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ICRA COMMENTS ON RBI'S FIFTH BI-MONTHLY MONETARY POLICY MEETING FOR 2023-24

MPC maintains status quo on rates for fifth consecutive time in Dec 2023; raises FY2024 GDP growth forecast sharply by 50 bps to 7.0%

DECEMBER 2023

HIGHLIGHTS

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The MPC unanimously kept the policy repo rate unchanged in Dec 2023; policy stance was maintained with 5:1 vote

While the FY2024 CPI inflation forecast was retained at 5.4% in Dec 2023, that for GDP growth was revised sharply to 7.0%, amidst considerable revisions for Q3-Q4 FY2024

The Monetary Policy Committee (MPC) unanimously decided to keep the policy rates unchanged for the fifth consecutive time in its December 2023 policy meeting, while five of the six members voted to maintain the policy stance. While these actions were along expected lines, the overarching tone of the policy was that of optimism on growth, rather than hawkishness on inflation, even as the focus on bringing down the latter to 4.0% was reiterated. The GDP growth projection for FY2024 was revised upwards sharply by 50 bps to 7.0%, following the higher-than-expected Q2 print and an upward revision in H2 numbers, even as the CPI inflation forecast for FY2024 was kept unchanged at 5.4%. Given a similar outlook on inflation and a weaker outlook on growth vis-à-vis the MPC, ICRA believes that further monetary tightening is not warranted in the near term, unless there is a durable shock to the inflation trajectory. Consequently, we expect a status quo until the beginning of a shallow rate cut cycle in August 2024. On the liquidity front, we believe that OMO sales are not warranted in the near term, unless there are large capital inflows towards the end of the fiscal, ahead of the Bond Index inclusion.

- In its fifth Bi-monthly Monetary Policy meeting for FY2024, the MPC unanimously decided to keep the policy repo rate unchanged at 6.50%, and retained the policy stance “to remain focused on the withdrawal of accommodation to ensure that inflation progressively aligns to the target, while supporting growth”, with a majority vote of 5:1. Accordingly, the standing deposit facility (SDF) rate stands unchanged at 6.25% and the marginal standing facility (MSF) rate and the Bank Rate at 6.75% each.
- While highlighting near-term upside pressures to the food inflation trajectory, the MPC retained its FY2024 CPI inflation forecast at 5.4% in Dec 2023, keeping the projections for Q3 FY2024 (+5.6%) and Q4 FY2024 (+5.2%) unchanged, with risks evenly balanced. Subsequently, the Committee expects inflation to print at 5.2% in Q1 FY2025, before moderating to 4.0% in Q2 FY2025, on a high base (+6.4% in Q2 FY2024). Further, the CPI inflation for Q3 FY2025 has been estimated at 4.7%.
- The MPC remained optimistic about the recovery in urban as well as rural demand, while remaining cautious regarding the protracted geopolitical tensions and volatility in financial markets. With the real GDP growth exceeding expectations in Q2 FY2024 (+7.6% vs. MPC’s estimate: +6.5%), the Committee revised its real GDP growth forecast for FY2024 sharply by 50 bps to 7.0% from 6.5% projected in Oct 2023. This entailed an upward revision in the estimates for Q3 FY2024 (to +6.5% from +6.0%) and Q4 FY2024 (to +6.0% from +5.7%). Subsequently, the MPC expects growth to print at 6.7% in Q1 FY2025, before moderating to 6.5% in Q2 FY2025, and 6.4% in Q3 FY2025.

Outlook: While we broadly concur with the MPC’s assessment and outlook around inflation, we remain more cautious on the growth outlook. This leads us to believe that the policy rates are appropriate at the current juncture and no further tightening is warranted in the near term, unless there is a durable shock to the CPI inflation trajectory. Consequently, we expect the Committee to maintain status quo for the next couple of policy meetings, while also riding out the uncertainty on account of the General Elections. Thereafter, we expect a shallow rate cut cycle of around 50-75 bps, beginning in the August 2024 meeting.

ICRA expects the 10-year Government security yield to remain between 7.2-7.35% over the remainder of this fiscal, with a downside bias emerging closer to the Bond Index inclusion.

MPC KEPT REPO RATE UNCHANGED IN DEC 2023 POLICY; GROWTH FORECAST REVISED UPWARDS BY 50 BPS TO 7.0%

The MPC unanimously kept the policy repo rate unchanged at 6.50%, while highlighting that it would continue to focus on withdrawal of accommodation

In its fifth bi-monthly policy meeting for FY2024, the MPC unanimously decided to keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.50% (refer Exhibit 1). Accordingly, it retained the SDF, Bank rate and MSF rates at 6.25%, 6.75% and 6.75%, respectively. Additionally, the Committee retained its policy stance – 'to remain focused on the withdrawal of accommodation to ensure that inflation progressively aligns to the target, while supporting growth', with a majority of five of the six members.

FY2024 CPI inflation projection retained at 5.4%: The year-on-year (YoY) CPI inflation had expectedly eased to 4.9% in Oct 2023 from 5.0% in Sep 2023, with nearly ~70% of this drop being led by the miscellaneous items sub-group. Moreover, the core inflation had eased for the fifth consecutive month to 4.5% from 4.7% respectively, the lowest reading since Feb 2020, partly on account of the base effect.

The Committee anticipates the spike in vegetable prices to push up inflation in Nov-Dec 2023; correction in global agricultural, edible oil and crude oil prices likely to act as positives

Going ahead, the Committee expects the inflation trajectory to be impacted by the uncertainty around food prices. The rise in vegetable prices, along with an unfavourable base, is likely to exert significant upward pressure on the headline inflation print for Nov-Dec 2023. Additionally, the ongoing rabi sowing for crops such as wheat and pulses needs to be closely monitored. However, the softening in global agricultural commodity prices, along with the moderation in international edible oil and crude oil prices, is likely to aid in keeping the headline inflation at moderate levels. Moreover, supply side measures by the Government may also aid in containing domestic food price pressures.

Taking these factors into account, the Committee retained its average CPI inflation forecast for FY2024 at 5.4% in Dec 2023. In quarterly terms, the MPC kept its CPI inflation projections for Q3 FY2024 (+5.6%) and Q4 FY2024 (+5.2%) unchanged in Dec 2023, with risks evenly balanced. Subsequently, the Committee expects inflation to print at 5.2% in Q1 FY2025, before moderating to 4.0% in Q2 FY2025, on a high base (+6.4% in Q2 FY2024). Further, the CPI inflation for Q3 FY2025 has been estimated at 4.7%.

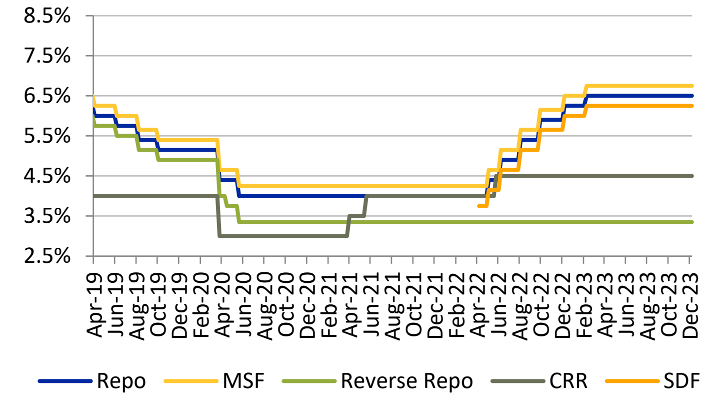
The MPC retained its FY2024 CPI inflation projection at 5.4% in Dec 2023; expects inflation to moderate to 4.0% in Q2 FY2025 from 5.2% in Q1 FY2025, on a high base

The MPC's quarterly CPI inflation projections are quite similar to ICRA's estimates, barring that for Q2 FY2025, wherein we are expecting a transient sub-4% headline inflation print. Given this and our relatively subdued outlook for growth vis-à-vis that of the MPC, we believe that further monetary tightening is not warranted in the near term, amid the continued transmission of the past rate hikes, unless there is a durable shock to the inflation trajectory. At the same time, the continued focus on bringing down inflation to 4.0% suggests that rate cuts remain distant. ICRA expects an extended pause on the policy rate and unchanged stance through the remaining part of FY2024. Thereafter, we expect a shallow rate cut cycle, limited to 50-75 bps, to commence from the August 2024 policy meeting.

The Committee highlighted that while the CPI inflation corrected to sub-5% levels in Oct 2023, alongside a moderation in core inflation and better-anchored household inflation expectations, the 4.0% inflation target is yet to be achieved. Consequently, the Governor emphasised the readiness of monetary policy to remain actively disinflationary to ensure a durable alignment of headline inflation to the target of 4%, while supporting growth. However, despite the cautious commentary around inflation, the overarching tone of this policy was of optimism on growth.

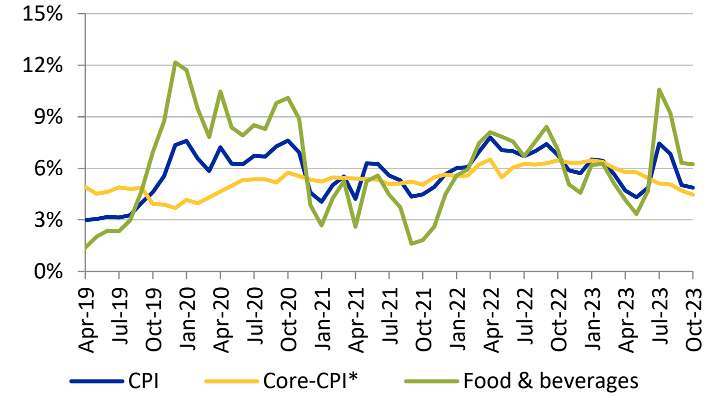
ICRA expects the earliest rate cut in August 2024

EXHIBIT 1: Movement in Key Rates



***Source**: RBI; CEIC; ICRA Research*

EXHIBIT 2: CPI Inflation, CPI-food and core-CPI inflation (YoY)



**Due to unavailability of data for March-May 2020, we have not excluded petrol and diesel indices for vehicles in computation of core CPI index for these months;*
***Source**: NSO; CEIC; ICRA Research*

EXHIBIT 3: RBI's earlier and current GDP growth and CPI inflation forecasts

YoY (%)	CPI Inflation		GDP Growth (at constant 2011-12 prices)	
MPC Policy Reviews	**October 2023**	**December 2023**	**October 2023**	**December 2023**
Q3 FY2024	5.6%	5.6%	6.0%	6.5%
Q4 FY2024	5.2%	5.2%	5.7%	6.0%
FY2024	**5.4%**	**5.4%**	**6.5%**	**7.0%**
Q1 FY2025	5.2%	5.2%	6.6%	6.7%
Q2 FY2025		4.0%		6.5%
Q3 FY2025		4.7%		6.4%

***Source**: RBI; ICRA Research*

The MPC is optimistic about the prospects of household consumption, with continued strengthening of manufacturing activity, buoyancy in construction, and gradual recovery in rural sector

Moreover, it expects the investment demand conditions to be favoured by healthy balance sheets of banks and corporates, improving business optimism and CU levels, and increase in Government capex

Following stronger-than-expected Q2 print, the MPC has raised its FY2024 GDP growth projection by 50 bps to 7.0%, compared to the Oct 2023 policy

FY2024 GDP growth forecast raised by 50 bps to 7.0%: The NSO placed the year-on-year (YoY) growth in India's GDP for Q2 FY2024 at a robust 7.6%, considerably surpassing the MPC's (+6.5%) as well as ICRA's (+7.0%) estimates for the quarter. This was on account of a double-digit expansion in government final consumption expenditure (+12.4%) as well as gross fixed capital formation (+11.0%), even as private final consumption expenditure grew by just 3.1% in the quarter. Notably, manufacturing and construction sectors performed exceedingly well, which boosted the overall GVA growth to 7.4% in Q2 FY2024, only a shade below the 7.8% seen in Q1 FY2024.

Going forward, the MPC is optimistic about the prospects of household consumption, with continued strengthening of manufacturing activity, buoyancy in construction, and gradual recovery in the rural sector. While investment demand conditions are likely to be favoured by healthy balance sheets of banks and corporates, increase in Government capital spending, improving business sentiments as well as supply chain normalisation. It also anticipates some moderation in the drag from net exports on the GDP, going forward, amid seasonal increase in exports. Nevertheless, headwinds continue to persist from the geopolitical turmoil, volatility in international financial markets and geoeconomic fragmentation, which poses risks to the growth outlook.

Taking all these factors into account as well as the Q2 GDP print coming in well above its estimate, the MPC has raised the FY2024 GDP growth forecast to 7.0% from 6.5% stated in the Oct 2023 policy, with an upward revision in Q3 FY2024 (by 50 bps; to +6.5% from +6.0%) as well as Q4 FY2024 (by 30 bps; to +6.0% from +5.7%). Besides, the Committee has marginally raised the Q1 FY2025 estimate to 6.7% from 6.6% and pegged the growth projections for Q2 FY2025 and Q3 FY2025 at 6.5% and 6.4%, respectively, with risks evenly balanced.

ICRA remains apprehensive of a sharp moderation in the growth momentum to around 5.0% in H2 FY2024 on account of multiple headwinds and challenges. These include weak prospects for agri output and rural demand, narrowing differentials with year-ago commodity prices, the possible slowdown in momentum of Government capex as we approach the Parliamentary Elections, tepid global growth and muted export performance, and the cumulative impact of monetary tightening. In our view, various high frequency indicators for the month of October 2023 are portraying an optically high growth on account of a shift in the festive calendar and change in the number of working days, and a moderation in growth prints is imminent for various sectors in the month of November 2023. We will review our growth forecast for FY2024 (current: +6.2%) after additional data for November 2023 becomes available.

After remaining in surplus mode in 5M FY2024, systemic liquidity turned into deficit in Sep 2023, for the first time since May 2019

The liquidity deficit widened to Rs. 532 billion in Oct 2023, and further to Rs. 571 billion in Nov 2023 amid drainage caused by higher CWP owing to festive season

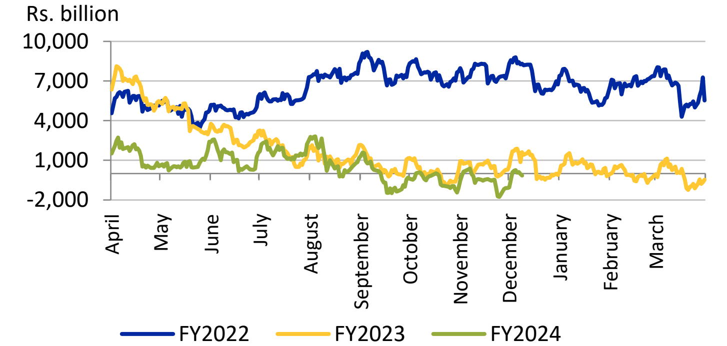
Notwithstanding the deficit in systemic liquidity in Q3 FY2024, durable liquidity continues to remain in surplus, and stood at an elevated Rs. 2.3 trillion as on November 17, 2023, owing to high cash balances of the Government

Systemic liquidity conditions tightened in Q3 FY2024, even as elevated GoI cash balances have kept durable liquidity in large surplus: The daily average systemic liquidity recorded a deficit amounting to Rs. 0.5 trillion in Q3 FY2024 so far (-0.2% of NDTL; till Dec 7, 2023), after remaining in surplus mode in Q2 FY2024 (+Rs. 0.9 trillion; +0.4% of NDTL) as well as in Q1 FY2024 (+Rs. 1.1 trillion; +0.6% of NDTL). The tightening of liquidity conditions in the ongoing quarter can mainly be attributed to seasonally higher currency leakage owing to the festive/marriage seasons, as reflected in an uptrend in currency with the public (CWP; to Rs. 32.5 trillion as on Nov 17, 2023 from Rs. 32.0 trillion as on Sep 22, 2023) and weaker capital inflows in Oct-Nov 2023. While the GoI cash balances eased since end-Sep 2023 (to Rs. 2.8 trillion as on Nov 17, 2023, albeit lower than Rs. 3.9 trillion recorded as on Sep 22, 2023), they remained elevated.

In monthly terms, systemic liquidity slipped into a deficit in September 2023, for the first time since May 2019, amounting to Rs. 152 billion, which subsequently widened to Rs. 532 billion in October 2023. Thereafter, the deficit rose further to Rs. 571 billion in November 2023, amid the onset of the festive and marriage seasons. Nevertheless, durable liquidity remained in surplus, touching Rs. 2.3 trillion as on November 17, 2023; this was only mildly lower than the Rs. 2.5 trillion recorded as on September 22, 2023.

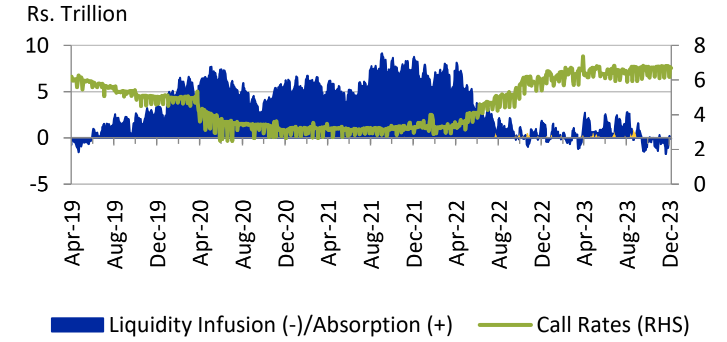
In the ongoing month, liquidity conditions have eased, with the size of the systemic liquidity deficit moderating to Rs. 252 billion up to December 7, 2023 from Rs. 571 billion in November 2023, which is likely to have been led by a pick-up in Government spending and the consequent drawdown of cash balances.

EXHIBIT 4: Liquidity Infusion (-)/ absorption (+) (Net Overnight & Term Repos/Reverse Repos; MSF; SLF; MSS)



Data for FY2024 is available up to Dec 7, 2023; **Source: RBI; ICRA Research*

EXHIBIT 5: Call money rates



***Source**: RBI; ICRA Research*

Amid tighter liquidity conditions, the average MSF funds availed by banks soared to Rs. 1.1 trillion in Q3 FY2024 so far (till Dec 7, 2023) from Rs. 0.4 trillion in Q2 FY2024

Amid tighter liquidity conditions, banks relied majorly on the MSF to raise funds, with this facility accounting for ~88% of the total liquidity injection (via MSF, FRR and VRR) in Q3 FY2024 so far (till Dec 7, 2023). On an average, the funds availed through this facility soared to Rs. 1.1 trillion in Q3 FY2024 so far (till Dec 7, 2023) from Rs. 0.4 trillion in Q2 FY2024.

Banks parked a larger proportion of funds under the overnight SDF, although the share of this facility in total absorption (via FRRR, VRRR and SDF) eased to 73% in November 2023 from 90% in October 2023, while remaining elevated.

The WACR remained elevated, above the repo rate through Q3 FY2024, rising from 6.52% in September 2023 to 6.64% in October 2023, which inched up further to 6.67% in November 2023

The daily weighted average call money rate (WACR) remained elevated and exceeded the repo rate through Q3 FY2024, rising from 6.52% in September 2023 to 6.64% in October 2023, which inched up further to 6.67% in November 2023, given the tightness in systemic liquidity. Additionally, the average 91-day, 182-day and 365-day T-bill yield rose by ~6-11 bps to 6.93%, 7.07%, and 7.12%, respectively, in November 2023 from 6.82%, 7.01% and 7.05%, respectively, in September 2023.

The RBI did not announce any OMO sales in view of already tight liquidity conditions in the ongoing quarter. As per the data published in the weekly statistical supplement, the net OMO sales (outright) stood at Rs. 1.1 billion during November 1-26, 2023, sharply lower than the levels seen in Sep 2023 (Rs. 73.3 billion) and Oct 2023 (Rs. 99.2 billion). **With liquidity conditions set to tighten in the second half of December 2023, owing to advance tax outflows and GST payments, ICRA believes that OMO sales are not warranted in the immediate term. We only expect significant OMO sales to materialise in the event of a surge in capital inflows towards the end of the fiscal, ahead of the Bond Index inclusion.**

With the proposal to reverse the liquidity facilities under MSF and SDF during weekends and holidays, ICRA expects the volatility in call money rates to reduce and the extent of balances used in MSF and SDF facilities over the weekend to also moderate

However, given the overall tight liquidity conditions in the banking system, ICRA does not expect the call money rates to decline substantially

Going forward, the Central Bank expects that a pick-up in Government spending could ease the liquidity conditions and highlighted that it would remain nimble in liquidity management. Owing to the high utilisation of MSF and SDF routes, the Central Bank has decided to allow reversal of liquidity facilities under both SDF and MSF even during weekends and holidays with effect from December 30, 2023. Given the 24X7 fund transfer facility available for customers, the banks face challenges on liquidity management over the weekend, when inter-bank markets are closed. Hence, as a matter of prudence they end up borrowing three-day funds in the inter-bank market and MSF window over the weekend. Similarly, banks with surplus liquidity surplus end up locking the funds for three days under SDF over the weekend. **With the proposal to reverse these three days MSF and SDF facility, ICRA expects the volatility in call money rates to reduce and the extent of balances used in MSF and SDF facilities over the weekend to also moderate. However, given the overall tight liquidity conditions in the banking system, we do not expect the call money rates to decline substantially.**

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