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RBI MPC: Cautious yet dovish

The monetary policy committee of the RBI voted by a 5-1 vote to keep the policy rate unchanged at 6.5%. The stance was changed to "neutral" from "withdrawal of accommodation". The MPC remained confident on domestic growth and inflation trajectory. While acknowledging the recent dip in inflation, the MPC noted that there are risks to the inflation trajectory and aligning inflation to the RBI's target remains a key priority for the RBI. Hence, the change in stance gives RBI the space to monitor the trajectory of inflation in the face of growing risks from geo-political tensions, adverse weather shocks and uptick in a few global prices. Given the volatility in food prices, especially for horticulture products, the need for caution is warranted. With inflation in Q3 FY25 projected higher, we now expect a rate cut in Feb'25.

Key rates: The newly constituted MPC decide to keep the repo rate unchanged at 6.5%, with a 5-1 vote. The dissenting vote was cast by Dr. Nagesh Kumar, who voted for a 25bps cut in policy rate. The stance of the monetary policy was changed to "neutral" from "withdrawal of accommodation" by a unanimous vote. Notably the stance of monetary policy was last changed in Apr'22. The MPC noted that inflation and growth dynamics remain well balanced. The statement also reiterated the need for aligning inflation to the target on a durable basis, while also supporting growth. The change in stance gives the MPC room to monitor the evolving risks to inflation and can be viewed as a prelude to monetary easing.

Growth projections: The RBI remained positive on the growth outlook and kept its projection for GDP growth unchanged at 7.2% for FY25. It must be noted that real GDP growth for Q1 FY25 at 6.7%, undershot RBI's projection by 40bps. Significantly, growth forecast for Q2 FY25 has been lowered by 20bps. High frequency indicators also pointed to a loss in momentum in economic activity in the Sep'24 due to seasonal effects. However, growth is likely to pick up in H2 FY25. RBI's estimates for other subsequent quarters have been revised up by 10-20bps. This will be supported by a pickup in consumption demand due to the festive season as well as a good monsoon. Government expenditure is also likely to be scaled up in line with budget estimates. Overall, we continue to expect FY25 GDP growth in the range of 7.3-7.4%, which is marginally higher than RBI estimates.

Figure 1: Growth projections

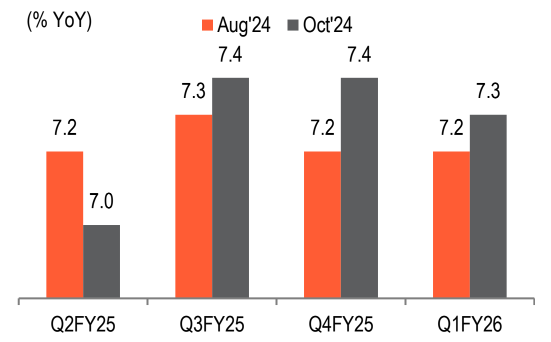
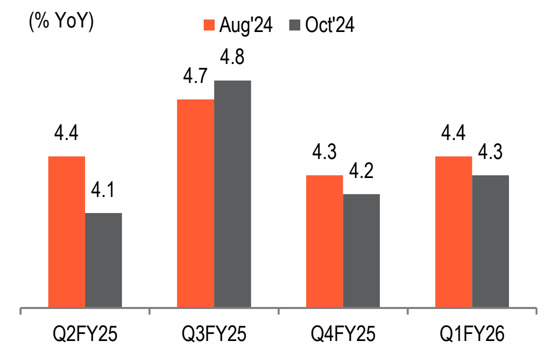


Figure 2: Inflation projections



Source: RBI, Bank of Baroda Research

Inflation projections: The RBI also retained its FY25 inflation projections unchanged at 4.5%. Inflation forecast for the current quarter was revised lower by 30bps to 4.1%, to account for the sharp moderation in inflation in Jul and Aug'24. Inflation projection for Q3 FY25 has been revised to 4.8% (from 4.7%), on the back of a negative base as well as uptick in vegetable prices. Inflation projections for the next two quarters were revised lower but remains above RBI's median target range of 4%. A normal monsoon, higher Kharif sowing and improvement in reservoir storage is positive for the food inflation outlook. However, risks to the inflation outlook stem from geo-political tensions, climate related risks and the recent uptick in global prices of certain commodities. The MPC hence, adopted a cautious approach to ensure that inflation aligns durably with its target of 4%.

Other announcements: The RBI Governor flagged some issues related to financial stability. These includes setting up of comprehensive underwriting and post sanction mechanisms for unsecured loans. Apart from this, the Governor also noted that while NBFCs have been growing rapidly, there is a need for caution with respect to sustainable banking practices, risk management and compliance. Concerns were also expressed on the high interest rates and other charges and penalties levied by a few NBFCs which can lead to high indebtedness and can have a detrimental impact on the overall health of the financial system. The RBI also advised NBFCs to revisit the compensation structure which is largely based on meeting targets and can lead to poor work culture and lower customer satisfaction.

Market reaction: While the decision to keep policy rate unchanged was largely expected, there appeared to be some ambiguity amongst market participants on the change in stance, with the markets now anticipating the RBI to start its easing cycle. This was reflected in the movement in key market indices with the Sensex inching up, 10Y yields declining and INR strengthening. It must however be noted that a large part of optimism in the domestic markets also stemmed from India's inclusion in the FTSE Emerging Markets Global Bond Index (EM-GBI).

Concluding remarks

RBI policy was balanced, with growth and inflation projections for FY25 retained. The overall tone of the policy was cautious with dovish undertones. While the MPC acknowledged the progress made in the fight against inflation, it remained wary of the risks to the trajectory. An adverse base, volatility in food prices, geo-political tensions and adverse climate shocks remain key concerns for the RBI. Despite some positive signs recently, emphasis was laid on ensuring that inflation aligns with the RBI's target of 4% on a durable basis. In this regard, the change in stance is justified as it gives RBI flexibility to adjust its policy as it awaits more clarity on how the risks to inflation play out. With inflation projected at an elevated level of 4.8% in Q3 FY25, we push back the possibility of a rate cut in Dec'24. However, in case inflation materially undershoots the RBI's estimates in the next 3-months, the room for a rate cut might open up. However, as of now we expect a rate cut in Feb'25 as the most likely scenario.

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