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HIGH INFLATION, LOW GROWTH: "STATUS QUO" MORE LIKELY IN RBI POLICY RATE

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The growth rate of real GDP of India in the second quarter (Q2) of the FY25 remains much less at 5.4% compared to 8.1% growth during the same period of the previous financial year i.e. FY25. Among other sectors, the growth of manufacturing remains quite abysmal, it grows only by 2.2% in Q2FY25 vis-à-vis 14.3% in the previous year.

The growth of construction and that of electricity and utility services remain disappointing. Whereas the real Gross Value Added (GVA) during (Apr-Sept) of FY25 (i.e. for the first half) is estimated at 6.2%, the real GDP for the same period is estimated at 6.0%. Interestingly, all the sectors -Primary, Secondary and Tertiary have shown lower growth in FY25 compared to FY24.

The disappointing Q2FY25 real GDP growth rate is bad news as at the same time, India is continually facing higher retail food inflation. The CPI in October 2024 remains at 6.21%, whereas in Aug'24, the CPI was nearing at the RBI's target rate at 3.65%. The vegetable inflation is the sole crook, which remains as high as 42.18% among all group and sub-group level Consumer Food Price Index (CFPI) and CPI.

Chhattisgarh has one of the highest inflation rates (8.84%) in India due to soaring food prices, particularly in vegetables, cereals, fruits, oils, and fats. This is further amplified by supply chain issues and a substantial reliance on agricultural produce in the region.

There is also certain structural issue in the state for which inflation remains higher, i.e. rural areas in Chhattisgarh experience higher inflation compared to urban areas due to dependence on local food markets. The other states that face higher inflation rates are Bihar (7.8%), Odisha (7.5%), Uttar Pradesh (7.4%), Madhya Pradesh (7%).

Nonetheless, in certain sectors, especially in rural areas, the high frequency indicators have shown robust growth trends. Agricultural exports remain buoyant at 32% growth in last couple of months. Inter-state e-way bills and GST collection remain impressive. Two-wheelers registrations have increased by 11.6% and 26.1% during Oct'24 and Nov'24 respectively. Electronics, chemicals, engineering goods, textiles have shown notable growth. While kharif output bodes well, going forward the rabi monsoon is likely to be normal, along with comfortable reservoir level.

However, there are ample reasons in support that RBI is left this time with little options but to hold the policy repo rate unchanged. In a nutshell, both domestic and external situations are not favourable, and with full of uncertainties. The Trump tariff threat is one of those factors. On 22 Nov'24, India's foreign currency assets (FCAs) was $567 billion (excluding gold and SDR), netting for forward and NDF premiums the net FCAs stood at less than $500 billion.

Interestingly, in Aug'24, whereas the RBI was a net seller of the FCAs (-US$ 6494 million) possibly to protect the declining rupee (₹), in Sept' RBI has tried to shore up the forex reserves (RBI purchased in Sept'24, US$ 28930 million FCAs, whereas it sold US$ 19291million FCAs, hence on net basis it added US$9639 foreign currency assets to the kitty).

One potential challenge is that, with Trump's tariff China would be desperate in selling their products, and such dumping might pose certain challenges for the Indian exports. Given that the Indian rupee (₹) has performed better compared to its Emerging Market (EMs) peers including the Chinese currency, such aggressive selling would be more challenging for Indian exporters, unless offset by a further fall in the Indian rupee. Trump's threat of placing 100% tariffs on BRICS countries, if they seek any alternative currency, is another challenge for the Indian rupee.

However, there is another side of the argument, which is the subdued growth is partly can be related to the high real cost of borrowing. After experiencing a surplus liquidity of around ₹1.4 lakh crore for last two months, the RBI had to inject some amount of liquidity (₹6956 crore) during end-November (25-26 Nov'24).[1]

[1] https://rbi.org.in/scripts/FS_PressRelease.aspx?prid=59179&fn=6

The liquidity deficit is caused by multiple factors- continuous outflows from Foreign Institutional Investors (FIIs), RBI's net selling of dollars to protect rupee's decline and somewhat negative Balance of Payments (BoP) in the current quarter.

Overall, the major bottleneck in rate softening is the high vegetable inflation. If the rabi season remains normal along with reservoir level, the vegetable inflation can be expected to soften going forward. Otherwise, a case of repo rate cut is getting stronger amid low real GDP growth and tight liquidity. However, at present, given the much higher inflation vis-à-vis RBI mandated target, the likelihood of "status quo' is expected to prevail. On the other hand, it needs to be seen if RBI introduce or take any measure to address the issue of liquidity.