RBI's Policy Preview: A Balanced Policy with Focus on Liquidity

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The Growth Remains Strong Accompanied by Key Risks

The upcoming monetary policy committee (MPC) meeting of the Reserve Bank of India (RBI), slated for this week, marks the first meeting of this fiscal year. The meeting is set against a backdrop of stronger-than-expected economic performance despite pressures in specific segments of the economy. Robust economic performance is underscored by the fact that FY24 growth is now seen at 7.6%, as per the advanced estimates of MOSPI, led by strong growth in the investment demand. Gross Fixed Capital Formation (GFCF), which is a proxy for investment growth, is projected to expand by a healthy rate of 10.2% in FY24. In terms of sectoral growth, industrial growth is estimated to outshine with a projected expansion of 9% in FY24, with an acceleration from 2.1% in the previous year. The services sector, commanding the highest share in India's gross value added (GVA), is also anticipated to sustain its momentum, projecting a 7.5% expansion driven by financial services, real estate, and professional services, as well as public administration, defence, and other services.

Robust high-frequency indicators of the Indian economy also underpin this strong economic momentum. As shown by the PMIs for manufacturing and services, the outlook in the organized sector remained in the expansionary zone. Industrial production grew by 5.9% during Apr-Jan FY24 compared to 5.6% in last year's corresponding period. Infrastructure and construction goods output supported the overall IIP with an expansion of 10% during Apr-Jan FY24 compared to 8.5% last year. E-way bill collections rose 18.9% YoY in February, up from 13.2% YoY in December. In February 2024, automobile sales surged by 24.3% year-on-year (YoY), supported by a notable uptick in two-wheeler and passenger vehicle sales. As per CMIE's data, the all-India unemployment rate averaged 7.4% in Jan-Feb 2024, lower than 9% in Q3 FY24. The improvement in the employment conditions in the first two months of 2024 was visible in both urban and rural areas, where it averaged 8.7% and 6.8%, respectively, lower than the Q3 FY24 average of 9.3% and 8.8%. The improvement in rural labour market conditions was also underscored by four months of consecutive contraction in MNREGA job demand (persons). Other high-frequency data of economic growth, like retail credit growth and GST collections, continue to remain robust.

While the overall economic performance remains robust, there are notable challenges, particularly at the bottom of the pyramid. Private consumption demand within the economy is anticipated to exhibit a tepid trajectory, with the growth rate estimated to decelerate from 7.1% in FY23 to 3% in FY24. This marks the slowest consumption growth in the past two decades, excluding the pandemic year of FY21, when it contracted by 4.6%. The significant deceleration in private consumption, a driver of over 50% of the GDP, raises concerns. Weather-related disruptions have impacted the agriculture sector, where the growth is expected to fall to 0.7% in FY24, lower than the decadal average of 4.1%. Slower growth in agricultural production impacts rural demand and raises 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), recent reductions in fuel prices coupled with supply-side measures to alleviate inflationary pressures in the food basket, are anticipated to provide some relief to the consumption sector. Based on the final data on Rabi sowing, the marginal increase in acreage will provide some comfort for the agrarian economy.

Looking ahead, we anticipate the economic momentum to persist in the next fiscal year as well. The government's sustained emphasis on capex and improving external situations will bolster the economic momentum. We foresee

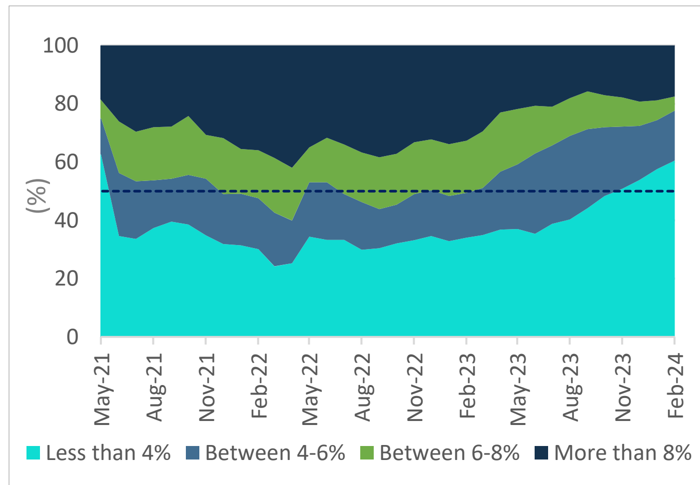
a recovery in the rural demand, which has already shown early signs of revival. The World Meteorological Organization's reports of weakening El Nino conditions and early projections of a normal southwest monsoon augur well for a robust recovery in the agricultural sector. A normal monsoon holds key for agricultural output as reservoir levels continues to remain low especially in the eastern and southern India. Against the backdrop of improved economic outlook, we project a 7% GDP growth in FY25 and expect the RBI to retain its growth projections. Having said that, a marginal increase in growth projections for FY25 cannot be ruled out completely as RBI's internal model shows a growth of 7.4% in FY25.

Inflation pressures eased but food prices remain a concern

Turning to inflation, headline inflation has eased significantly from 5.7% in December to 5.1% in January and February. The fall in overall inflationary pressures over the past couple of months has been broad-based, with core inflation consistently trending downward, remaining below the 4% threshold for three consecutive months. However, the food and beverages inflation remain elevated, with a 7.8% increase in February, led by price pressures in vegetables (30.3%), pulses (18.9%), and spices (13.5%). Sustained inflationary trend in non-perishable food categories, such as pulses and spices, raises concerns about the potential broadening of price pressures due to their inherent stickiness. However, it is worth noting that supply-side interventions have played a pivotal role in tempering prices, particularly in cereals. Disinflationary trends in cereal inflation are evident, with a decline from an average of 10.3% in Q3 FY24 to an average of 7.7% in the months of January and February. The recent uptick in global commodity prices also warrants close monitoring, with Brent crude and industrial metal prices up 4.4% and 5.5% since the last MPC meeting. Prolonged production cuts by OPEC countries, trade disruptions due to geopolitical tensions, and increased demand from major consumers like US and China have contributed to uptick in commodity prices.

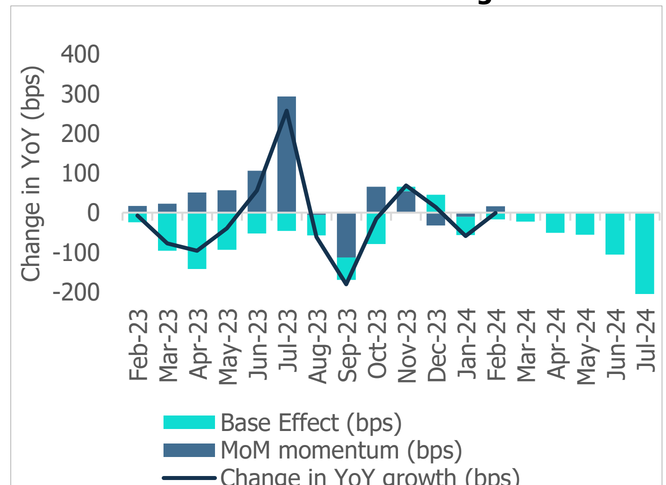
Overall, we expect inflationary pressures to ease going ahead on the back of a favourable base in the coming months. Continued government interventions on the supply side and recent reductions in LPG and fuel prices are poised to mitigate any potential upward price pressures. The expected improvement in food production on the back of a projected normal monsoon will also help alleviate price pressures in the food basket. The RBI is expected to retain its 5.4% and 4.5% inflation projections for FY24 and FY25, respectively. However, our projection indicates headline inflation of 4.8% for FY25, marginally higher than RBI's projection.

Share of items in different inflation buckets



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 a narrowing current account deficit and robust foreign exchange reserves. Overall merchandise exports rose to an 11-month high of USD 41.4 bn in February. This improvement was supported by both petroleum and non-petroleum exports, which increased by 5.1% and 13.7% YoY, respectively. Monthly service exports increased by a strong 6.8% YoY during April- February FY24. Services exports continued to be led by software services, followed by the business services component. Amid strong trade data, we expect CAD forecasts to lower to around 0.7% of GDP for FY24. 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 fiscal support in China will support growth momentum. Improvements in the global economic outlook will support India's exports.

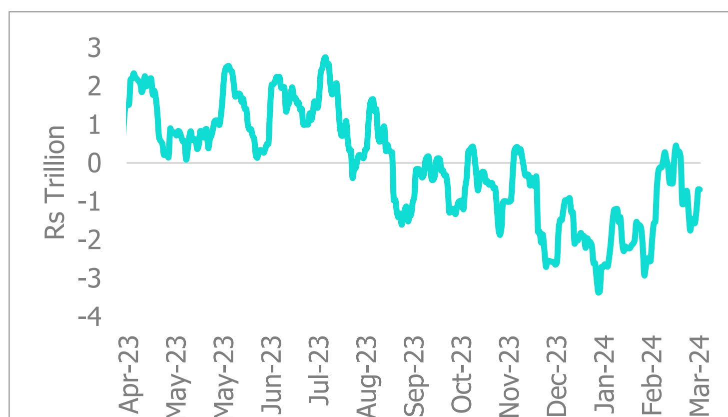
Foreign investment inflows continue to remain strong led by strong FPI inflows. The cumulative Foreign Portfolio Investment (FPI) inflows in FY24 stand at USD 41 billion. Factors such as India's index inclusion in the major global bond Indices, and the robust performance of the domestic economy are expected to sustain FPI flows in the future. However, it's important to note that the global economic landscape is not without its challenges. The markets have tempered their expectations of a rate cut by the US Fed over the past few months, with a 75-bps rate cut now expected in 2024. Stronger than expected macro data in the US and expectations of less aggressive rate cuts by the US Fed have resulted in a bullish bias in the USD. Additionally, 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 which could in turn, affect external trade. These factors underscore the need for a cautious approach to assessing India's external sector.

However, the overall outlook on India's external sector remains positive, backed by strong macro fundamentals and BoP surplus. The RBI's comfortable FX buffer of about USD 642 billion will provide a cushion against unforeseen external shocks. We expect USD/INR to appreciate from the current levels to around 82 by the end of FY25 on the back of comfortable external positions and a favourable interest rate differential with the US due to an expected shallower rate cycle of the RBI.

Money Market Conditions Remain Tight

Even though the systemic liquidity continues to remain in deficit, overall money market conditions have eased significantly compared to the beginning of the calendar year. Monthly average of deficit in systemic liquidity has fallen from INR 2 trillion in January to about INR 500 billion in March. As a result, the weighted average call money rate has inched closer to repo rate with monthly average of call repo spread declining from about +15 bps in January to -3 bps in March. Even though, the systemic liquidity continues to remain in deficit, the durable liquidity (systemic liquidity plus government cash balance) remains in surplus. A pickup in government spending ahead of elections will likely aid in in further easing of liquidity conditions. However, the overall liquidity condition is expected to remain tight. The RBI will continue managing liquidity through both main and fine-tuning operations

Banking Sector Liquidity*



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

as necessary to support money market conditions. It will be of interest to see any measures introduced by the RBI to regulate passive inflows resulting from index inclusions, starting from June 2024. The RBI is likely to absorb much of the inflows from index inclusion after Q1 FY25 as much of the FPI inflows can have inherent volatility rather than earned inflows via current account surpluses. RBI may look to sterilize the same with possible OMO sales.

Way Forward

In conclusion, the overall economic outlook remains upbeat despite some challenges in specific sectors. While there has been broad-based moderation in inflation, higher food inflation keeps headline numbers elevated. However, benign core inflation will comfort RBI as strong growth has mainly remained non-inflationary. Nevertheless, 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 along with expectations of a normal monsoon next year will also alleviate pressure on food prices. The RBI will thus be inclined to adopt a cautious approach, preferring to assess the evolving risks associated with food inflation before making any changes in its decisions. As guided by the March monetary policy bulletin, monetary policy will remain in "risk-minimisation mode" to align inflation towards the target while supporting growth. Given that the RBI Governor has been highlighting the aim of getting inflation to 4% on a durable basis, the policy rates are likely to be kept on hold in the upcoming policy meeting, with no change in stance. Liquidity conditions continue to remain tight but have eased compared to the start of this calendar year. The RBI will continue managing liquidity to support money market conditions.

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. We expect 10y G-sec yield to range between 6.5-6.6% by end-FY25.

Going ahead, we anticipate that the MPC will contemplate rate cuts in the second half of FY25 as headline inflation approaches the 4% threshold. By that time, the RBI will likely have gained further clarity on the risks associated with food inflation and the policy outlook of the US Fed.

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