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Status quo for now

The Reserve Bank of India's Monetary Policy Committee (MPC) is likely to vote for status quo on both rates and stance in its October policy meet. While inflation has fallen below the RBI's target of 4% in each of the last 2 months, this was led primarily by a positive base effect. Even so, the outlook on food inflation is positive supported by a normal monsoon. Further, arrival of fresh crops should help ease the stickiness in prices of key vegetables. Core inflation is also expected to remain at or below 4%. However, risks to the outlook remain from unseasonal rainfall during the withdrawal of monsoon which can impact standing crops. On growth, it does appear that the economy is moving along at a steady rate. As such, India's macro fundamentals remain robust, and the economy is likely to register growth of 7.3-7.4% in FY25. Given this backdrop, the MPC is likely to wait for another few months to assess the risks to the inflation trajectory, before cutting rates. We expect a rate cut and change in stance in Dec'24.

Growth and inflation dynamics

Domestic growth: Recent high frequency indicators paint a mixed picture of the economy in Q2 FY25. Manufacturing PMI slipped to 56.5 in Sep'24 from 57.5 in Aug'24. Vehicle sales have moderated, with PV sales declining by 4.5% in Aug'24. Tractor sales have also moderated sharply. Core sector output also contracted for the first time since Feb'21.

On the other hand, GST e-way bills have seen a steady growth. Services sector activity is also witnessing a continued expansion as signalled by the services PMI. The weakness in domestic activity can be attributed to seasonal factors as activity is sluggish during the monsoon period. Despite this, India remains on track to register a strong growth of 7.3-7.4% in FY25.

Growth is likely to get a boost from the upcoming festive season. Further, abundant rainfall during the monsoon is also likely to quicken the pace of recovery in the rural sector. Government expenditure has also started to pick up after the elections, and there are signs of a revival in the private sector capex cycle as well. CMIE data on new investment announcements indicate improvement over Q2-FY24. Merchandise exports are expected to benefit from a recovery in global demand amid a synchronised monetary policy easing cycle by global central banks.

Inflation scenario: CPI inflation has tracked below RBI's median target of 4% in the last 2-months, led by a favourable base. Food inflation also moderated but continued to track above the 4% mark. Prices of key vegetables (tomato and potato) have corrected in Sep'24 but continue to remain high. On the other hand, prices of onion have increased by 13.4% on a MoM basis. However, prices should correct once the new harvest enters the market. Overall, the outlook on food inflation is largely positive given that the monsoon rains have been adequate. Kharif sowing has surpassed last year levels for most crops, and improvement in reservoir levels should also translate into higher Rabi sowing. It will however be crucial to monitor the withdrawal of monsoon and unseasonal rainfall. Despite some pickup, core inflation continues to remain at comfortable levels which is also positive for the overall inflation outlook. Overall, we expect inflation to average ~ 4.5% in FY25.

Banking and liquidity

Banking sector: Growth in bank credit (excl. merger) continues at a healthy pace of 14.7% in Sep'24 (6 Sep 2024), a tad weaker than 15% in Aug'24. On the other hand, deposit growth has improved marginally to 11.6% in Sep'24 from 11.3% in Aug'24. However, it continues to lag the growth in credit. Consequently, the credit/deposit ratio of the banking system remains elevated at ~77%, leading to a shortage of investible funds for banks. Hence, banks have thus been tapping into other avenues for funding, including borrowing from CD markets as well as hiking deposit rates besides raising bonds.

Transmission of rates: In terms of transmission of rates, PSBs have continued to fare better than PVBs in both deposits and lending rates. For deposits, the weighted average domestic term deposit rate (WADTDR) has increased by a cumulative 266bps since Apr'22, while for PVBs it has risen by 201bps. On the other hand, transmission to lending rates (WALR) has been lower at 183bps for PSBs and 166bps for PVBs.

Table 1. Fresh term deposit and lending rates

	Apr'22	Aug'24
WADTDR: PSBs	4.32	6.85
WADTDR: PVBs	4.39	6.44
WALR: PSBs	6.77	8.60
WALR: PVBs	8.53	10.19

Source: RBI, Bank of Baroda Research

System liquidity: Domestic liquidity situation has improved considerably in the last few months. From an average daily deficit of Rs. 1 lakh crores in May-Jun'24, system liquidity has remained in surplus in the last 3-months. In Sep'24, the average daily liquidity surplus in the system was Rs. 1 lakh crores. This can be attributed to a pickup in government expenditure post the elections as well as seasonal factors. However, advance tax outflows and GST payments can put some pressure on liquidity in the coming days which is likely to be managed by RBI's finetuning operations.

Domestic market variables

Softening bias in domestic sovereign yields to continue: Since the last policy, the yield on benchmark 10Y security has eased by ~13bps. Similar magnitude of softening bias has also been witnessed in other short-end bond yields. We expect a further downward bias in sovereign yields. This will be led by continued FPI inflows in debt, supportive domestic liquidity conditions and range-bound oil prices. Further, the government recently announced its H2 FY25 borrowing programme, and stuck to its borrowing target for FY25. However, given the robust tax collections there is a possibility that the actual market borrowings might be lower which will also be positive for bond yields. The global backdrop is also conducive for lower bond yields.

INR stability positive for inflation outlook: INR has remained relatively stable in the past few weeks and traded with an appreciating bias. This can be attributed to the dip in the dollar post Fed's outsized rate cut as well as lower oil prices. India's strong external macros, as well as sizeable FPI inflows are likely to lend an appreciating bias to the rupee. However, the exchange rate is likely to hover around current levels in order to preserve India's export competitiveness.

Concluding remarks

The newly constituted MPC is likely to await more clarity on the evolution of the inflation trajectory before embarking on monetary easing path. While the near-term outlook on inflation is positive, the MPC's decision is likely to be guided by the long-term outlook of inflation and growth, as has been explicitly stated by the Governor. Against this backdrop and considering the fact that the recent bouts of volatility in food prices is likely to elicit a cautious approach from the RBI, we believe that a rate cut at this juncture is unlikely. We see an opportunity of a rate cut only in Dec'24, once the RBI is sure that inflation has moderated on a durable basis.

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