KERALA ECONOMY
2024, VOL. 5, NO.3. pp 88-92

ISSN : 2583-4436

RBI remained cautious yet sounded dovish in the October policy meet

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Abstract

The RBI's Monetary Policy Committee (MPC) voted 5-1 to keep the policy rate unchanged at 6.5 percent, shifting its stance from 'withdrawal of accommodation' to 'neutral'. The MPC expressed confidence in domestic growth and the inflation trajectory while noting that aligning inflation to the RBI's target remains a key priority due to potential risks. These include geopolitical tensions, adverse weather conditions, and rising global prices. Given the volatility in food prices, particularly horticulture products, caution is warranted.

Keywords: *Monetary Policy, inflation, growth*

1. Introduction

The newly constituted MPC decided to keep the repo rate unchanged at 6.5 percent with a 5-1 vote. The committee unanimously shifted the monetary policy stance from 'withdrawal of accommodation' to 'neutral,' a change not seen since April 2022. The MPC emphasized that inflation and growth dynamics remain well balanced, reiterating the need to align inflation with the target while supporting growth. This change in stance provides the MPC with the flexibility to monitor evolving inflation risks and can be seen as a precursor to potential monetary easing.

2. Why cautious note on inflation?

Despite the shift in stance, the RBI maintained a cautious tone, highlighting the ongoing risks to the inflation outlook. Over the past two years, tighter monetary policy has significantly brought down headline inflation within the target range. However, the governor reiterated his commitment to achieving and maintaining the 4 percent inflation target on a durable basis.

Inflation has stayed well below 4 percent over the past two months, thanks to a favorable base and some moderation in food inflation. Core inflation has been benign, averaging 3.3 percent from April to August. However, inflationary risks persist, especially with ongoing concerns about food prices. Sequential price momentum remains high for vegetables, pulses, cereals, and edible oil. Notably, vegetable prices, which constitute 6 percent of the Consumer Price Index (CPI) basket, have been the most volatile and significantly influence household inflation expectations.

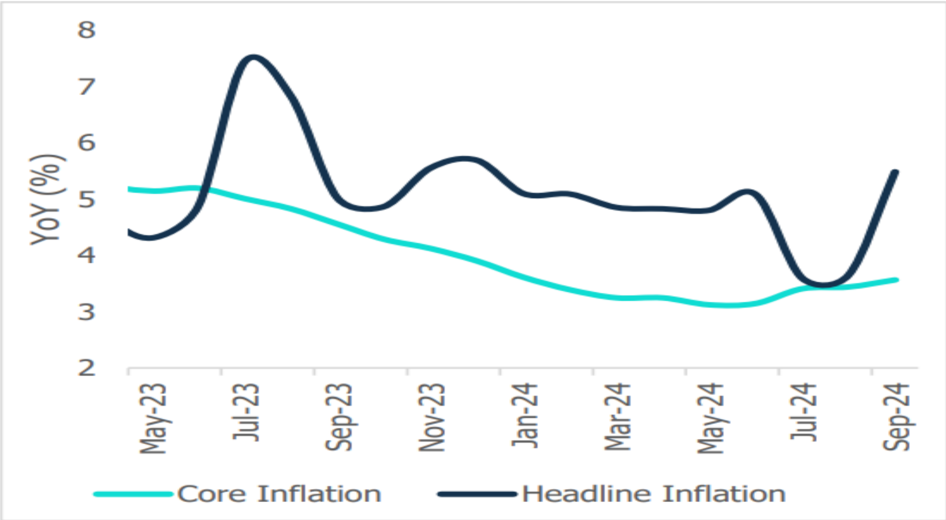
Factors like uneven monsoons, pre-harvest rainfall, and rising global edible oil prices heighten food inflation risks. Although this year's monsoon was 8 percent above normal, distribution issues persisted. Kharif sowing for pulses and some oilseeds has been below the historical average, raising concerns. In addition to that, the extended monsoon season and recent pre-harvest showers increase the risk of crop damage.

In addition to food inflation, the recent rise in global commodity and Brent crude prices adds to inflationary pressures and requires close monitoring. Over the past month, industrial metal prices have increased by about 8 percent, and Brent crude prices by about 9 percent. The base effect of food inflation is also expected to turn adverse in the coming months, further contributing to the rise in food inflation.

3. Persistent inflationary pressures

In September, CPI inflation rose to 5.5 from 3.7 percent in August. Core inflation also slightly increased by 10 bps to 3.5 percent, yet remained below the 4 percent mark for the eleventh month in a row. Inflation in personal goods stood at 9 percent in September, up from 8 percent in August. Food inflation surged to 8.4 percent from 5.3 percent in the previous month, driven by the waning favorable base effects. Vegetable inflation hit a 14-month peak, while edible oils exited deflation after 19 months. Sequential momentum remained strong in categories like vegetables (3.5 percent month-on-month (m-o-m)), edible oils (2.9 percent m-o-m), eggs (1.6 percent m-o-m), and pulses (0.6 percent m-o-m) (Figure-1).

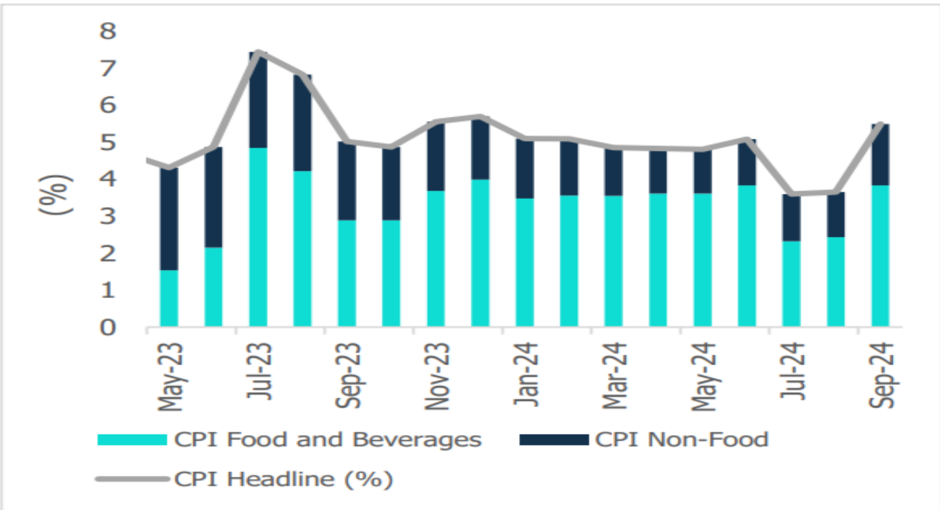
Figure 1: Headline versus core inflation



Source: MOSPI

Risks to food inflation remain and require close monitoring. Factors such as uneven monsoon, pre-harvest rainfall, and rising global edible oil prices add to these risks. Despite a monsoon 8 percent above normal, distribution issues persisted. Key agrarian regions like Punjab, Haryana, Eastern UP, Bihar, and Gangetic West Bengal experienced deficit rainfall during the sowing season. Besides, Kharif sowing for pulses and some oilseeds has been below the historical average, which is worrisome given their import dependence. The extended monsoon and recent pre-harvest showers further increased crop damage risk. Vegetable prices, which account for 6 percent of the CPI basket, have been highly volatile, significantly impacting household inflation expectations (Figure 2).

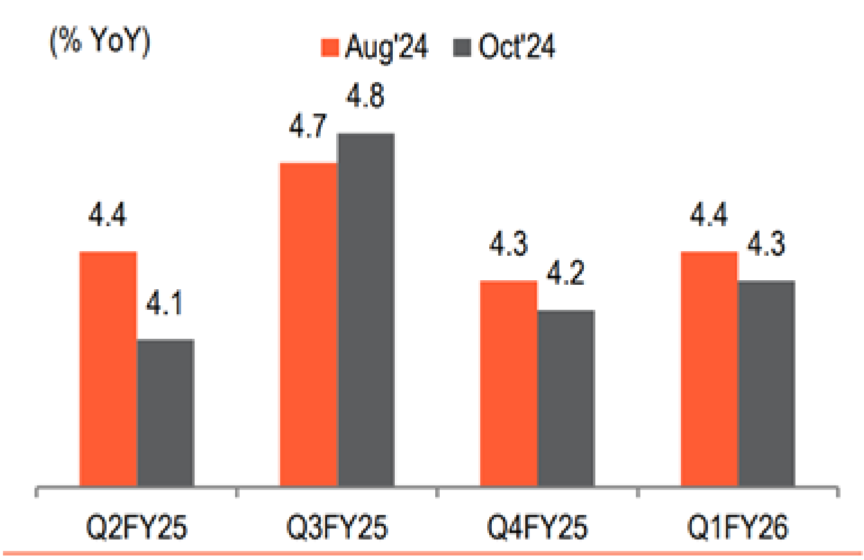
Figure 2: Food inflation keeps headline elevated



Source: MOSPI

Besides food price pressures, additional inflation risks stem from the external sector. A potential escalation of conflict in the Middle East could disrupt supply chains and affect global energy prices, causing ripple effects on the domestic economy. Furthermore, China's recent economic stimulus announcement has led to a rise in global commodity prices over the past few weeks. Brent Crude oil has increased by ~10 percent to USD 78 per barrel since late September. Monitoring geopolitical developments is crucial, as they can significantly impact global commodity prices (Figure 3).

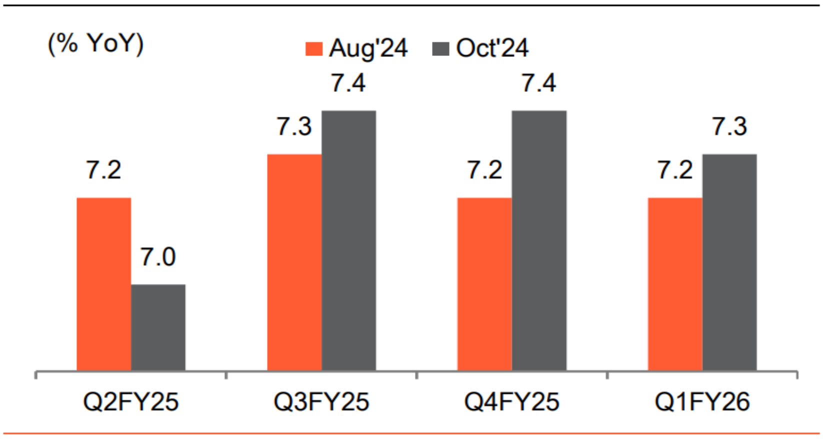
Figure 3: Inflation projections



Source: RBI, Monetary Policy Statement October 2024

The RBI has retained its FY25 inflation projection at 4.5 percent. The current quarter's inflation forecast was revised lower by 30bps to 4.1 percent due to a sharp moderation in inflation in July and August 2024. The Q3 FY25 projection was revised to 4.8 percent (up from 4.7 percent) due to a negative base effect and rising vegetable prices. Projections for the next two quarters were revised lower but remain above the RBI's median target range of 4 percent. Positive factors for the food inflation outlook include a normal monsoon, higher Kharif sowing, and improved reservoir storage. However, risks remain from geopolitical tensions, climate-related challenges, and recent increases in global commodity prices. The MPC has adopted a cautious approach to ensure that inflation durably aligns with its 4 percent target Figure 4).

Figure 4: Growth projections



Source: Monetary Policy Statement, October 2024

The RBI remains optimistic about growth, maintaining its GDP growth projection at 7.2 percent for FY25. Real GDP growth for Q1 FY25 was 6.7 percent, 40bps below the RBI's projection. Notably, the growth forecast for Q2 FY25 has been lowered by 20bps. High-frequency indicators pointed to a dip in economic activity in September 2024 due to seasonal effects. However, growth is expected to recover in H2 FY25. The RBI has revised its estimates for subsequent quarters upwards by 10-20bps, supported by increased consumption demand from the festive season and a favorable monsoon. Government expenditure is also expected to rise in line with budget estimates. Overall, there is an anticipation of FY25 GDP growth to be in the range of 7.3-7.4 percent, slightly higher than RBI's estimates.

Conclusion

The RBI's policy stance remains balanced, retaining growth and inflation projections for FY25. The overall tone is cautious, with dovish undertones. While the MPC acknowledges progress in controlling inflation, it remains cautious about potential risks, including an adverse base, food price volatility, geopolitical tensions, and climate shocks. Despite recent positive signs, the emphasis remains on ensuring durable alignment of inflation with the RBI's 4 percent target.

The change in stance is justified, providing RBI the flexibility to adjust its policy as it gains more clarity on inflation risks. With Q3 FY25 inflation projected at 4.8 percent, the possibility of a rate cut in December 2024 is pushed back. However, if inflation undershoots the RBI's estimates in the next three months, the scope for a rate cut may open up. Currently, a rate cut in February 2025 appears the most likely scenario.

Reference

RBI, R. B. of I. (2024, October). Monetary Policy Statement. Reserve Bank of India; October 2024. https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=58851