Monetary policy | First cut

Eyes peeled on prices

August 8, 2024

RBI stays pat on rates to ensure sustained cooling of inflation

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) made no changes to its policy rates and stance in today's meeting. The RBI remains steadfast on ensuring sustained cooling of inflation amid sticky food inflation.

The RBI's status quo is in contrast to the shift in monetary policy *stance of other major global central banks. While the European Central Bank (ECB) and Bank of England (BOE) have initiated a rate cut, the Bank of Japan (BoJ) has raised its policy rate, and the US Federal Reserve (Fed) is likely to cut rates this September.*

Inflation remains a key gauge for the RBI's MPC decision, with elevated food prices the biggest hurdle in shifting its stance. Food inflation has been persistently high for over a year now, and the RBI remains cautious of its direct and indirect impact on disinflation process.

However, better monsoon and higher kharif sowing vs last year is expected to ease food inflation this fiscal, with the picture becoming clearer by September. Extreme weather events, including excess rainfall, remain a monitorable, though. Globally, the Fed rate cuts from September will also provide more room for the RBI to cut rates.

We see the RBI cutting rates starting October 2024 at the earliest, and expect a total of two rate cuts this fiscal.

Highlights from the August monetary policy review

- The MPC voted to keep policy rates unchanged, with a 4-2 majority
- The repo rate was kept unchanged at 6.50%, standing deposit facility at 6.25% and marginal standing facility at 6.75% for 17th month in a row
- There was also status quo on 'withdrawal of accommodation' stance, with a 4-2 majority
- The MPC retained its forecasts for consumer price index (CPI)-based inflation at 4.5% and gross domestic product (GDP) at 7.2%, as was the case in the previous meeting
- The RBI highlighted potential risks in certain lending segments

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MPC looking for more broad-based disinflation

- **Persistently elevated food inflation the biggest obstacle**: Since the last monetary policy meeting, CPI inflation has risen, though trending within the MPC's tolerance range of 2-6%. It rose to 5.1% in June from 4.8% in the previous month. To be sure RBI wants to bring inflation down durably to 4%. Moreover, food inflation was considerably above the headline reading, and surged to 9.4% in June from 8.7% in the previous month.

In contrast, non-food inflation eased to 2.3% from 2.4%. Also, core inflation (inflation excluding food and fuel) – a firmer measure of demand pressures in the economy – has been at a record low of 3.1% in the past two months.

Yet, the MPC chose not to look past high food inflation, as it has been above 6% for a year now. In fact, the MPC does not view this as transitory. If growth momentum is strong, as if the case right now, the MPC would tend to gravitate towards inflation control even in the case of a supply-driven shock.

The MPC sees food as a critical component for the disinflation process, as food, along with beverage, constitutes 46% of the CPI basket. Food also significantly influences household inflation expectations, which indirectly influences overall inflation (through wages, for instance). The governor pointed out that household inflation expectations has moved up since November 2023.

Nevertheless, the MPC saw good progress on the monsoon front and kharif sowing, as well as easing in global food prices, which should support a cooling in food inflation. However, extreme climate events remain a risk. The MPC is also monitoring pressures on non-food inflation from mobile tariff rate revision and expectation of producers raising prices in the second half of this fiscal – based on its survey on manufacturing and services firms.

Overall, the MPC kept its CPI inflation forecast unchanged at 4.5% for fiscal 2025, with risks evenly balanced. CPI inflation is expected to ease to 4.4% in the second quarter (Q2) from 4.9% in Q1, supported by a favourable base. But it expects CPI to rise again to 4.7% in Q3, moving to 4.3% in Q4 and 4.4% in Q1 next fiscal.

- **Resilient growth gives comfort**: High frequency data indicates GDP growth was healthy in Q1 of this fiscal. The MPC views improving global trade to be supporting domestic growth. Domestic demand is also becoming broadbased, with rural demand picking up and urban demand for discretionary consumption staying stable. The RBI governor stated private corporate investment is gaining momentum as well.

  The MPC expects growth to remain strong in the current fiscal, with an above-normal monsoon driving up agriculture and rural consumption, services supporting urban consumption, conducive investment conditions, and improving global trade.

  The central bank kept its GDP growth forecast unchanged at 7.2% for fiscal 2025, with 7.1% in Q1, 7.2% in Q2, 7.3% in Q3 and 7.2% in Q4. It expects growth to be stable at 7.2% in Q1 next fiscal as well.

RBI weighs market risks amid shifting global monetary policies

- Monetary policies are diverging at major central banks. The ECB initiated a rate cut in June, followed by the BoE at July-end. However, the BoJ hiked its policy rate at July-end. And while the Fed has not changed its policy rates so far, it is expected to cut rates in September following a sharp weakening in the country's labour market
- Diverging monetary policies have induced volatility in global markets. In particular, the unwinding of the yen carry trade put pressure on foreign portfolio inflows in August so far, dragging the rupee to a record low on August 7
- Still, the RBI governor emphasised that India's vulnerability remains low given the benign current account deficit and record-high foreign exchange reserves – which has improved the country's ability to mitigate external shocks

RBI vigilant of potential risks in the backdrop of sustained strong credit growth

- The RBI has kept policy rates and stance unchanged for 17 months now, which was preceded by a rate hike cycle in fiscal 2023. Rate hikes are getting transmitted with a lag to bank lending and deposit rates. Yet, bank credit growth remains close to decadal highs, at 15.5% as of mid-July, marginally higher on-year

- The RBI governor, though, flagged some lending practices that could become risks. The governor pointed to excess leverage in the personal loans segment emanating from retail loans for consumption purposes, home equity loans and top-up loans in segments such as gold loans
- The governor also flagged a wide gap between credit and deposit (growing slower at 11.3%), and urged banks to attract household financial savings and avoid structural liquidity issues
- That said, the governor maintained that the financial sector remains sound. The central bank's past regulatory measures to clamp down on non-banking financial companies and unsecured lending are also yielding results

Our view

The MPC's decision to hold rates at this juncture was expected as elevated food inflation has proven to disrupt disinflation of late. Climate change is also increasing the frequency and intensity of extreme weather events, and needs continuous monitoring.

However, we expect the macroeconomic environment to gradually turn favourable for a rate cut.

The food challenge to a rate cut is expected to ease as agriculture prospects look better than last year. The monsoon has been above normal (7% above the long period average as on August 7), and sowing has picked up across major foodgrains. As agriculture prospects become clearer by September, we expect it to pave the way for a rate cut.

Core inflation, though, could see an upside in the coming months because of the recent firming up in international freight costs, geopolitical risks to crude oil prices, and hikes in domestic telecom tariffs. However, the uptick is expected to be mild.

But the pace of growth of the economy is expected to ease this year, with lower fiscal support as the government pursues fiscal consolidation.

S&P Global expects the Fed to cut rates from September. Cumulatively, it expects 50 basis points (bps) rate cuts in 2024 (calendar year), and 100 bps in 2025.

While the RBI does not follow other central banks, their actions do give it space to manoeuvre.

We expect the RBI to begin cutting rates from October at the earliest, lest weather and international commodity prices play spoilsport. Overall, we expect two rate cuts this fiscal.

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