

RBI MPC likely to hold policy but adopt liquidity easing measures at December meet

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RBI MPC likely to hold policy but adopt liquidity easing measures

- Two challenges have emerged in the macroeconomic backdrop since the last RBI MPC meet. Headline CPI inflation breached 6% in October, and though the uptick was expected, it was higher than anticipated. Also, real GDP growth for Q2-FY25 surprised on the downside, slipping below 6% to seven-quarter low. Again, though the moderation was priced in to some extent due to the weakness in high frequency indicators during the quarter, the extent of slowdown was an unpleasant surprise.

- There are silver linings, though. Real GDP growth excluding the 'others' component (discrepancies, change in stocks, and valuables) has been above 7% in both Q1 and Q2-FY25, suggesting favorable underlying fundamentals. Government spending could provide impetus to growth in H2, but the catch up in capex has been uneven so far, though higher revenue spending could support consumption, and therefore, growth, in the near term. Despite improvement in economic activity, as per the latest high frequency indicators for October, there are concerns that growth revival could be underwhelming.

- In case of inflation, CPI ex-vegetables remains sub-4%. The first advance estimates for Kharif output for FY25 show year-on-year increase, and Rabi sowing is progressing well, auguring well for both inflation and rural growth outlook. However, as noted by authors of the 'state of the economy' article in the RBI's recent monthly bulletin, spillovers from higher food prices to other components of the food basket have started to emerge, impinging on urban consumption and firms' earnings and capex. The latest PMI data ascertained elevated input costs and output charges in services and manufacturing sectors.

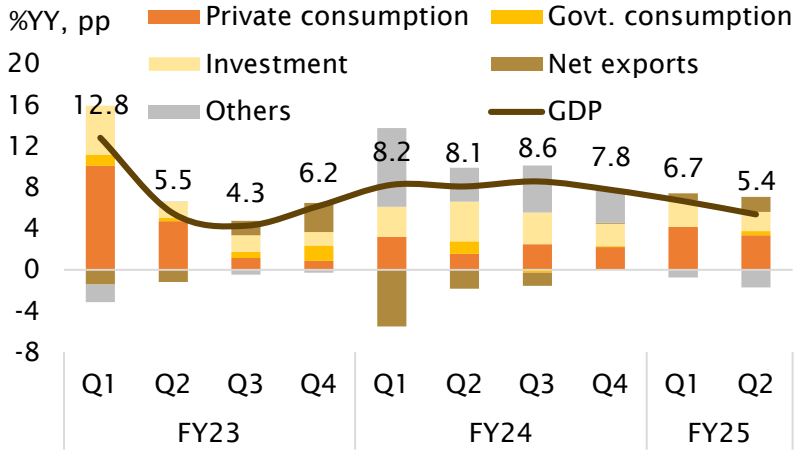
- Liquidity under net LAF remains in surplus but has moderated since the last MPC meet, lifting overnight money market rates. Core liquidity surplus, which excludes government cash balances, has also eased amid FX interventions to contain volatility in the INR and leakages due to seasonal demand for currency.

- Against this backdrop, there are expectations that that RBI MPC could keep both policy stance and rate unchanged at its December meet. However, with the recent moderation in durable liquidity, the MPC could choose to focus on liquidity provisioning via a CRR cut. There are also expectations that instead of tinkering with CRR that impacts durable liquidity, the RBI could opt for VRR operations or OMO purchases. Most market pricing measures continued to point to a shallow easing cycle of 75bps, starting within three months, indicating expectations of a 25bp policy repo rate cut at the February meeting.

GDP internals favorable; industry weakness warrants vigilance

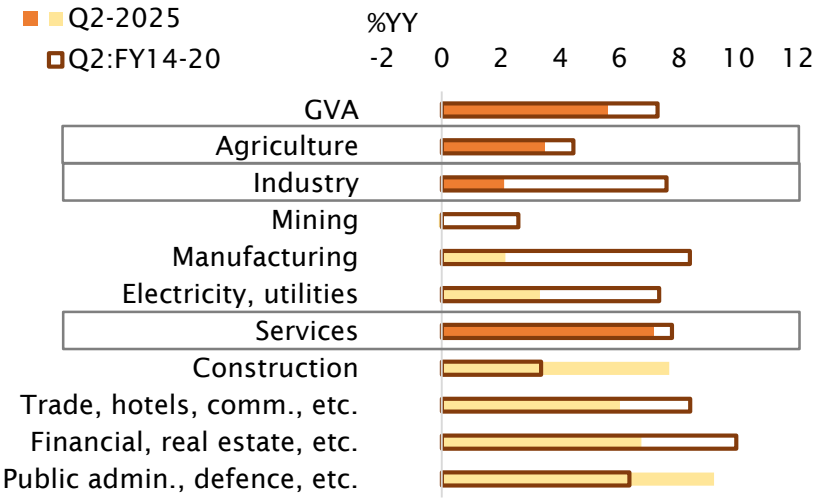
- In Q2-FY25, real GDP growth surprised on the downside at 5.4%YY, the softest in seven quarters and lower than 6.7% in Q1. The print was below street estimates (Bloomberg poll: 6.5%) and RBI MPC's forecast of 7.0%.
  - The 'others' component (discrepancies, change in stocks, and valuables) deducted 1.7pp from growth in Q2, steeper than 0.7pp in Q1. Excluding 'others', real GDP growth has been above 7% in Q1 and Q2, suggesting that the underlying drivers of consumption, investment, and net exports remained robust.
  - In FY24, the 'others' component had added strongly to GDP growth, and therefore, the latest bout of weakness needs to be assessed with a grain of salt, and warrants further analysis of this component.
- In Q2-FY25, real GVA growth stayed above GDP growth for the second straight quarter and eased to 5.6% from 6.8% in Q1. Industry was dragged down by manufacturing, which posted the weakest growth in six quarters, and mining, which contracted for the first time in eight quarters.
  - The monsoon-bound Q2 tends to be weak for mining, though growth has been positive historically, averaging ~2.5%, so it needs to be seen to if the recent drop reverses going forward. In average terms, manufacturing has been strong in Q2 historically, so the latest slump warrants caution, with PMI prints softening further in Q3. However, an expected pick up in public spending in H2 could support growth.
  - Agriculture growth rose to five-quarter high in Q2, though remained below the historical average for the quarter. The year-on-year growth in services eased from the previous quarter but remained above 7%.

Contribution of components to GDP growth



Others include discrepancies, valuables, change in stocks

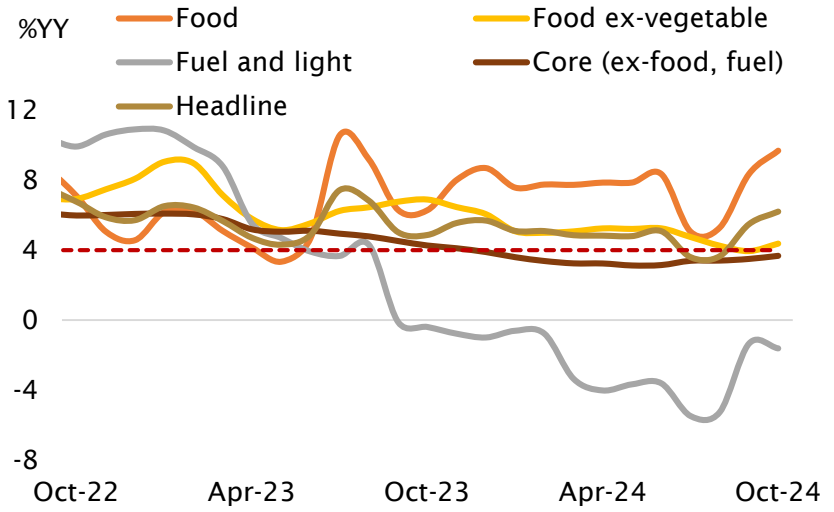
Industry growth dragged by mining, manufacturing



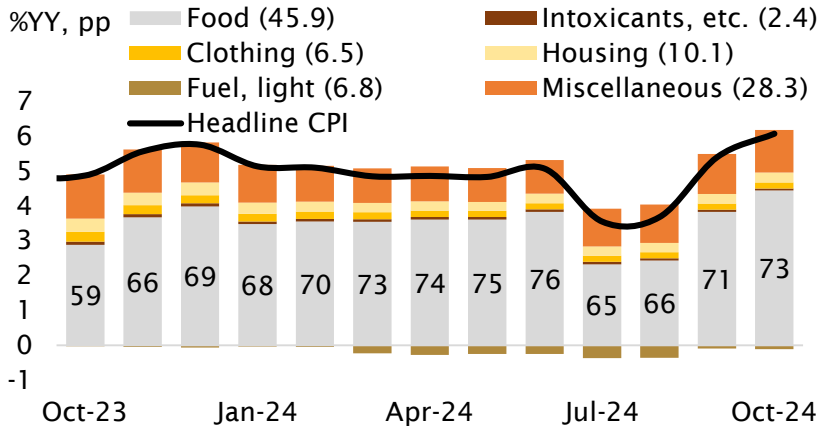
Above 6% inflation in October could prompt MPC to revise forecasts

- Since the last RBI MPC decision in October, inflation data for September and October has been released. In both months, food price pressures remained elevated and drove overall inflation higher, particularly in October, when headline CPI breached the RBI's upper tolerance band of 6% after more than a year.
- In Q2-FY25, inflation averaged 4.2%, close to the RBI MPC's forecast of 4.1%. However, inflation will need to average 4.2% in November and December to match the MPC's Q3 forecast of 4.8%. Though winter months tend to ease food prices, rising core inflation and the likely impact of second round effects of high food prices pose upside risks to Q3 inflation estimate, and could prompt revisions at the upcoming MPC meet.
- On the bright side, the first advance estimates of Kharif output for FY25 marks year-on-year increase and augurs well for food inflation outlook. The stocks of major food grains (rice and wheat) in the central pool remain above the buffer norm. The procurement of rice and wheat under the Kharif and Rabi Marketing Season FY25, respectively, is progressing well, and so is Rabi sowing. In an attempt to ease food prices, the government continues to actively intervene on the supply side to ensure availability of food grains and major horticulture crops at subsidized prices. These factors could cap the upside to food inflation.
- Global commodity prices remain a wildcard. Food prices have been rising, while oil prices have stayed range-bound. Metal prices remain mixed, with industrial metals vulnerable to shifts in growth outlook of major economies, and precious metals in broad uptrend on safe haven demand amid uncertain external backdrop.

Headline inflation at 14-month high in October



Food prices continued to add over 70% to headline CPI

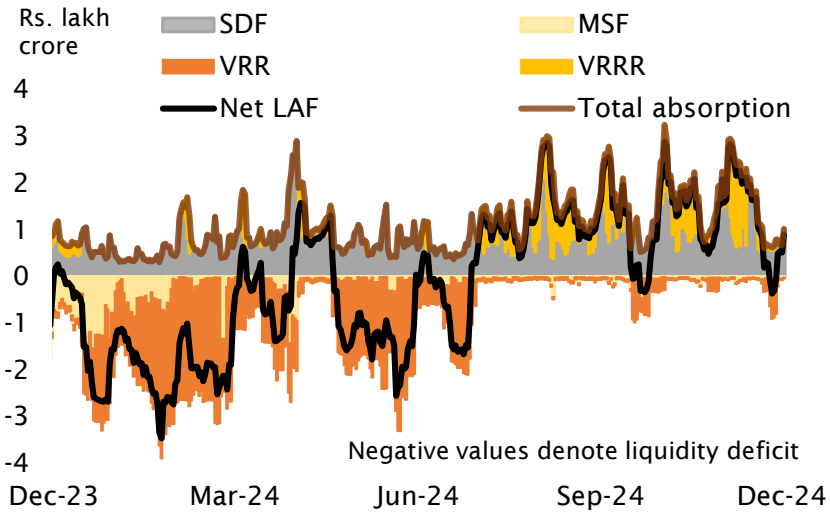


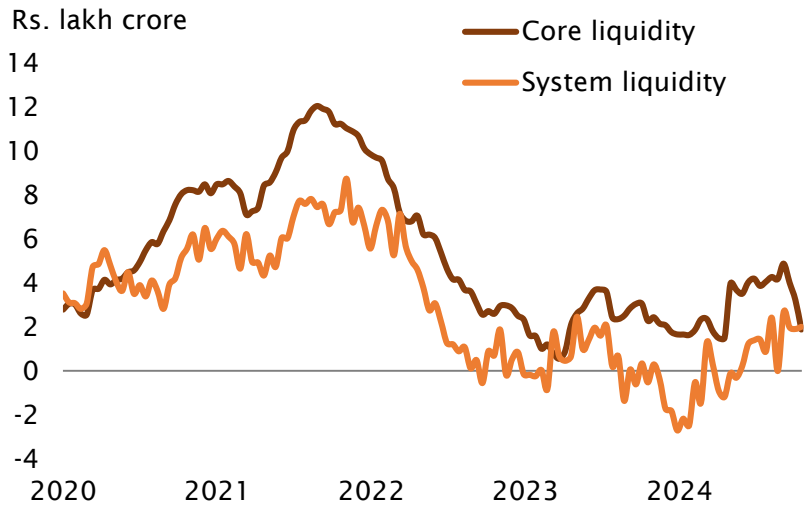
Note: Numbers in parenthesis show weights and in bars indicate share (in percent) of food in headline CPI

Core liquidity surplus has moderated since last MPC meet

- Liquidity surplus under net LAF has almost halved since the last RBI MPC meet to Rs.0.7 lakh crore (Dec 4) from Rs. 1.3 lakh crore (Oct 10). For liquidity management, the central bank conducted two-way measures since the last MPC meet. It absorbed liquidity to the tune of Rs.9.4 lakh crore via four main and 19 fine-tuning VRRR operations and infused liquidity of around Rs.1.3 lakh crore towards month-end (October and November) via total of five fine-tuning VRR operations. Banks continued to prefer to park funds under the SDF, amounting to an average of Rs.1 lakh crore, similar to the previous inter-meeting period.
- Since the last RBI MPC meet, core or durable liquidity surplus, which excludes the impact of government cash balances, has also narrowed by around Rs.0.7 lakh crore to Rs.2.0 lakh crore. Leakages due to seasonal demand for currency in circulation around festive time, and foreign exchange pressures amid FPI outflows and a strong US dollar are likely to have impacted durable liquidity.
- While a larger-than-anticipated deceleration in Q2 GDP growth calls for policy easing, inflation breaching 6% in October has complicated the RBI MPC's task. Amid these factors, the moderation in core liquidity surplus has raised market expectations of a CRR cut at the RBI MPC meet in December, which could provide liquidity support to the banking system without accentuating inflationary impulses, and also pave the way for further easing via rate cut(s) at subsequent meetings. There are also market views that instead of tinkering with durable liquidity, the RBI might resort to VRR or OMO purchases to ensure liquidity availability in the system.

Liquidity surplus under net LAF has almost halved since last MPC meet; core liquidity surplus has also moderated

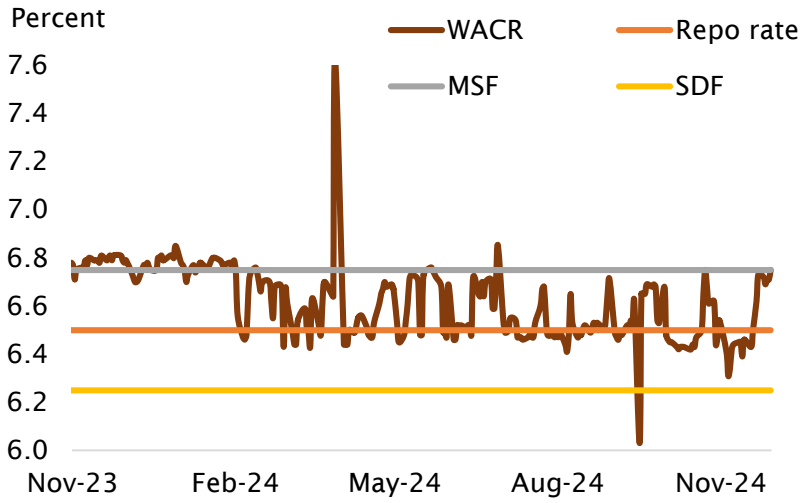




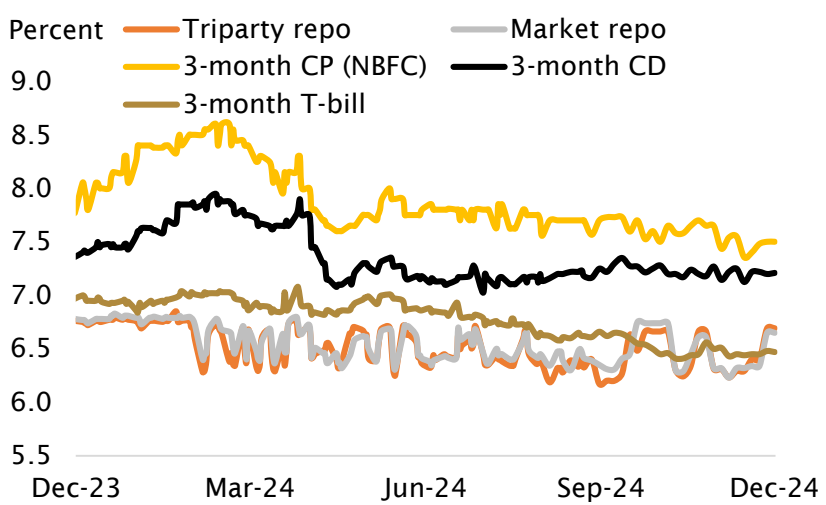
Mixed trends in money market rates since the last MPC meet

- The weighted average call rate (WACR), which is the operating target of monetary policy, moved in tandem with liquidity conditions, hitting and even breaching the upper end of the corridor around month-end (both in October and November), when liquidity conditions tend to be tight. In terms of monthly average, the WACR was close to the policy repo rate in October but higher by a couple of basis points in November, reflecting relatively tighter liquidity conditions. Even as liquidity tightened in October-end, it remained in surplus, but in November-end, it briefly slipped into deficit, prompting the RBI to infuse liquidity via four VRR fine-tuning operations in November-end vis-à-vis only one in October-end.
- Additional money market rates also mirrored liquidity conditions, particularly the tri-party and market repo. On average, these rates remained below the policy repo rate since the last MPC meet, except around month-end time when both tended to rise above 6.5%, as liquidity tightened.
- On the other hand, yields on 3-month CP issued by NBFCs and 3-month CD continued to average above 7.5% and 7.0%, respectively, in the latest and previous inter-meeting periods of the RBI MPC. However, on average, both have softened by 13 and 3 basis points, respectively since the last MPC meet. The yield on 3-month t-bill also eased by 13 bps between the two intermeeting periods but averaged a few basis points below the policy repo rate since the last MPC meet. The average risk premium (spread between 3-month CP and t-bill rates), was 108bps, almost unchanged from the previous inter-meeting period.

WACR averaged slightly above policy repo in November



Money market rates mixed since last MPC meet

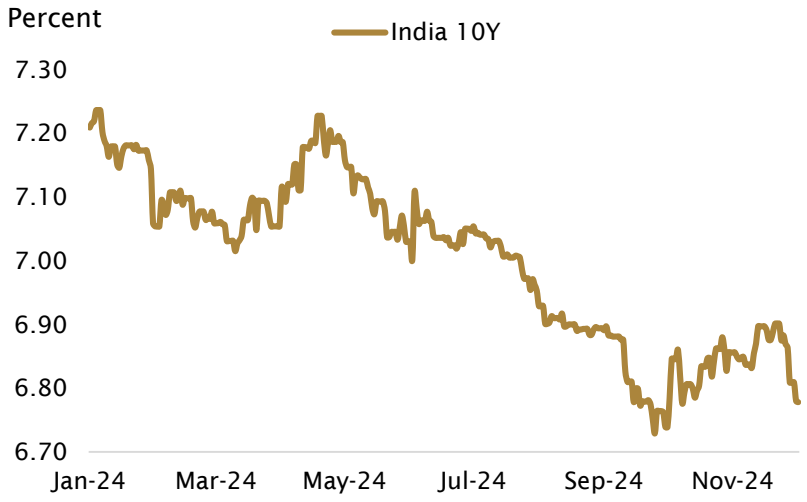


Except at the short-end, yields have eased across the curve

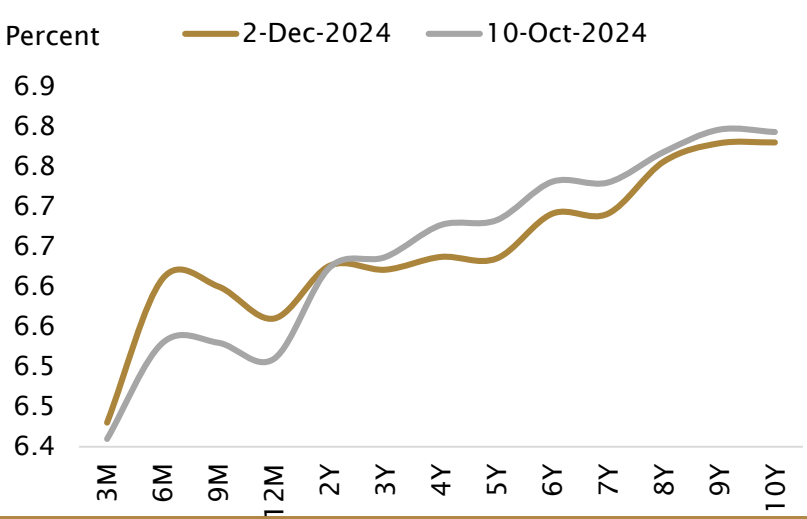
- Since the last RBI MPC meet, yields at the short-end of the curve have increased, reflecting tighter liquidity conditions, particularly towards the end of November, when liquidity briefly turned to deficit. However, other than money market rates of less than or equal to a year, yields have fallen across the curve. The easing was evident in the 10-year benchmark post the Q2-FY25 GDP data release that disappointed market participants and prompted pricing in of some sort of policy easing at the upcoming RBI MPC meet in December.

- Market pricing as on Dec 2: Since the muted GDP data release, the 1YOIS shed around 20bps to levels last seen in mid-September 2022. Most market pricing measures continued to point to a shallow easing cycle of 75bps, starting within three months, indicating expectations of a 25bp policy repo rate cut at the February meeting. However, market is also abuzz with talk of varied measures that the RBI MPC might adopt or announce at the December meet to ease durable liquidity conditions.

10Y yield eased post lower-than-expected GDP data



Higher yields at the short-end due to tight liquidity



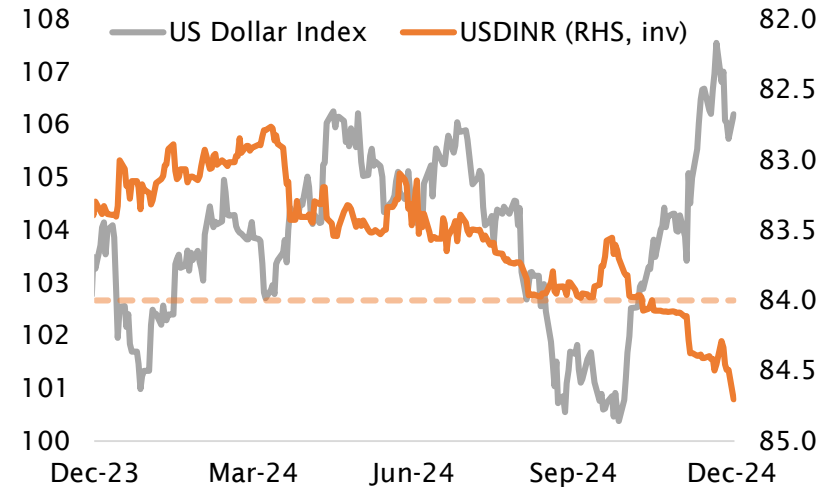
FII outflows, strong USD accentuated recent INR weakness

- In October, the Indian rupee breached a key resistance level of Rs.84/USD and has been hitting fresh lows in early December. Year-to-date, the INR remains the least volatile among peer currencies and has held up reasonably well, but underperformed relative to some of its peers.

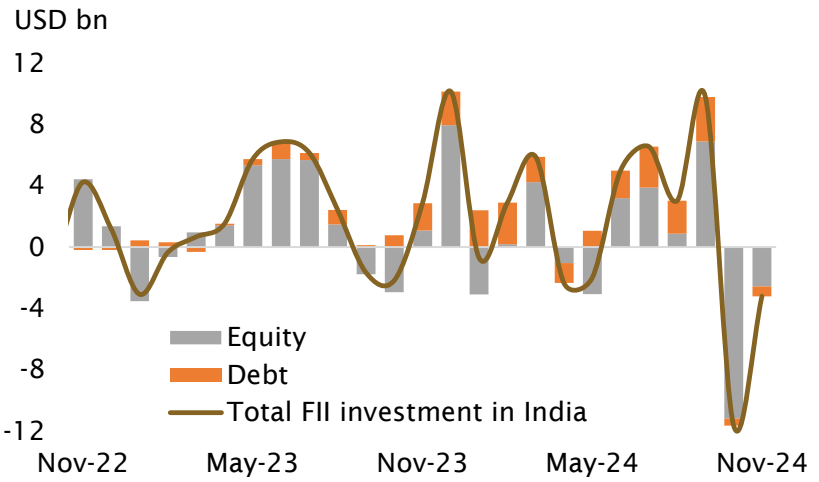
- The recent depreciation has been driven by multiple factors, primary among which include a strengthening US dollar post the results of the US Presidential elections and foreign portfolio outflows from emerging market economies, including India. In November, portfolio outflows from Indian debt and equities amounted to USD12bn, though the sell-off moderated to USD3bn in November.

- The sell-off in financial markets accentuated pressure on the INR and triggered central bank intervention. Initial data for October shows strong build-up of short USD positions in the forwards market. Foreign exchange reserves have dwindled by around 7% from the recent peak of USD705bn in September-end but remain sufficient to cover 11 months of import.

INR breached 84/USD in October



Sharp FII sell-off from India in October

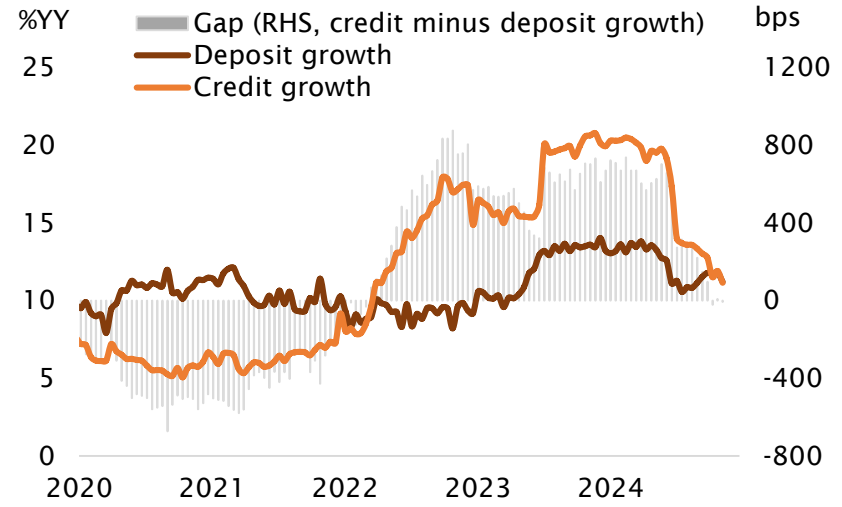


Easing credit growth has enabled closing of credit-deposit gap

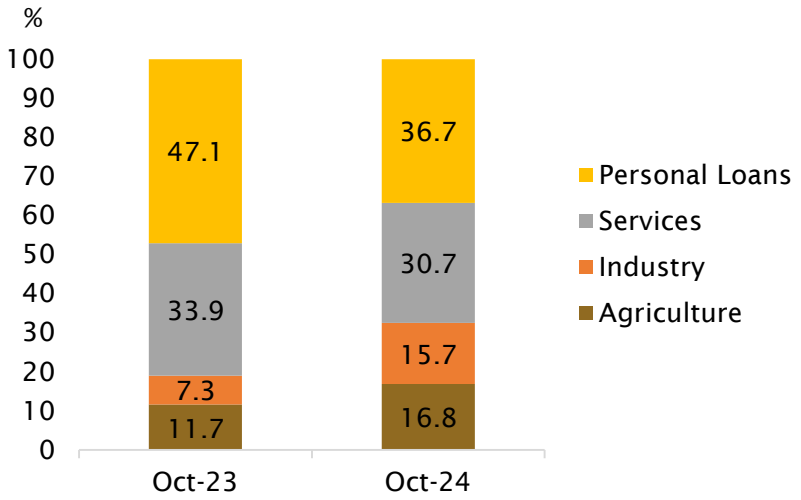
- For most of the post-pandemic period, the year-on-year credit growth had been above deposit growth and in October, this gap closed, with deposit growth marginally outpacing credit growth. Since 2023, the RBI had been voicing concerns regarding the credit-deposit growth gap that had the potential to cause balance sheet management issues for banks. To curb exuberance in lending, the RBI raised risk weights on certain segments of consumer loans in November 2023, which worked in tandem with the transmission of higher policy rate to deposit rates and enabled closure of the credit-deposit growth gap.

- Latest data for October shows that both including and excluding the impact of merger of a bank with non-bank, non-food credit grew at the slowest year-on-year pace since mid-2022 at around 12-13%. Including the merger impact, less of incremental credit (year-on-year change in absolute terms) went to personal loans and services, while industry and agriculture attracted more credit. Though growth in consumer credit has more than halved (includes loans for consumer durables, advances against FDs, advances to individuals against shares and bonds, credit card outstanding, and other personal loans) to 11.7%YY from 24.7% in October 2023, risks have shifted to certain other segments of personal loans such as loans against gold jewellery that have been growing at accelerated rates in recent months.

Credit-deposit gap has closed recently



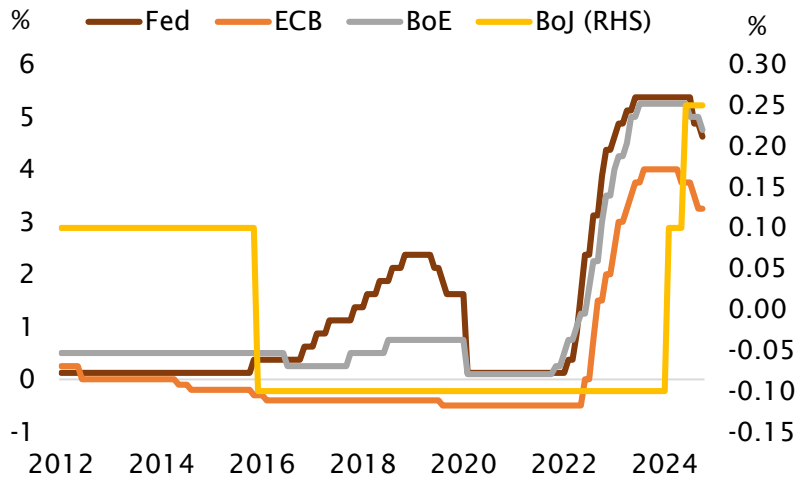
Share of sector in year-on-year incremental credit



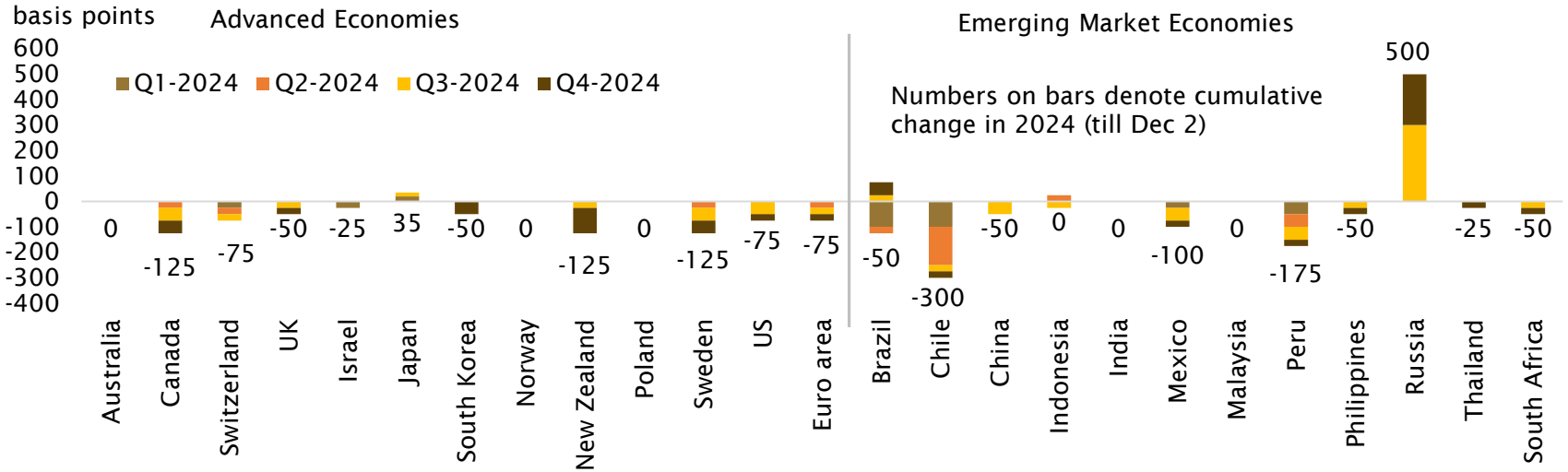
Most central banks have eased policy rates in 2024

- In 2024, not only did systemic central banks embark on easing but most other central banks in both advanced and emerging markets eased policy rates, though there were exceptions.
- At its monetary policy meeting held in November, the US Federal Reserve cut the target range for its policy rate by 25bps to 4.50-4.75%, following a larger-than-expected 50bp cut in September. In October, the ECB delivered a third 25bp cut, while in November, the Bank of England lowered its policy rate by 25bp, making it the second one since the start of easing in August. On the other hand, the Bank of Japan kept policy unchanged at its latest meeting in October after hiking in March and July. The PBoC announced easing measures in July and September, including slashing policy rates, to support the economy.

The US Fed, ECB and BoE cut policy rates in Oct-Nov



Majority of central banks in both advanced and emerging market economies have eased policy rates in 2024



Select high frequency indicators

Colour codes based on minimum and maximum Z-score values since April 2023 for respective variables; green shows improvement, red indicates weakening. (Reversed for MGNREGA data where a fall implies improved farm activity)

(%YY, unless mentioned otherwise)		Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24
Agriculture and rural sector	Fertiliser sales	0.6	-3.7	10.5	7.3	-1.4	-9.4	-7.7	-7.8
	Tractor sales	-19.5	-2.9	0.5	3.5	1.4	-5.5	2.4	21.0
	Tractor registrations	-3.2	1.4	-1.0	-28.4	-11.9	-11.4	14.7	3.1
	Two wheeler sales	15.3	30.8	10.1	21.3	12.5	9.3	15.8	14.2
	Two-wheeler registrations	5.8	33.6	2.8	4.7	17.2	6.3	-8.5	36.3
	Three-wheeler registrations	21.1	12.9	23.7	5.1	12.9	1.6	0.7	11.5
	Household work demand under MGNREGA	-19.2	-10.6	-14.3	-21.7	-19.5	-16.0	-13.4	-7.6
Industry, construction and urban sector	Industrial production	4.9	5.0	5.9	4.2	4.8	-0.1	3.1	
	Core sector output	5.2	6.2	6.3	4.0	6.1	-1.8	2.0	
	Cement production	10.6	0.2	-0.6	1.8	5.5	-3.0	7.1	
	Natural gas production	6.2	7.8	6.7	2.9	-1.4	-3.7	-1.6	-1.6
	Electricity requirement	9.4	9.0	17.3	8.0	4.0	-5.4	1.2	0.5
	Steel consumption	12.5	11.5	13.0	21.1	13.8	10.3	10.5	9.0
	Fuel consumption	-0.6	7.8	1.9	2.3	10.6	-2.3	-1.6	2.9
	Passenger vehicle sales	12.9	1.2	4.3	5.0	-1.9	-1.6	-0.4	1.1
	Passenger vehicle registrations	-3.9	18.6	1.5	-6.8	10.2	-4.5	-18.8	32.4
Services	Commercial vehicle sales	0.6			3.3			-4.2	
	Commercial vehicle registrations	-1.6	6.0	7.7	-4.7	5.9	-6.0	-10.4	6.4
	Railway freight traffic	9.8	5.3	4.4	11.2	4.9	-5.0	-0.1	0.8
	Port cargo traffic	2.7	1.3	3.8	6.8	5.9	6.7	5.8	-3.0
	Toll collection (volume)	10.6	7.6	3.6	5.8	9.4	6.8	6.5	11.3
	Domestic air cargo traffic	8.7	0.3	10.4	10.3	8.8	0.6	14.0	8.9
	International air cargo traffic	22.5	16.2	19.2	19.6	24.4	20.7	20.5	18.4
	Domestic air passenger traffic	4.7	3.9	5.9	6.9	7.5	6.7	7.4	9.6
	International air passenger traffic	15.0	16.7	14.6	11.4	8.9	10.9	11.2	10.3
	Tourist arrivals	8.0	7.7	0.3	9.0	-1.3			
	GST e-way bills (total)	13.9	14.5	17.0	16.3	19.2	12.9	18.5	16.9
	GST revenue collection	11.2	12.3	10.1	7.6	10.3	10.0	6.5	8.9
PMI (Index)	PMI Manufacturing	59.1	58.8	57.5	58.3	58.1	57.5	56.5	57.5
	PMI Services	61.2	60.8	60.2	60.5	60.3	60.9	57.7	58.5

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