RBI Shifts Stance to 'Neutral' while Retaining Policy Rate

October 09, 2024 l Economics

In its October 2024 meeting, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) maintained the policy repo rate at 6.5% with a 5:6 majority, with one member favouring a rate cut. However, the MPC has unanimously changed its stance to 'neutral' from 'withdrawal of accommodation.' We feel, with the change in stance, the MPC has kept the flexibility to cut policy rate going forward if food inflation moderates further.

Despite a shift in stance, the governor maintained a cautious tone, emphasizing the ongoing risks to inflationary outlook. Over the last two years, tighter monetary policy has made significant progress in bringing down the headline inflation within the target range. Nevertheless, the governor again reiterated his intention of aligning headline inflation with the 4% target on a durable basis.

While economic growth has remained healthy, there are early indications of softness. Recent high-frequency indicators, such as passenger car sales, toll collections, steel consumption, and petroleum consumption, suggest a softness in the economic momentum over the past few months. This softness is further reflected in the RBI's downward revision of its growth projections for Q2 FY25 by 20 bps to 7%.

The RBI Remains Cautious on Inflation

The inflation has remained well below 4% over the past two months, primarily due to a favourable base and some moderation in food inflation. While core inflation has remained benign (averaging 3.3% in April – August), inflationary risks have not fully abated, particularly with ongoing concerns regarding food inflation. The sequential momentum in prices is still high for vegetables, pulses, cereals and edible oil. The vegetable prices, that have a weight of 6% in CPI basket, have remained most volatile, and this is of concern as they also have a strong bearing on the household inflationary expectations.

Factors such as uneven monsoon, pre-harvest rainfall, and an increase in global edible oil prices add to the risks to food inflation. Although the monsoon was approximately 8% above normal, distribution issues persisted. Kharif sowing for pulses and some oilseeds has been below the historical average, which is concerning. Additionally, the extended monsoon season and recent pre-harvest showers increase the risk of crop damage.

Apart from food inflation, the recent uptick in the global commodity and brent crude prices pose further risks to inflation and warrants close monitoring. Industrial metal prices and Brent Crude prices have risen by about 8% and 9% respectively over the past one month. The base effect of food inflation is expected to turn adverse in the coming months, further contributing to increase in food inflation.

Notably, the RBI has revised down its inflation projection by 30 bps to 4.1% from 4.4% in Q2 FY25. However, the average inflation projection for the FY25 is maintained at 4.5%, lower than our projection of 4.8%.

RBI’s Inflation Outlook (%)					
	FY25	**Q2 FY25**	**Q3 FY25**	**Q4 FY25**	**Q1 FY26**
Oct-24	**4.5**	4.1	4.8	4.2	4.3
Earlier Aug-24	**4.5**	4.4	4.7	4.3	4.4

The RBI Retains Growth Estimates for FY25 but Sees Slower Growth in Q2

The RBI maintained its GDP growth projection for FY25 at 7.2%, higher than our projection of 7%. However, it is important to note that the Q2 FY25 projection for growth was reduced to 7% from earlier projection of 7.2%. Overall economic growth has been remained healthy. However, there are some early signs of softness as indicated by some high frequency indicators. Passenger car sales declined in both July (-2.5% YoY) and August (-1.8% YoY). Domestic tractor sales also fell in September (-5.8% YoY). Average daily petroleum consumption decreased by 2.6% YoY in August 2024, primarily due to a drop in diesel consumption. India’s core sector output contracted by 1.8% YoY in August, marking the first contraction in nearly four years. The Manufacturing Sector PMI remains above 50 but has been declining since June due to slower growth in output and new orders. This softness in high frequency data is also reflected in the RBI's downward revision of its growth projections for Q2 FY25 (7% in October vs 7.2% in August). The RBI anticipates that the recent softness in economic data will reverse going ahead. It now projects a slightly higher growth in H2 FY25 averaging 7.4%, higher than 7.3% estimated in the August policy.

RBI’s Growth Outlook (%)					
	FY25	**Q2 FY25**	**Q3 FY25**	**Q4 FY25**	**Q1 FY26**
Oct-24	7.2	7	7.4	7.4	7.3
Earlier Aug-24	7.2	7.2	7.3	7.2	7.2

External Situation Remains Comfortable

India’s external situation remains comfortable with sufficient forex reserves and a manageable current account deficit. Current account deficit remained comfortable at 1.1% of GDP in Q1 FY25. While merchandise exports contracted in both July (-1.7% YoY) and August (-9.3% YoY), it is counteracted by a growing services export. Services exports growth in Jul-Aug averaged 11% (YoY).

Foreign investment inflows are expected to remain strong on the back of passive inflows into the debt market and recent rate cuts by major central banks. India's sovereign bonds has been included in JPMorgan's bond index starting in June 2024 and will be included in Bloomberg's Government bond indices from January 2025, following a staggered approach. Additionally, FTSE Russell has announced plans to incorporate India's sovereign bonds into its Emerging Markets Government Bond Index (EMGBI) in September 2025. This inclusion is expected to attract inflows of ~ USD 4-5 billion, in addition to the anticipated inflows of USD 25-30 billion from the JPMorgan and Bloomberg indices.

The RBI will continue to remain vigilant of the external developments mainly on the geopolitical front as it may impact global supply chains and impact energy prices. The recent increase in global commodity prices in response to the stimulus measures announced by China is also a key monitorable.

Financial Stability and Liquidity Management

The Governor reiterated the significance of financial stability and identified potential risks within the financial sector. The RBI has been focussing on the build-up of stress in the unsecured lending and had raised risk weights of certain segments of the unsecured loans and NBFCs. As a result, bank's personal loan growth moderated to 16.9% in August as compared to 18.3% a year ago. The slowdown in personal loans is largely due to decline in credit card debt. Additionally, the C-D ratio has moderated from the peak 80.25 in March to 79.1 in September. The governor also called for further assessment and calibration of underwriting standards and enhanced post-sanction monitoring for such loans. He also warned against NBFCs pursuing aggressive and unsustainable growth practices.

Over the past couple of months, systemic liquidity has stayed mostly in the surplus territory. Amid strong FPI inflows, the RBI has managed the inflows through FX purchases and OMO sales to neutralise the impact on liquidity. In the fiscal year so far, RBI has conducted OMO sale of Rs 241 billion mostly over the past three months (July-September). The RBI will continue to remain nimble and flexible in its liquidity management ensuring money market interest rates evolve in an orderly manner. It will continue managing liquidity through both main and fine-tuning operations as necessary to uphold favourable money market conditions. The RBI will ensure ample liquidity is available to support the credit demand.

Way Forward

RBI will continue to remain cautious about risks to inflation. The RBI can opt for a shallow rate cut of 25 bps in the December policy, followed by another 25 bps in the February policy, provided food inflation moderates. While the Central Bank remains optimistic on growth, some moderation in recent high frequency economic indicators also give reason for the RBI to look at rate cuts going forward. Expectations of further rate cuts by major global Central Banks including US Federal Reserve is also supportive of a rate cut by RBI. The US Federal Reserve is expected to reduce policy rates by 50 bps more in 2024 and by ~100 bps in 2025. However, the RBI's policy actions would be primarily driven by deliberations on the domestic economy's growth-inflation dynamics.

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