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MPC meeting: Policy is reflective of growing inflationary risks

While the MPC has explicitly recognised the risks to growth and inflation originating from this year's extremely uneven monsoon, global economic slowdown, elevated energy prices, etc., it has not revised at all its annual projections of GDP growth and the headline CPI inflation for India for the year FY24. This is puzzling

The policy action, the stance, and the warnings issued by the RBI Governor, while announcing the fourth bi-monthly monetary policy for FY24 have been reflective of the growing inflationary risks in India and the pressures coming from the external environment. The statements like 'the need of the hour is to remain vigilant and not give room to complacency' or 'our inflation target is 4% and not 2-6%' show that the RBI wishes to stay on target amid a challenging economic environment.

Responding to the sustained inflationary pressures in key food components, elevated global energy prices and increased volatility in global financial markets, the MPC members unanimously decided today to keep the policy rates (repo, SDF & MSF) at their current elevated levels. Also, they retained the policy stance at 'withdrawal of accommodation' by a majority of 5 out 6 members, with an aim to align inflation to its target progressively.

Liquidity Management

The RBI has been systematically siphoning off excess liquidity from the banking system since its August policy. Imposition of the I-CRR in its August policy that impounded about Rs 1.1 lakh crore from the banking system, raised the weighted average call rate (WACR) from 6.48% in July to 6.58% in August to 6.65% in September. The I-CRR is being discontinued in a phased manner since September 8, to take care of the extra demand for funds during the festival season. However, the RBI highlighted today that it may consider OMO-sales (Open Market

Operations) if needed, to manage liquidity. This means if systemic liquidity exceeds the desired level again, the RBI is willing to take a more durable, long-term action to control liquidity compared to a temporary measure like VRRR (variable rate reverse repo).

Interest Rates & Cost of Funds

Factoring in the tight liquidity conditions going forward, the short-term interest rates will remain elevated until the inflation starts falling on a durable basis. The yields on the top-rated corporate bonds across tenors climbed by 8-9 points today after the RBI's policy announcement. The uncertainty over the size and timing of OMO sales – as a liquidity management tool- will weigh on the fixed markets' sentiment and keep yields elevated in H2, FY24. Upside risks to inflation and the central bank's tight liquidity management will raise the cost of funds for companies and retail borrowers in the remaining part of the year.

Financial Stability

For the second time, the RBI has highlighted the build-up of risks in certain components of personal loans in the books of banks and NBFCs and advised them to strengthen their internal surveillance mechanisms and institute adequate safeguards. Currently, the growth in personal loans of banks is hovering near 31-32% (y-o-y). The RBI has also warned about rapidly changing global financial landscape and the possibility of a potential stress that may emerge from unanticipated corners. At present, the major risks to emerging market economies like India are stemming from three factors – the Brent crude price, US treasury yields and the US dollar index. The RBI has assured that it is closely monitoring the global situation and will proactively take steps to protect financial stability.

Puzzling Projections

While the MPC has explicitly recognised the risks to growth and inflation originating from this year's extremely uneven monsoon, global economic slowdown, elevated global commodity (especially energy) prices, etc. it has not revised at all its annual projections of GDP growth and the headline CPI inflation for India for the year FY24. This is puzzling. But its 'policy action' and 'stance' appear to be driven by due consideration to these evolving risks. Hence, today's monetary policy is holding the line. After all, actions speak louder than words.

Given the RBI's dedicated focus on inflation targeting and tight liquidity management, inflation may ease to some extent in H2, FY24 but will stay above target for an extended period. There is a strong possibility that the sticky inflation in some key food components would get generalized in the coming months. This combined with the hawkish outlook of the central banks of the advanced nations is likely to significantly delay the rate cut cycle further.

Rupa Rege Nitsure is Group Chief Economist, L&T Finance. Views are personal, and do not represent the stand of this publication.

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