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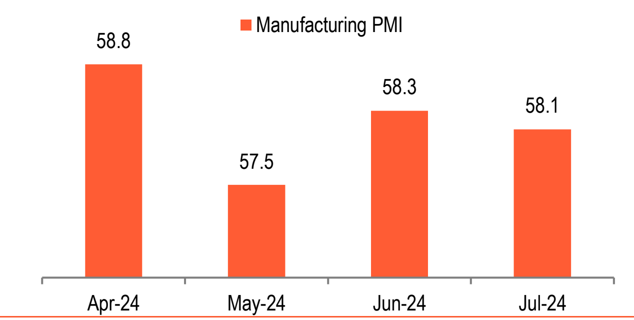
No change in rate or stance

The Reserve Bank of India's Monetary Policy Committee (MPC) is likely to hold repo rate steady for the 8th consecutive meeting in Jul'24. The stance of the monetary policy is also expected to be retained at withdrawal of accommodation. Incidentally, the stance of the monetary policy was last changed in Jun'22. This is because RBI is unlikely to be comfortable with the elevated levels of food inflation in the recent months. On the other hand, domestic growth impulse has been strong giving RBI the room to keep rates at current levels until it has sufficient confidence that inflationary pressures have subsided on a durable basis. Liquidity conditions have eased significantly with the average system liquidity in surplus in Jul'24. RBI is likely to manage the evolving liquidity situation through its fine-tuning operations including scaling up its VRRR auctions. At the current juncture, the inflation trajectory faces risks from skewed distribution of rainfall, geo-political tensions in the Middle East and a depreciating currency. Taking this into cognizance, the earliest possibility of rate cut is pushed back to Dec'24.

Growth and inflation dynamics

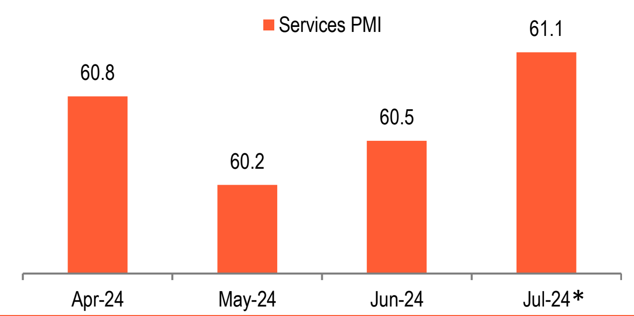
Domestic growth remains on strong footing: High frequency indicators suggest that India's growth held ground in Q1FY25. Manufacturing PMI stood at 58.1 in Jul'24, indicating buoyant activity in the sector. Core sector output too was broadly steady at 5.7% in Q1 FY25 versus 5.8% in Q4 FY24. Services PMI signals continued momentum in the sector. On the demand side, urban demand indicators such as PV sales, toll-collections have shown some moderation. However, Centre's revenue receipts have continued to grow at a sharp double-digit pace, led by both direct as well as indirect taxes. Building on this, even rural demand is showing signs of a recovery as reflected in an improvement in tractor and 2-wheeler sales. Commentary by major FMCG companies also signalled a positive outlook for the rural economy aided by the prospects of a normal monsoon. Support to growth will also stem from Budget announcements relating to capital expenditure and employment. It is to be noted that capital expenditure by the government at both the Centre as well as state level has remained muted so far, due to elections. This should pick up in the coming months. Private sector investment too is showing some signs of recovery, even though it seems to be highly skewed in capital intensive sectors. With a pickup in government capex, there is a possibility that this becomes broad based.

Figure 1: Manufacturing PMI steady



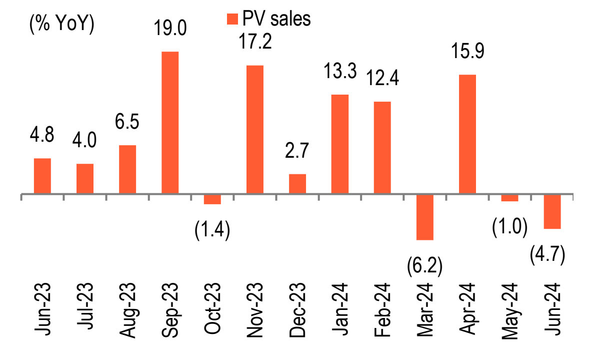
Source: CEIC, Bank of Baroda Research

Figure 2: Services PMI improves in Jul'24



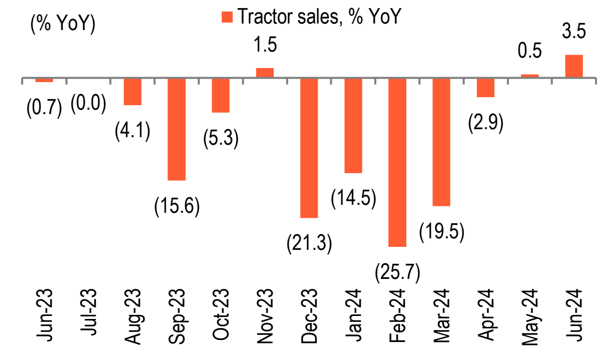
Source: CEIC, Bank of Baroda Research | Note: * Flash estimate

Figure 3: Moderation in PV sales



Source: CEIC, Bank of Baroda Research

Figure 4: However, tractor sales improved

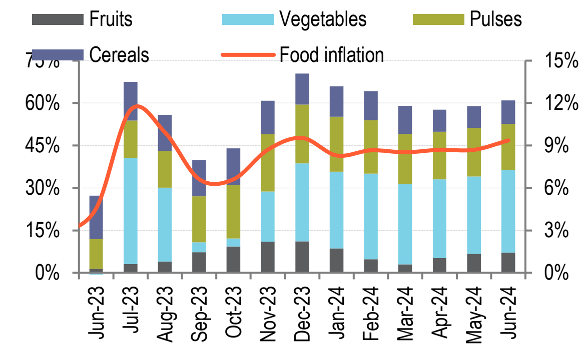


Source: CEIC, Bank of Baroda Research

Given this backdrop, we believe that GDP is on track to register a growth of ~7.3-7.4% in FY25, which is higher than RBI's estimate of 7.2%. We do not believe that the RBI is likely to change its full-year GDP forecast at this juncture, as it awaits more clarity on the domestic economic scenario. Even in the past, RBI has shown a predisposition towards a conservative growth estimate. However, there might be some minor tweaks in the quarterly projections, especially for H1FY25.

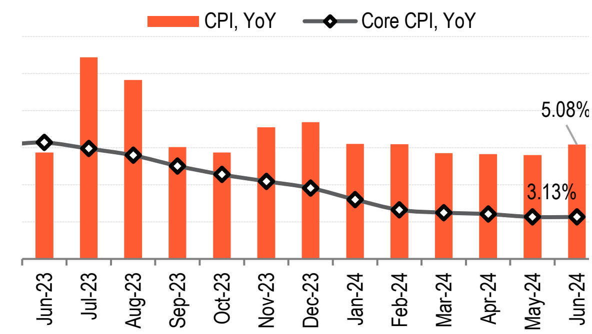
Inflation scenario: Food inflation remains elevated: CPI inflation in Jun'24 inched up to a 4-month high at 5.1%, from 4.8% in May'24. With this, inflation has now remained above RBI's target of 4% for the 57th straight month. In Q1 FY25, inflation averaged 4.9%, which was in line with RBI's estimate. Much of the increase in inflation in the last few months can be attributed to elevated food inflation, even as core inflation has eased significantly and stands at its lowest in the current series.

Figure 5: Food inflation driving CPI higher



Source: CEIC, Bank of Baroda Research

Figure 6: Even as core CPI has moderated



Source: CEIC, Bank of Baroda Research

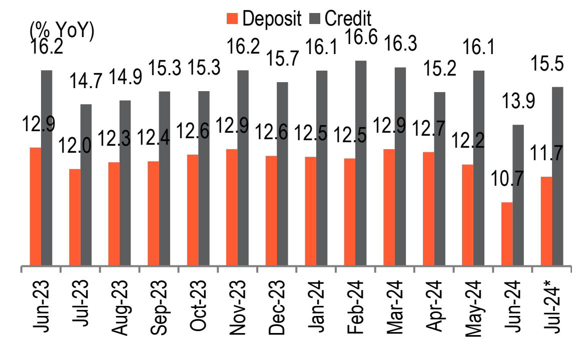
Food inflation in turn has been driven by higher prices of vegetables, cereals and pulses, which have a combined weight of ~18% in the overall CPI basket. In fact, inflation in vegetables and pulses has registered double-digit growth consecutively in each of the last 8-months and 13-months respectively. Within vegetables, prices of key crops namely tomato, onion and potato which account for a major part of household consumption basket have surged sharply. This in turn has been led by intense heatwaves experienced during the key growing season. For pulses, lower sowing last year has resulted in the supply demand mismatch, leading to higher prices. While prices of pulses have started to soften driven by higher imports and pickup in sowing in the current season, vegetable prices have shown a further upward momentum. In fact, retail prices of tomatoes, onion and potato have increased further by 57.4%, 21.3% and 16.1% respectively in Jul'24, and we do not expect any significant respite in the next few months. This imparts an upward bias to RBI's expectation of inflation averaging 3.8% in Q2 FY25. While a favourable base will undoubtedly bring down headline number, the underlying price pressures are likely to sustain.

Progress of South-West Monsoon: The progress on South-West monsoon is likely to have figured at the MPC's top priority since the last policy, as it will determine the trajectory of inflation. Monsoon has progressed well with cumulative rainfall of 4% above LPA (as of 2 Aug 2024), even though spatial distribution suggests skewness of rains in the southern region. On the other hand, rainfall in key agriculture states of Uttar Pradesh, Punjab and Haryana have received below normal rainfall. The situation is likely to correct as IMD forecasts suggest a pickup in rainfall activity in Aug-Sep'24 due to development of La-Nina conditions. It will be crucial to watch if the actual rainfall progresses as per IMD estimates, with spatial distribution of the rainfall being the key. Withdrawal of monsoon and unseasonal rainfall can also be detrimental for the food inflation outlook and will require keen monitoring.

Banking and liquidity

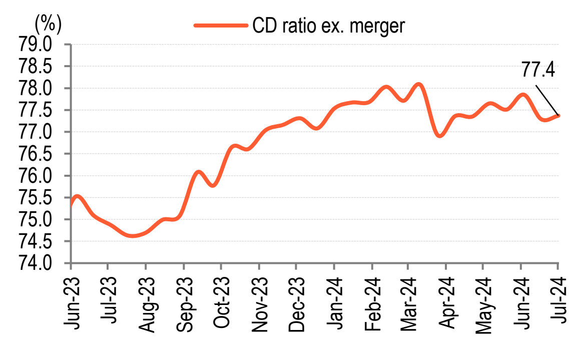
Banking sector: Growth in bank credit (excl. merger) continues at a healthy pace of 15.5% in Jul'24 (12 Jul 2024), higher than 13.9% in Jun'24. While deposit growth too has picked up to 11.7% in Jul'24 (10.7% in Jun'24), it continues to lag the growth in credit. Consequently, the credit/deposit ratio of the banking system remains elevated at ~77%, leading to a shortage of funds for banks. As a result, banks have been resorting to measures including borrowing from CD markets as well as hiking deposit rates to fund the growing demand for credit. Given this, the RBI might announce some temporary measures to address the liquidity stress in the banking system, including stepping up of its VRR auctions.

Figure 7: credit growth outpacing deposit growth



Source: CEIC, Bank of Baroda Research | Note: Ex. Merger *Data for Jul'24 as of 12 Jul 2024

Figure 8: CD ratio elevated



Source: CEIC, Bank of Baroda Research

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 253bps since Apr'22, while for PVBs it has risen by 203bps. On the other hand, transmission to lending rates (WALR) has been lower at 169bps for PSBs and 178bps for PVBs.

Table 1. Fresh term deposit and lending rates

	Apr'22	Jun'24
WADTDR: PSBs	4.32	6.85
WADTDR: PVBs	4.39	6.44
WALR: PSBs	6.77	8.46
WALR: PVBs	8.53	10.31

Source: RBI, Bank of Baroda Research

System liquidity: Domestic liquidity situation has improved considerably in Jul'24. From an average daily deficit of Rs. 1 lakh crores in May-Jun'24, system liquidity turned into a surplus of Rs. 1 lakh crores in Jul'24. The turnaround in the liquidity situation can be attributed to a pickup in government spending post the elections. To align with its stance of withdrawal of accommodation, RBI has conducted a total to 20 VRRR auctions in Jul'24 which have mostly been met with tepid demand from banks. The total notified amount in the auction stood at Rs. 12.75 lakh crores, out of which only Rs. 5.24 lakh crores was accepted. With government spending picking up, the RBI is also likely to continue with more VRRR auctions to absorb the excess liquidity in the system.

Domestic market variables

Softening bias in domestic sovereign yields to continue: Government bond yields have softened significantly since the last policy led by both global as well as domestic factors. Expectations of monetary policy easing by the Fed and other major global central banks have led to softening of bond yields across the globe, including India. On the domestic side, lower borrowings by the government, buying by FPIs and soft global oil prices have led to a downward bias for India's benchmark 10Y yield. Since Jun'24, the yield on 10Y g-sec has fallen from 7.01% to 6.90% currently.

Depreciation in exchange rate can be inflationary: INR has come under pressure lately and closed at a record low of 83.75/$ in the last session. The pressure on currency stemmed from strong dollar demand from importers and a slowdown in FPI equity inflows. While the RBI is likely to ensure that the movement in exchange rate is orderly and prevent a rapid slide in INR, a sustained depreciation of the rupee can have an inflationary impact.

Concluding remarks

Given the domestic growth and inflation dynamics, we do not expect any change in either rate or stance from the RBI. Domestic liquidity is likely to be managed by RBI's finetuning operations. RBI is likely to monitor incoming data and continue to exercise caution before deciding on cutting rates. We believe that the nearest possibility of a rate cut is Dec'24.

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