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THE LONG AND THE SHORT OF PRUDENT POLICY MAKING: SHORT TERM RATES MAY REMAIN HIGHER FOR LONGER

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The MPC decision to keep policy repo rate at 6.50% (it was hiked to present level exactly an year ago in Feb'23) by a wide majority (though not unanimously) indicates the unwavering regulatory commitment to remain focused on withdrawal of accommodation, ensuring inflation progressively aligns to the target, while supporting growth.

RBI MPC retained its inflation projection for FY24 at 5.40% with Q4 at 5.0% (earlier 5.2%). The outlook for inflation will largely be shaped by evolving food inflation. Real GDP growth for FY25 is projected at 7.0% with risks evenly balanced. Recovery in rabi sowing, sustained profitability in manufacturing and underlying resilience of services may support growth in FY25. On the demand side, household consumption is expected to improve, while prospects of fixed investment remain bright owing to upturn in the private capex cycle. However, risks may arise from geopolitical tensions, volatility in international financial markets and geoeconomic fragmentation.

Liquidity deficit has increased since the last policy in Dec'23. Net LAF has remained in the deficit mode since mid-Sep'23, with the system liquidity deficit at Rs 1.5 lakh crore and average of Rs 1.8 lakh crore post Dec'23 policy. The RBI has been actively managing liquidity through main as also fine-tuning operations. However, Government surplus cash balances have increased to an average of Rs 3.9 lakh crore post Dec'23 policy. With higher Government surplus cash balances and reduced system liquidity, durable/core liquidity surplus (or the potential liquidity surplus as referred to by the governor) has come down moderately to Rs 1.8 lakh crore. **The build-up of Government cash balance is also because of the Government moving into a JIT mechanism of spending. We expect this will have wide ranging ramifications on the banking system liquidity by impacting government cash balances. Pertinently, system liquidity slips into deficit when government is not spending whereas it improves to surplus mode when government spending resumes. On a positive cue, the governor reiterated the commitment to remain vigilant of the evolving liquidity situation and ensure that money market interest rates evolve in an orderly manner and financial stability is maintained.**

The JIT mechanism to streamline funds transfer to states under Centrally Sponsored Schemes juxtaposed against a declining CASA ratio of ASCBs (40.5% as on Sep'23 vis-à-vis 43.1% on Mar'23 / 45.2% on Mar'22) is ensuring over reliance of systemic players on other-than-deposit sources that can have precipitating effects on short term yields and floor of interest rates on advances apart from having an overhang on liquidity as government spending is waning, while systemic players are moved out of the spend pipeline.

The major announcements made today point to a nuanced growth oriented mindset while simultaneously fortifying the financial landscape against any shock; exogenous/in-house as key tenets are being aligned with the evolving global best practices.

With a deepening INR offshore market necessitating meaningful integration and enhanced availability of authorised avenues on a global scale which can be better monitored and data can be share/analyzed as internationalization of rupee gathers winds, RBI has announced to review the existing mechanism pertaining to ETPs to chalk out guidelines allowing access to offshore ETPs offering permitted INR products.

With a view to providing greater flexibility to resident entities to hedge the price risk of their gold exposures efficiently, RBI had in Dec'2023 MPC permitted resident entities to hedge their gold price risk on recognised exchanges in the IFSC, benefitting importers and exporters of gold to manage/mitigate price risk as well as currency movement risk. Now, RBI has gone a step further adding OTC contracts in IFSC to offer greater structuring and enhanced flexibility to desirous parties.

To enhance the security of AePS transactions (37 crore users now with 47 entities), RBI has proposed to streamline the onboarding process, including mandatory due diligence for AePS touchpoint operators, to be followed by banks.

RBI has also extended the requirement of the Key Fact Statement (KFS) to cover all retail and MSME loans and advances. This move can be seen as a significant step towards empowering customers with comprehensive information, enabling them to make informed decisions about their borrowing.

With Additional Factor of Authentication for digital security slowly moving away from SMS based OTP regime alone as alternative authentication mechanisms have emerged in recent years, a principle-based "Framework for authentication of digital payment transactions as indicated by RBI should benefit alternatives like CDCVM, authenticators, Biometric like fingerprint, IRIS, Voice Recognition etc.

Last, the changes proposed in CBDC-R that aim to augment government agencies to ensure that payments are made for defined benefits, or corporates can program specified expenditures like business travel for their employees as also introducing an offline functionality that enables transactions in areas with limited internet connectivity spurs the movement in right direction as onboarding people from fringe areas into the CBDC architecture would enhance its acceptability exponentially.

REPO RATE KEPT AT 6.5%

- As widely expected, MPC decided to keep repo rate at 6.50%, though not unanimously. One of the members voted to reduce the policy repo rate by 25 bps. RBI also decided to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns to the target, while supporting growth. One of the members voted for a change in stance to neutral.
- RBI retained its inflation projection for FY24 at 5.40% with Q4 at 5.0% (earlier 5.2%). The outlook for inflation will largely shaped by evolving food inflation with considerable uncertainty owing to possibility of adverse weather events. While effective supply side responses may keep food price pressures under check volatility in crude oil may pose risks. CPI inflation for FY25 is projected at 4.5%.
- Real GDP growth for FY25 is projected at 7.0% with risks evenly balanced. Recovery in rabi sowing, sustained profitability in manufacturing and underlying resilience of services may support growth in FY25. On demand side, household consumption is expected to improve, while prospects of fixed investment remain bright owing to upturn in the private capex cycle, improved business sentiments, healthy balance sheets of banks and corporates. However, risks may arise from geopolitical tensions, volatility in international financial markets and geoeconomic fragmentation.

LIQUIDITY MANAGEMENT BY RBI

- Liquidity deficit has increased since the last policy in Dec'23. Net LAF has remained in the deficit mode since mid-Sep'23, with the system liquidity deficit at Rs 1.5 lakh crore and average of Rs 1.8 lakh crore post Dec'23 policy. The RBI has been actively managing liquidity through main and fine-tuning operations.
- However, Government surplus cash balances have increased to an average of Rs 3.9 lakh crore post Dec'23 policy. With higher Government surplus cash balances and reduced system liquidity, durable/core liquidity surplus (or the potential liquidity surplus as referred to by the governor) has come down moderately to Rs 1.8 lakh crore. The build-up of Government cash balance is also because of the Government moving into a JIT mechanism of spending. We expect this will have wide ranging ramifications on the banking system liquidity by impacting government cash balances. Pertinently, system liquidity slips into deficit when government is not spending whereas it improves to surplus mode when government spending resumes.

RBI Growth & Inflation Outlook for India

CPI Inflation (%)	Q4 FY24	FY24	Q1 FY25	Q2 FY25	Q3 FY25	Q4 FY25	FY25
Feb'24	5.0	5.4	5.0	4.0	4.6	4.7	4.5
Dec'23	5.2	5.4	5.2	4.0	4.7	-	-
Oct'23	5.2	5.4	5.2	-	-	-	-
Real GDP Growth (%)	**Q4 FY24**	**FY24**	**Q1 FY25**	**Q2 FY25**	**Q3 FY25**	**Q4 FY25**	**FY25**
Feb'24	6.8*	7.3**	7.2	6.8	7.0	6.9	7.0
Dec'23	6.0	7.0	6.7	6.5	6.4	-	-
Oct'23	5.7	6.5	6.6	-	-	-	-

Source: RBI, SBI Research,* estimated from RBI Fan chart, **NSO estimate

- The RBI governor reiterated its commitment to remain vigilant of the evolving liquidity situation and ensure that money market interest rates evolve in an orderly manner and financial stability is maintained.
- Another important issue is the asymmetry with simultaneous parking of funds in SDF by a set of banks and another set of banks borrowing through MSF. Interestingly, the amount parked by banks in SDF during the liquidity deficit days is termed as unusable liquidity/precautionary motive.
- This situation has however moderated since the last policy when RBI decided to allow reversal of liquidity facilities under both SDF and MSF even during weekends and holidays.
- **However, certain other measures including clear articulation that CRR and LCR can fall below mandated levels in case of emergency and published set of rules/guidelines that define emergency and facilitate auto-implementation without any prior approval can be taken to address the issue further.**

Average Liquidity Position (Rs lakh crore)

	Average in FYTD24	8-Dec-23	Average post policy	7-Feb-24
Repo Outstanding	0.45	0.09	1.66	2.50
Reverse Repo Total	0.32	0.22	0.08	0.81
SDF	0.82	0.43	0.51	0.50
MSF	0.51	0.63	0.64	0.16
Net LAF (-absorption)	-0.10	0.13	1.78	1.53
Government Cash Balance (net LAF-core liquidity)	2.30	2.77	3.89	3.80
Core Liquidity (-Surplus) system liquidity adjusted with Governemnt Borrowing	-2.42	-2.45	-2.08	-1.77

Source: RBI, SBI Research

DEVELOPMENT AND REGULATORY MEASURES

- ***Key Fact Statement (KFS) for Retail and MSME Loans & Advances:*** RBI has extended the requirement of the Key Fact Statement to cover all retail and MSME loans and advances. The Key Fact Statement for retail and MSME loans is designed to provide customers with a clear understanding of the actual annualised interest rate and the overall financial commitment associated with the loan. This move can be seen as a significant step towards empowering customers with comprehensive information, enabling them to make informed decisions about their borrowing.
- ***Review of the Regulatory Framework for Electronic Trading Platforms:*** The decision to review ETP framework is good move as it addresses the issue of regulator arbitrage in virous sector of the financial markets.
- ***Hedging of Gold Price Risk in the Over the Counter (OTC)*** in IFSC is good move as it allows major gold players to hedge the price of gold. Further small players are expected to benefit more given the access to IFSC.
- ***Enhancing the Robustness of AePS:*** The AePS is now being used by more than 37 crore users and 47 entities, including state government departments, ministries in the central government and some banks and play a greater role in financial inclusion. To enhance the security of AePS transactions, RBI has proposed to streamline the onboarding process, including mandatory due diligence, for AePS touchpoint operators, to be followed by banks.
- ***Principle-based Framework for Authentication of Digital Payment Transactions:*** Though RBI has not prescribed any particular AFA, the payments ecosystem has largely adopted SMS-based One Time Password (OTP). With innovations in technology, alternative authentication mechanisms have emerged in recent years, RBI proposed to adopt a principle-based “Framework for authentication of digital payment transactions”. Instructions in this regard will be issued separately.
- There are multiple innovations in the authentication space, including the consumer device cardholder-verification method (CDCVM), Authenticators, Biometric like fingerprint, IRIS, Voice Recognition etc, GPS and Time based, FIDO Standards, GSMA’s Mobile Connect, OAuth 2.0, and OpenID Connect.
- ***Introduction of Programmability and Offline Functionality in Central Bank Digital Currency (CBDC) Pilot:*** RBI has been spearheading the CBDC project on both wholesale as also retail channels, augmenting user cases as the initial results of transactions in CUG (Closed User Groups) of customers and merchants of pilot banks through P2P as also P2M modes. Additional use cases, post stabilization would allow users like the government agencies to ensure that payments are made for defined benefits while corporates will be able to program specified expenditures like business travel for their employees through CBDC-R. Introducing an offline functionality in CBDC-R would enable transactions in areas with poor or limited internet connectivity, onboarding people from outlier areas into the CBDC architecture, enhancing its acceptability.

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