No Indications of Pause; Inflation Precedes Growth

The Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in a 4-2 majority decided to increase the policy repo rate by 25 basis points to 6.5% with immediate effect. The calibrated withdrawal of accommodation stance of the MPC continues to remain unchanged, with 4-2 majority. Today's rate hike decision by MPC is in line with B2K expectations. This is the sixth straight hike in the policy rate by RBI, and cumulatively the rates have been increased by 250 bps since May 2022, taking the repo rate to the August 2018 level.

Key Takeaways from RBI Governor's Statement

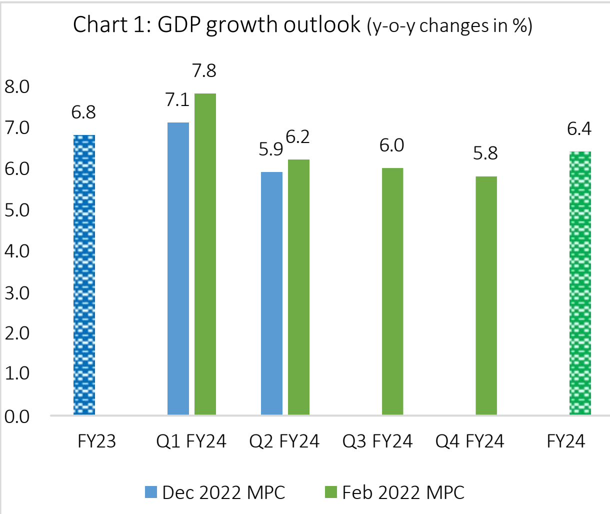
- The repo rate has been increased by **25 bps to 6.5%,** the Standing Deposit Facility (SDF) rate stands adjusted to 6.25% and the Marginal Standing Facility (MSF) rate and bank rate have been increased to 6.75%.
- The overall liquidity remains in surplus, with average daily absorption under the LAF increasing to Rs 1.6 lakh crore during December-January 2023 from an average of Rs 1.4 lakh crore in October-November 2022.
- The overall monetary and liquidity conditions have remained accommodative and hence, the MPC decided to continue with the withdrawal of accommodation.
- Two MPC members voted against the decision of rising the policy rates by 25 bps and continuation of the current policy stance.
- RBI revised the inflation outlook for FY23 to **6.5% from 6.7%** and projected **5.3%** inflation for FY24. Quarterly inflation outlook for all the four quarters of FY24 have been placed above the 5% levels.
- The GDP growth outlook for FY24 is estimated at **6.4%,** and for Q1FY24 and Q2FY24 growth outlook is revised upwards.

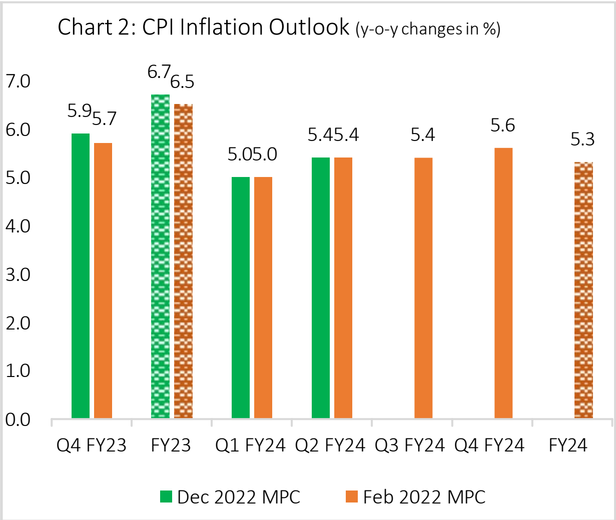
Growth and Inflation outlook by RBI

In the monetary policy statement, RBI pegs FY24 GDP growth at 6.4%, considering both the rebound in domestic economic activities and external vulnerabilities. Rural demand is expected to be stronger boosted by improved prospects of agriculture and allied activities. Uptick in urban demand supported by rebound in contact-intensive sectors and discretionary spending further enhance services sector prospects. The government's continued thrust on infrastructure spending also augurs well for crowding in private investment. In the Budget 2023, the government has increased the capital expenditure from 2.7% of GDP to 3.3% for FY24, which is higher by 37% in nominal terms, compared to the previous year's revised estimates. However, the global economic environment poses serious uncertainties, which is likely to dent external demand and pose adverse implications for exports. Despite the global adversities, the growth rates for Q1 and Q2FY24 are slightly revised upwards from the February forecasts.

The global economic outlook has slightly improved and global central banks have also moderated their pace and size of rate hike actions recently (Chart 1). Several domestic high frequency indicators also continue to show resilience suggesting sustained growth in economic activity.

On the inflation front, the outlook for FY23 has revised downwards to 6.5% from 6.7%, as the food inflation has eased notably in the last few months (Chart 2). With some moderation in global commodity prices, the inflation is expected to soften in the coming months, while the core inflation continues to remain sticky at around 6%. The persistence of core inflation is warranting the MPC for further calibrate monetary policy actions. RBI continues to foresee inflation at above 5% level in all the four quarters for the next fiscal, which negates any reversal in policy actions in the near term.





Source: RBI's Monetary Policy Statements, B2K Research

Says Dr M Govinda Rao, Chief Economist, B2K Analytics, "The decision of the RBI's MPC to raise the repo rate by 25 basis points to 6.5% is in line with our expectations. Although the inflation rate in India has come below the upper tolerance limit in recent months, the core inflation continues to be sticky. Besides, the better employment data in the US and the possibility of a further increase in the rate by the Fed could lead to the outflow of FII widening the current account deficit and exchange rate depreciation putting pressure on prices. Therefore, the MPC's decision to increase the rate by 25 basis points is well in line with the market expectations. The approach of the MPC to maintain growth with stability and to control inflation without changing the policy stance suggests the RBI is still not done with its monetary tightening cycle. The future course of actions by the MPC is largely depend upon the inflation and growth trajectory. The disagreement between the committee members to continue with the current stance of further withdrawal of accommodation as well as rate hikes provides some hope for a pause in the next MPC meeting. However, inflation outlook of above 5% for all the four quarters of FY24, indicates little room for any easing in the near term. This also implies that the dilemma of supporting growth on the one hand and controlling inflation on the other will continue for some more time".

Regulatory Measures Announced by the RBI

- **Introduction of Securities Lending and Borrowing in Government Securities (G-secs):** To facilitate wider participation in the securities lending market by providing investors an avenue to deploy idle securities and enhance portfolio returns, the RBI has proposed to permit lending and borrowing of G-secs which will augment the existing market for 'special repo's'. The move is expected to add depth and liquidity to the G-secs market, which aids to efficient price discovery.

- **Recovery of Penal Charges on Loans:** RBI has reviewed the extant regulatory guidelines on levy of penal interest and has decided to remove capitalisation of penal charges. It has decided that any penalty for delay/default in servicing of the loan or any other non-compliance of material terms and conditions of loan contract by the borrower shall be in the form of 'penal charges' in a reasonable and transparent manner and shall not be levied in the form of 'penal interest' that is added to the rate of interest being charged on the advances.

- **Regulatory Initiatives on Climate Risk and Sustainable Finance**: To mitigate the adverse impacts of climate change, which can translate into climate-related financial risks for Regulated Entities (REs) the RBI has decided to issue the following guidelines:
  a. Broad framework for acceptance of Green Deposits,
  b. Disclosure framework on Climate-related Financial Risks,
  c. Guidance on Climate Scenario Analysis and Stress Testing.

- **Expanding the scope of Trade Receivables Discounting System (TReDS):** The RBI has proposed to expand scope of activity to provide further impetus to TReDS platforms. These measures will help in further improving the cash flows of MSMEs.

  a. Insurance facility will now be permitted on TreDS. This will encourage financing / discounting of payables of buyers irrespective of their credit ratings. Accordingly, insurance companies will be permitted to participate as a "fourth participant" on TreDS, apart from the MSME sellers, buyers and financiers.

  b. All entities / institutions eligible to undertake factoring business under the Factoring Regulation Act will be permitted to participate as financiers in TreDS.

  c. T**he s**econdary market operations will now be enabled on TReDS platforms. This would allow financiers to offload their existing portfolio to other financiers within the same TReDS platform, if required.

- **Extending UPI for Inbound Travellers to India:** RBI has proposed to permit all inbound travellers to India to access UPI for their merchant payments (P2M) while they are in the country. To start with, this facility will be extended to travellers from the G-20 countries, arriving at select international airports. Going forward, this facility will be enabled across all other entry points in the country. Necessary operational instructions will be issued shortly.

- **QR Code based Coin Vending Machine - Pilot project:** To improve distribution of coins among members of the public, the RBI is preparing a pilot project on QR Code based Coin Vending Machine (QCVM) in collaboration with a few leading banks. The QCVM is a cashless coin dispensation machine which would dispense coins against a debit to the customer's bank account using Unified Payments Interface (UPI). Customers will also have the option to withdraw coins in required quantity and denominations in QCVMs.

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