasingly seek multiple credit products within a short timeframe. Collaborations between banks, non-banking financial companies (NBFCs), and fintechs have become more prevalent, given the fintechs capability to serve customers remotely.

Way Forward

While the moderation observed in core inflation offers a certain level of reassurance, it's important to note that certain upside risks to inflation continues to persist. The positive economic data has brightened growth prospects, leading to an upward revision of growth projections by the RBI. However, the central bank remains mindful of the downside risks stemming from expected muted agricultural output and potential spillovers from global uncertainties. In the current scenario, the RBI aims to strike a delicate balance between the risks of over-tightening and the optimism surrounding positive economic surprises. The central bank will continue to support growth while exercising caution in the face of evolving macroeconomic headwinds. The liquidity conditions will continue to remain tight. The likelihood of a rate cut is anticipated after the first quarter of the next fiscal year, aligning with a period when quarterly inflation is projected to approach the 4% target.

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