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RBI MONETARY POLICY: TARGETING INFLATION ALONG WITH BALANCING GROWTH

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The RBI Monetary Policy Committee (MPC) decided by a majority[1] to keep the **policy repo rate unchanged at 6.50 per cent in the 6 December 2024 monetary policy**. Subsequently, the standing deposit facility (SDF) rate remains at 6.25 per cent and the marginal standing facility (MSF) rate and the Bank Rate at 6.75 per cent. Further, **the MPC decided to maintain the stance to 'neutral'** in line with their focused approach towards a durable alignment of inflation with the target, while supporting growth.

The major decisions and related aspects are illustrated as follows:

Rationale for keeping repo rate at 6.50%: The recent GDP growth slowdown has prompted the RBI to revise a downward forecast of the real GDP growth. Inflation swelled above the upper tolerance band of 6.0 per cent in Oct'24, driven by high food inflation, which is likely to linger in Q3 of this financial year.

[1] Interestingly, this time the ratio remains at 4:2 while in the previous monetary policy the ratio was 5.1, indicating RBI members are tilting towards more rate softening.

It is expected to be assuaged from Q4:2024-25, through seasonal correction in vegetables prices, kharif harvest arrivals, likely good rabi output and sufficient cereal buffer stocks. The MPC highlighted that adverse weather events, geopolitical uncertainties and financial market volatility pose upside risks to inflation. Hence, the focus of the RBI remains in maintaining the 'neutral' stance that provides flexibility for monitoring future inflation and growth trajectory and act accordingly.

Implications of Global Developments for Domestic Economy: Since the last MPC meeting, financial markets have remained jittery amidst strong US dollar and hardening bond yields, resulting in substantial capital outflows from emerging markets (EMs) and volatility in equity markets. The outlook is misty due to growing protectionism trends, which might promote further global adverse outcomes.

Real GDP Growth Projections: Growth in real GDP in Q2 at 5.4 per cent remains much lower than expected, primarily driven by poor performance of the manufacturing companies. Operating profit of 1679 listed private manufacturing companies contracted by 0.3 per cent (y-o-y) during Q2:2024-25. On the other hand, the real GDP increased by 6.7 per cent in the first quarter of FY25.

In the previous monetary policy, the real GDP growth for the first quarter (Q1) in 2025-26 was projected at 7.3 per cent, moderately increased from the 7.2 per cent from the previous policy, whereas the real GDP growth projection for 2024-25 remained at 7.2 per cent. Amid the lower GDP in the second quarter, **the real GDP growth for 2024-25 is now projected at 6.6 per cent,** with Q3 at 6.8 per cent; and Q4 at 7.2 per cent. Real GDP growth for Q1:2025-26 is projected at 6.9 per cent; and Q2 at 7.3 per cent.

Inflation Projections: Inflation increased sharply in September and October 2024 led by an unanticipated increase in food prices. The vegetable inflation remains particularly elevated among different sub-groups. Going ahead, a good rabi season would be crucial for softening food inflation pressures. The evolving trajectory of domestic edible oil prices, following the hike in import duties and rise in their global prices, needs to be closely monitored.

Moreover, manufacturing and services firms surveyed by the RBI revealed hardening input costs. Considering these factors, **CPI inflation for 2024-25 is projected at 4.8 per cent,** with Q3 at 5.7 per cent; and Q4 at 4.5 per cent. CPI inflation for Q1:2025-26 is projected at 4.6 per cent; and Q2 at 4.0 per cent.

In this context, let's highlight the following extract from the RBI Governor as follows: "*At present, it is necessary to draw on the flexibility provided by the neutral stance to wait for and monitor the incoming data for confirmation of the decline in inflation. The gains achieved so far in the broad direction of disinflation, notwithstanding the recent upticks, need to be preserved. At the same time, the growth trajectory and the evolving outlook also need to be monitored closely*."

Therefore, apparently it seems that the RBI would keep policy rates on hold until the inflation trajectory shows a sustained downward trend at the 4 per cent target level, while at the same time policy support in different forms (e.g. CRR reduction/any other measures) would be continued to arrest any downfall in growth momentum. The expectation, however, is going forward, the inflation would soften provided a good rabi harvest prevails with comfortable reservoir level that would soften the vegetable inflation.

Stance on Liquidity: The RBI has highlighted that systemic liquidity may tighten in the coming months due to tax outflows, increase in currency in circulation and volatility in capital flows. Therefore, to ease the potential liquidity stress, the *RBI decided to reduce the cash reserve ratio (CRR) of all banks to 4.0 per cent*. This will be done in two equal tranches of 25 bps each with effect from the fortnight beginning December 14, 2024, and December 28, 2024.[2] This reduction in the CRR is consistent with the neutral policy stance and *would release primary liquidity of about ₹ 1.16 lakh crore to the banking system.*

The Outlook of the Indian Rupee (INR): During the current calendar year (CY) 2024, the INR depreciated by 1.4% till November 19, 2024, against the US dollar (USD) mostly due to strong US Dollar Index and outward FII flows. The Dollar Index increased by about 4.8% till November 19, 2024. Further, the Dollar Index touched 108.07 on November 22, 2024, its highest in more than a year, exerting pressure on emerging market currencies. Moreover, geopolitical tensions in the Middle East and uncertainty surrounding US elections results also remain despair. A declining INR would enhance export competitiveness, but on the other hand, the import costs would rise.

However, the overall impact would depend on many factors like pass through of commodity prices, the degree of export-import elasticities or the so-called Marshall-Learner Conditions etc.[3] Experts also expressed fear that a relatively stronger INR vis-

[2] This will restore the CRR to 4.0 per cent of NDTL, which was prevailing before the commencement of the policy tightening cycle in April 2022.

[3] The condition states that a country's currency depreciation can improve its trade balance if the sum of the absolute values of its export and import price elasticities is greater than one.

à-vis its emerging market partner countries, especially that of the Chinese currency renminbi, might push Indian exportable in a further disadvantageous position.

Financial Stability: To address the issues of unclaimed deposits, inoperative accounts and frozen accounts due to pendency of KYC updation, ***banks have been advised to take necessary steps to bring down the number of such accounts*** and make the process hassle free. ***Further, banks have been advised to segregate the accounts of beneficiaries of various Central/ State Government schemes through Direct Benefit Transfer (DBT)*** and facilitate uninterrupted credit and utilisation of DBT amounts, without inconveniencing such vulnerable segments of customers.

External Sectors Measures: To attract more capital inflows, RBI will increase the interest rate ceilings on FCNR(B) deposits. ***Accordingly, effective from 6 December 2024, banks are permitted to raise fresh FCNR(B) deposits of 1 year to less than 3 years maturity at rates not exceeding the ceiling of overnight Alternative Reference Rate (ARR) plus 400 bps*** as against 250 bps at present. Similarly, ***for deposits of 3 to 5 years maturity, the ceiling has been increased to overnight ARR plus 500 bps*** as against 350 bps at present. This relaxation will be available till March 31, 2025.

Expanding the reach of FX-Retail Platform through Linkages with Bharat Connect: The FX-Retail platform, which was launched in 2019, is now proposed to be linked with the Bharat Connect platform of NPCI, *which would enable users to transact on the FX-Retail platform through mobile apps of banks and non-bank payment system providers.* This will further expand the reach of FX-Retail platform, enhance user experience and promote fairness and transparency in pricing with adequate safeguards.

Introduction of the 'Secured Overnight Rupee Rate (SORR)' – a Benchmark based on the Secured Money Markets: With a view to further develop the interest rate derivatives market in India and improve the credibility of interest rate benchmarks, ***the Reserve Bank proposes to introduce a new benchmark - the Secured Overnight Rupee Rate (SORR)***; based on all secured money market transactions – overnight market repo as well as TREPS.

'Connect 2 Regulate' – An Initiative for Open Regulation: As part of the Reserve Bank's consultative approach in framing regulations, a new programme, namely, ***'Connect 2 Regulate'*** will be launched under the ongoing RBI@90 commemorative events. A dedicated section in the Reserve Bank's website will be made available for stakeholders to share their ideas and inputs on specific topics.

<u>Introduction of Podcast Facility as an Additional Medium of Communication</u>: Over the years, the Reserve Bank has expanded its communication toolkit and techniques to enhance transparency and better connect with the people. ***In continuance of this endeavour, the Reserve Bank proposes to add 'podcasts' to its communication toolkit for wider dissemination of information***.

<u>Enhancement of Limit for Collateral-free Agriculture Loan</u>: The limit for collateral-free agriculture loans was last revised in 2019. Considering the rise in agricultural input costs and overall inflation, ***it has been decided to increase the limit for collateral-free agriculture loans from ₹1.6 lakh to ₹2 lakh per borrower*** to enhance credit availability for small and marginal farmers.

<u>Extending the Scope to Small Finance Banks for Pre-sanctioned Credit Lines through UPI</u>: Credit line on UPI was launched in September 2023 and was made available through Scheduled Commercial Banks (SCBs). ***It has now been decided to permit Small Finance Banks also to extend pre-sanctioned credit lines through the UPI,*** *which* will further deepen financial inclusion and enhance formal credit, particularly for 'new to credit' customers.

<u>Framework for Responsible and Ethical Enablement of Artificial Intelligence (FREE-AI) in the Financial Sector : Setting up of a 'Committee'</u>: The financial sector landscape is witnessing rapid transformation, enabled by technologies such as AI, tokenisation, Cloud Computing, etc. To harness the benefits from these technologies, while addressing the associated risks such as algorithmic bias, explainability, data privacy, etc., ***a committee comprising of experts from diverse fields will be set up to recommend a Framework for Responsible and Ethical Enablement of AI (FREE-AI) in the financial sector***.

<u>Combating Digital Frauds</u>: As part of the Reserve Bank's continued efforts to prevent and mitigate digital frauds, an innovative AI / ML based model, namely, ***<u>MuleHunter.AITM'</u>*** has been developed by the Reserve Bank Innovation Hub (RBIH), Bengaluru. This will help the banks to deal with the issue of mule bank accounts expeditiously and reduce digital fraud.