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RBI MONETARY POLICY- PAUSE NOT PIVOT

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WHY NO CHANGE?

The RBI was widely expected to raise its benchmark rate for the seventh consecutive meeting by 25 basis points (bps) to a seven-year high of 6.75 per cent on April 6, 2023 with the distinct possibility of more hikes to contain inflation within its comfort zone. Almost all central banks hiked rates since April 2022 with the cumulative hikes being US 450 bps, Hong Kong 450 bps, Canada 400 bps, UK 350 bps, and Australia 350 bps.

The series of rate hikes began with 40 bps hike from 4 per cent at an off-cycle meeting in May 2022, its first rate increase in nearly four years and, therefore, "it is now necessary to evaluate cumulative effect of rate hikes". Early signs of a slowdown have been visible in bank credit growth which decelerated to 15.7 per cent on-year as of March 10, easing from a decade high of 17.9 per cent in October 2022.

However, given that the RBI had already raised rates by 250 bps since May 2022; the dip in retail inflation from a three-month high 6.52 per cent in January 2023 to 6.44 per cent year-on-year in February 2023; and the "downside risks from financial stability concerns"- "unprecedented uncertainties in geopolitics, economic activity, price pressures and financial markets" (e.g., banking turmoil manifested in the crash of the Silicon Valley Bank, Credit Suisse Group AG), the RBI refrained from any such hike even though inflation continues to persist disconcertingly above its tolerance level of 6 per cent. In other words, the decision to keep the key lending rate unchanged was taken on the basis of an "assessment of the current macroeconomic and financial conditions".

POLICY IMPACT - PAUSE NOT PIVOT

This decision of the RBI would provide relief to borrowers in rate sensitive sectors like real estate including residential complexes, passenger cars, commercial vehicles with the home loan and other EMIs are unlikely to rise in the aftermath of the Policy. Further, large debt companies, growth stocks, small and mid-cap space companies, and specific sectors, viz., consumer durables and real estate would not be adversely impacted by the RBI's policy move, business sentiments will improve by containing the rise in borrowing costs and thus augur well for broad-based Indian economy. It has been justifiably maintained that any further hike in the benchmark repo rate at this juncture would have affected India's economic growth even as domestic demand impulses remain healthy.

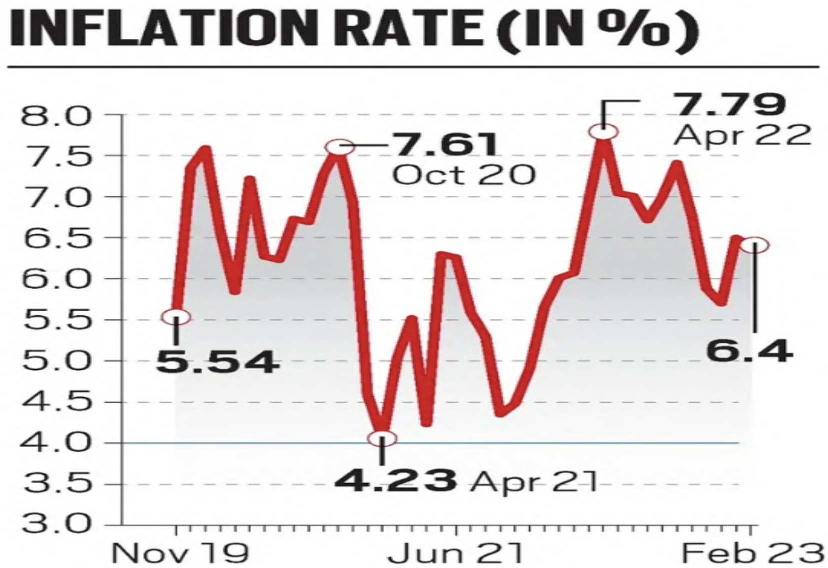
However, the cost of wholesale borrowings in money markets could rise in money markets and corporates because of the RBI's decision to reduce surplus liquidity. Incidentally, this *status-quoist* decision of the RBI is in line with the decision of some other central banks in the region, including Indonesia, South Korea and Malaysia.

FURTHER RATE HIKES

It clearly emerges that the MPC remains focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth. The Governor did not explicitly say that there would be a rate hike post the next monetary policy committee (MPC) meeting. But reading between the lines, the Policy statement is strongly suggestive of the fact that there could be one more hike because the "*war against inflation will continue until durable decline in inflation closer to target is seen*". Governor Shaktikanta Das said, "*the MPC unanimously decided to keep rates unchanged in this meeting with readiness to act if the situation so warrants*". "*The MPC will not hesitate to act as needed in future meetings*". While keeping the interest rate intact, the Governor stressed that core inflation remains sticky. Hence, there is a real possibility that the Repo rate could reach 6.75 per cent with a possibility of a final 25 bps hike in the first half of FY24.

INFLATIONARY SPIRAL

High retail inflation since December 2022, spike in food inflation hiking retail inflation and persisting high core inflation across many goods and services cause concern and consternation. While headline inflation is likely to moderate in FY 24, the inflation trajectory would be a function of both domestic and global factors, viz., global dynamics, record rabi food-grains production, volatility in crude oil prices with potential high imported inflation risks, El Nino, etc. Since inflation is the primary objective of monetary policy both by design and law, there has to be a consistent vigil on the inflation to achieve low and durable inflation.

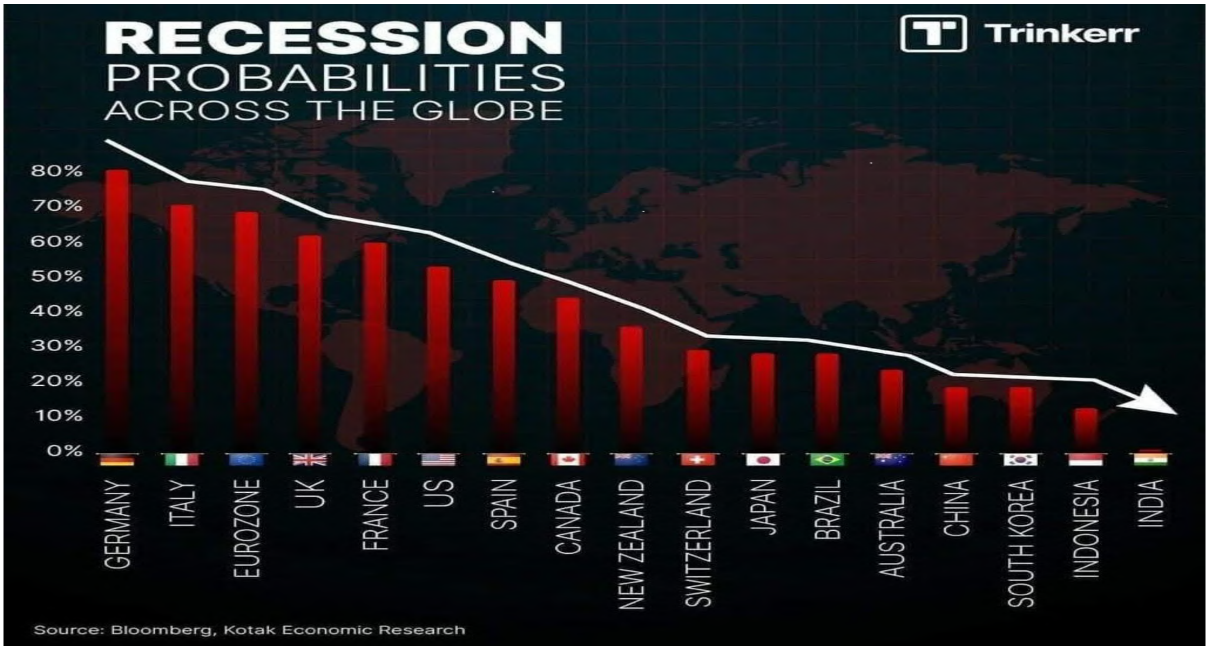


"*Taking into account these factors and assuming an annual average crude oil price (Indian basket) of $85 per barrel and a normal monsoon, CPI inflation is projected at 5.2% for 2023-24, with Q1 at 5.1%, Q2 at 5.4%, Q3 at 5.4% and Q4 at 5.2%, and risks evenly balanced*".

GDP GROWTH

India's real GDP is likely to have grown by 7 per cent in 2022-23 and economic activity remains resilient to global spill-overs. The banking turmoil in some countries and the volatility in the rupee movement are being closely monitored by the RBI. India's financial sector is strong. The RBI marginally revised upwards the economic growth projection for the current fiscal to 6.5 per cent from its earlier estimate of 6.4 per cent. Traction in high-frequency indicators, such as, fuel consumption, automobile sales, PMI (purchasing managers' index) manufacturing and services, and GST collections is reflected in higher annualised growth rates and sequential improvements.

Despite geopolitical tensions constituting downside risks to outlook, FY24 GDP growth has been projected at 6.5 per cent. The thesis of India's resilient growth despite some manifestations of moderation in growth can also be substantiated by the latest *India Development Update*, the World Bank India's biannual flagship publication. Growth is driven by strong investment consumption, particularly among higher income earners but there are headwinds of slower consumption growth, challenging external conditions, rising borrowing costs, slower income growth reducing private consumption growth, and muted government consumption because of the withdrawal of pandemic-related fiscal support measures. The overarching scenario is characterised by two years of pandemic, on-going Russia-Ukraine War, globally synchronized slowdown and collapse of banks. India's economy, however, remains stable and growth outpaces most economies with the lowest risk of recession as clearly brought out by Bloomberg.



Tailwinds to the growth include likely 6.2 per cent growth in the rabi crop, higher rural wages, a renewed thrust on allied agricultural activities, sustained buoyancy in contact-intensive services, an accent on capital expenditure, higher capacity utilisation in manufacturing, double digit credit growth, muted commodity prices and RBI's optimistic businesses and consumers survey. Hence sustained growth seems here to stay.

The external demand drag could accentuate, given slowing global trade and output. Protracted geopolitical tensions, tight global financial conditions and global financial market volatility pose risks to the outlook. "*Taking all these factors into consideration, real GDP growth for 2023-24 is projected at 6.5% with Q1:2023-24 at 7.8%; Q2 at 6.2%; Q3 at 6.1%; and Q4 at 5.9%, with risks evenly balanced*.

RUPEE DEPRECIATION

The Rupee's relatively lesser depreciation in the calendar years 2022 and 2023 (in line with decline in most major currencies, the Rupee depreciated by 7.8 per cent in FY 23 *vis-à-vis* a more pronounced depreciation of Chinese Yuan, S. Korean Won, Malaysian Ringitt & Philippine Peso) reflects the strength of domestic macroeconomic fundamentals and the resilience of the Indian economy to global spill-overs from recent developments in financial markets in the US and Europe. These uncertainties, together with spiralling inflation, have led to financial market volatility, reflected in sizeable two-way movements in bond yields, a fall in equity markets, and the U.S. dollar no longer being the global default currency. While these spill-overs imperil short-term investment flows to emerging markets, including India, Indian banks remain well capitalized.

As the IMF's *Global Financial Stability Report* highlighted "*increased geopolitical tensions among major economies could cause a sudden reversal of cross-border capital flows and pose macro-financial stability risks by increasing banks' funding costs, reducing their profitability, and lowering their provision of credit to the private sector. These effects would likely be disproportionately more significant for banks with lower capitalization ratios*".

WELCOME MACRO-ECONOMY

Some welcome aspects of India's development discourse include a significant narrowing of CAD in Q 3 to 2.2 per cent from 3.7 per cent in Q2; surge in foreign exchange reserves to over US$ 600 billion and fiscal consolidation.

OTHER MEASURES

An important Developmental measure relates to developing an onshore non-deliverable derivative market. Regulatory and supervisory measures attempt at enhancing efficiency of regulatory processes, developing centralised web portal for the public to search unclaimed deposits, instituting a grievance redress mechanism relating to credit information reporting by credit institutions and credit information provided by Credit Information Companies. In respect of payment and settlement systems, operation of pre-sanctioned credit lines at banks through the UPI is welcome. All these measures are contextually significant in enhancing the strength and reliance of the Indian financial sector.

CONCLUDING OBSERVATIONS

In sum, given the growth-inflation trade-off, the Governor took the right call by recalibrating the monetary policy with effective transmission to financial markets, particularly in the context of globally synchronized slowdown to less than 3 per cent this year, with India and China accounting for half of global growth in 2023 as highlighted by IMF's Chief Ms. Kristalina Georgieva.