RBI's Policy Preview: Liquidity to Remain in Focus

February 06, 2023 I Economics

CareEdge RATINGS

Growth Outlook Remains Strong Despite Some Hiccups

The forthcoming Reserve Bank of India's (RBI) monetary policy committee (MPC) meeting, scheduled this week, is set against a backdrop of better-than-expected economic performance despite pressures in certain segments of the economy.

Robust economic performance is underscored by the fact that FY24 growth is now seen at 7.3% as per the first advanced estimates of MOSPI, led by strong growth in the investment demand, which is projected to grow by 10.3%. In terms of sectoral growth, industrial growth is estimated to outshine with a projected expansion of 7.9% in FY24, with an acceleration from 4.4% in the previous year. This strong industrial growth is underpinned by robust expansion in manufacturing, mining, and construction activities. Data from high-frequency indicators also point toward the sustained strength of the Indian Economy.

As shown by the PMIs for manufacturing and services, the outlook in the organized sector remained in the expansionary zone. E-way bill collections rose 13.2% YoY in December, up from 8.5% YoY in November. As per CMIE's data, the all-India unemployment rate declined to 6.8% in January 2024 from 8.7% in December 2023. This improvement was observed across both urban and rural areas, with the urban unemployment rate decreasing from 10.1% in December to 8.9% in January and the rural unemployment rate moderating to 5.8% in January from 8% in the previous month. Notably, the 1.2% YoY contraction in demand for jobs under MNREGA in January also signals an improvement in labour market conditions in rural areas, marking the first contraction since March 2023. Other high-frequency data like auto sales and GST collections continue to remain robust.

While the overall economic performance remains strong, there are notable challenges, particularly at the bottom of the pyramid. Consumption demand within the economy is anticipated to exhibit a tepid trajectory, with the growth rate estimated to decelerate from 7.5% in FY23 to 4.4% in FY24. This marks the slowest consumption growth in the past two decades, excluding the pandemic year of FY21, when it contracted by 5.2%. The significant deceleration in private consumption, a driver of over 50% of the GDP, raises concerns. The agriculture sector is also expected to face headwinds due to below-average rainfall, leading to a projected growth slowdown from 4% in FY23 to 1.8% in FY24. This not only impacts rural demand but also gives rise to concerns about higher food inflation, contributing to elevated inflation expectations. Despite these challenges, recent initiatives such as the reduction in LPG prices and the extension of the Pradhan Mantri Garib Kalyan Anna Yojana (PMGKAY), coupled with supply-side measures to alleviate inflationary pressures in the food basket, are anticipated to provide some relief to the consumption sector.

Against the backdrop of an improved economic outlook, we expect the RBI to raise its growth projections for FY24 closer to 7.3%.

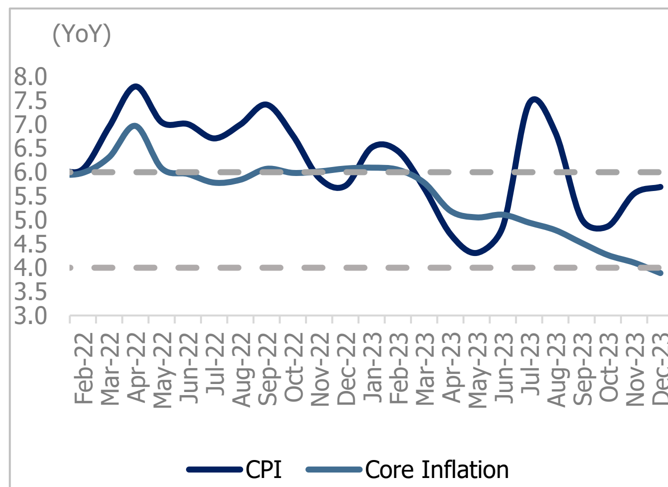
Inflation Pressures Eased but Food Prices Remain a Concern

Turning to inflation, elevated food prices and an unfavourable base drove headline inflation to a four-month peak of 5.7% in December. The headline inflation maintained its upward trajectory over the past two months. The elevated levels of food inflation continue to be a source of apprehension, as prices within the food and beverage

recorded a growth of 8.7% YoY in December, up from 8% in the preceding month. While prices of perishables, led by vegetable prices, continue to be in double digits, enduring inflationary trend in non-perishable food categories, such as cereals, pulses, and spices, raises serious concerns about the potential broadening of price pressures due to their inherent stickiness. After a projected contraction in Kharif output, lagging rabi sowing of pulses (-4.6%) and rice (-3.7%) remains a concern. The primary risk to the RBI's efforts to align headline inflation with the 4% target is likely to stem from potential volatility in food prices.

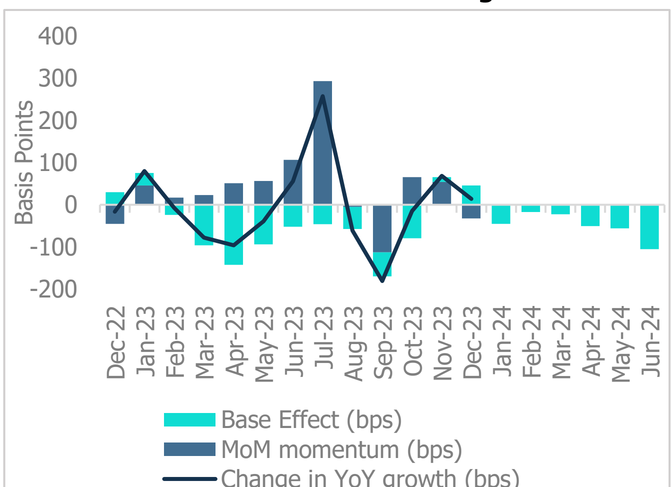
Nevertheless, the benign nature of core inflation, dipping below the 4% mark in December, the first time since the onset of the pandemic, is expected to provide reassurance to the RBI. The consistent fall in core inflation in line with easing commodity prices and subsiding demand-side pressures is a positive. Brent prices persistently remain below the USD 80/bbl mark, attributed to demand uncertainty and robust supply from non-OPEC nations. Additionally, global industrial metal prices have declined by about 5.5% since December's MPC meeting. The softer global commodity and energy prices are poised to somewhat alleviate domestic inflationary pressures. The RBI is expected to retain its inflation projection of 5.4% for FY24.

CPI and Core Inflation



Source: CEIC

Favourable Base Effect of CPI Going Forward



Source: CEIC, CareEdge

External Situation Remains Comfortable with Key Risks as Monitorable

The external environment remains favourable, with narrowing trade deficits and robust foreign exchange reserves. In December, the goods deficit reached a 5-month low of USD 19.8 billion, attributed to increased non-oil exports and relatively stable oil imports. The services surplus also improved to USD 16 billion in December compared to 14.4 billion in November and H1 FY24 average of USD 12.5 billion. Projections for the overall current account deficit for FY24 indicate a modest figure of 1.2% of GDP. The cumulative Foreign Portfolio Investment (FPI) inflows for the calendar year 2023 stand at USD 28.7 billion. Anticipated factors such as India's inclusion in the JP Morgan bond index, potential incorporation in Bloomberg EM Local Currency Indices, and the robust performance of the domestic economy are expected to sustain FPI flows in the future.

IMF in January has revised up its projections for global growth by 20 bps to 3.1% in 2024. Greater-than-expected resilience in the United States and several large emerging economies, as well as fiscal support in China, has supported growth momentum. However, despite the improved outlook, global growth is still lower than the 10-year pre-pandemic average of 3.7%. With the moderation in global inflationary pressures from last year's highs, major central banks are expected to start their rate-cutting cycle around the middle of 2024. After a dovish policy

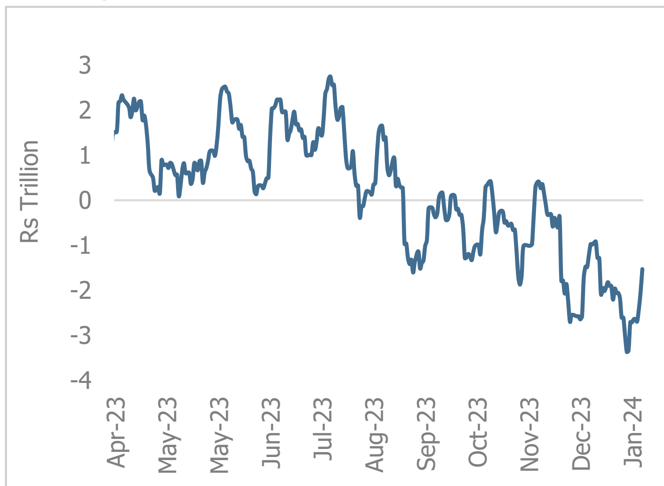
in January, the Fed dot plot shows the possibility of a 75-bps rate cut in 2024, higher than the 50-bps rate cut indicated by the dot plot in their September update.
However, monitoring the escalating geopolitical tensions in the Middle East is crucial, as they could impact global energy prices in the event of large-scale disruptions. The conflicts can have repercussions on global shipping lines, particularly in the Red Sea region, which could, in turn, affect external trade, especially amidst a slowing global economy.

Money Market Conditions Remain Tight

In its upcoming meeting, the RBI is anticipated to sustain its emphasis on liquidity management, given the persistently tight money market conditions where call money rates continue to hover above the repo rate. Despite some moderation observed in the past week, liquidity in the banking system has remained in deficit since the last policy meeting, reaching a peak of over Rs 3.5 trillion in the last week of January. The deficit in systemic liquidity has consequently tightened overall money market conditions, leading to an inversion in a segment of the yield curve.

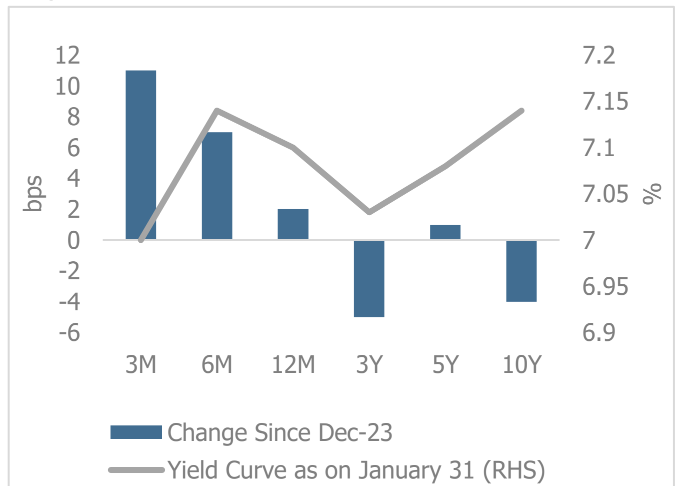
Despite systemic liquidity persisting in deficit, durable liquidity remains positive, primarily due to higher surplus government cash balances with the RBI. The existing deficit in systemic liquidity is primarily attributed to reduced government spending and advance tax outflows. In addressing this current mismatch, the RBI will likely continue to support liquidity conditions through variable rate repo auctions (VRR), potentially considering an extension in the tenor of these auctions. An uptick in government spending in the upcoming days is expected to alleviate the deficit in systemic liquidity to some extent. However, the overall liquidity condition is expected to remain tight.

Banking Sector Liquidity*



Source: CEIC, RBI. *Derived from LAF. Negative indicates deficit.

Segments of the Yield Curve Invert



Source: CareEdge, CEIC

Way Forward

In conclusion, the overall economic outlook remains upbeat despite challenges in specific sectors. While headline inflation is elevated, primarily due to rising food prices, core inflation remains relatively subdued. The persistent concern lies in higher food inflation. Nevertheless, there is an expectation that headline inflation will moderate in the coming months, aided by a favourable base effect lasting until July 2024. The arrival of rabi harvests in the market from mid-March will also alleviate pressure on food prices.

Liquidity conditions have tightened, and money market rates are currently elevated. Given the prevailing circumstances, the RBI will continue to support economic growth while maintaining a cautious stance on inflation. Consequently, we expect the MPC to keep the current policy rates unchanged. However, there is a possibility of a shift in stance to "neutral" in the February policy. Additionally, the RBI might announce liquidity measures to improve conditions in the money market.

Lower budgeted gross borrowing figures, coupled with passive inflows resulting from India's inclusion in global bond indices, are expected to keep the cost of borrowing low in FY25. Looking ahead, we expect MPC to consider cutting rates in Q2FY25 when headline inflation inches closer to the 4% mark.

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