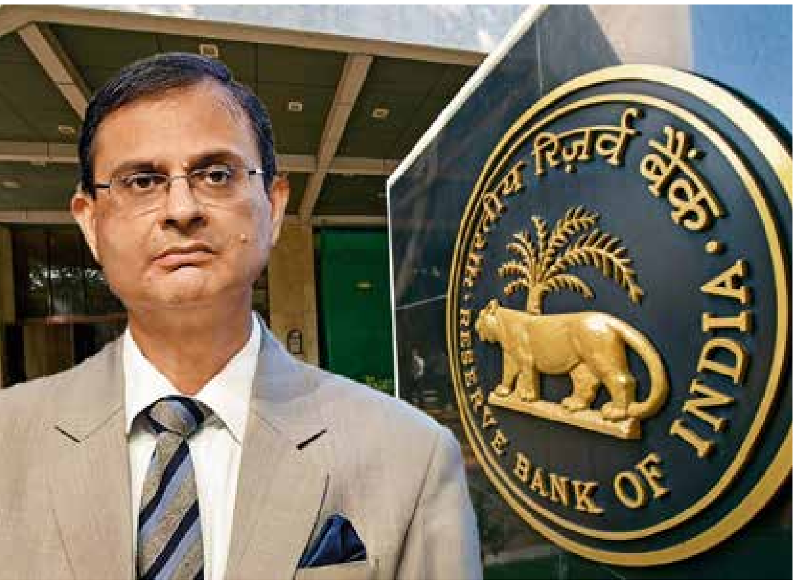
Governor Starts Steady on a Seaming Pitch



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RBI's February 2025 Policy, which was entirely in conformity with our expectations, was formulated against the backdrop of the global setting of "*divergent and uncertain*" growth of 3.3 % both in 2025 and 2026 and global headline inflation of 4.2 % in 2025 and 3.5 % in 2026, the Russia-Ukraine war, and the uncertain Middle East. In this tumultuous time, adroit risk management *"requires a keen policy focus on balancing trade-offs between inflation and real activity, rebuilding buffers, and lifting medium-term growth prospects through stepped-up structural reforms as well as stronger multilateral rules and cooperation"*. This is a tall order because of geopolitical risks, President Donald Trump's accent on tariffs, greater protectionism, currency volatility, and checking inflationary impulses while raising growth.

Sluggish Macro Backdrop and Policy Action

Domestically, India's GDP could decline to 6.4 % in FY 25 because of flagging investment growth and urban consumption and slackening corporate profits. This slowest growth rate since the pandemic manifests moderation across key sectors and occurred with higher interest rates amid elevated inflation, particularly food commodities, slack urban consumption, and capital expenditure. While external headwinds are persisting concerns, resuscitating growth stemming from higher farm and service sector activities could raise H2 GDP growth to 6.5 %. Heightened global uncertainty and elevated spillover risks hamper the revival of stock markets, *inter-alia* because of muted Q3 corporate earnings.

Without detracting from inflation targeting and macroeconomic stability, the MPC cannot be oblivious to growth concerns. Accordingly in this overarching framework of global uncertainties, decelerating GDP growth, sluggish private investment, weak credit demand in key sectors, and easing inflation, the Repo rate was reduced for the first time in five years by 25 bps from 6.5 % to 6.25 %.

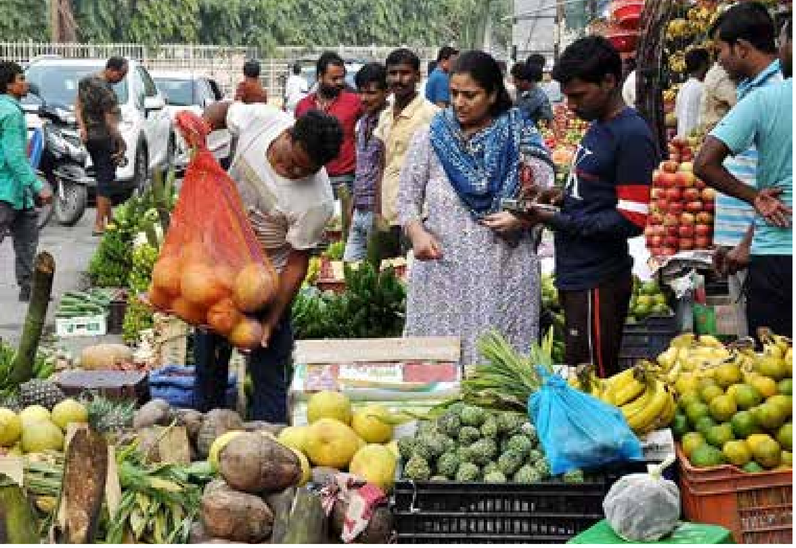
Mixed signals are seen in *"rural demand continues to be on an uptrend, while urban consumption remains subdued with high-frequency indicators providing mixed signals. Going forward, improving employment conditions, tax relief in the Union Budget, and moderating inflation, together with healthy agricultural activity bode well for household consumption"*.

Subsequent MPC minutes confirmed *"the ebbing of price pressures and improving inflation outlook"*. The cumulative impact of the monetary and fiscal stimulus provides tailwinds to the macroeconomy. This changing scenario provided the MPC space to focus on reviving underwhelming growth. As the Governor Mr. Sanjay Malhotra justifiably stressed *"These growth-inflation dynamics open up policy space for the MPC to support growth, while remaining focussed on aligning inflation with the target. At the same time, excessive volatility in global financial markets and continued uncertainties about global trade policies coupled with adverse weather events pose risks to the growth and inflation outlook. This calls for the MPC to remain watchful. Accordingly, it decided to continue with a neutral stance."*

Banking System

Strong RBI measures, regulatory warnings, and "*moral suasion*" tempered personal loan growth from 15.2% in September to 13.7% in December 2024. Total bank credit growth also decelerated, though all population groups maintained double-digit growth. Lending for trade, finance, and professional services rose, while credit for agriculture and industry moderated. Aggregate deposits rose by 11%, with term deposits rising significantly.

Private banks pruned CD ratios amid tight liquidity and banks enhanced their liability franchises by offering



higher rates on term deposits in FY 26. Private lenders have also lowered their CD ratios to align with regulatory expectations.

This growth-supportive Monetary Policy needs to be seen in conjunction with extensive measures to infuse liquidity of Rs 1.5 lakh crore to change the liquidity deficit banking ecosystem on top of Rs 1.16 lakh crore of liquidity infusion in December 2024 because of 50 bps reduction in cash reserve ratio (CRR).

Inflation

In terms of the Flexible Inflation Targeting Framework (FITF) introduced in 2016, the Government of India mandated the RBI to fix the policy rate to maintain the Consumer Price Index (CPI) (corresponding to a basket inclusive of food, fuel, manufactured goods, and select services) within the target range of 4 % (+/- 2 %).

Inflation fell steadily to a four-month low of 5.22 % in December, down from 5.48 % in November and 6.21 % in October. Food inflation, which weighs around 40 % in CPI, is impacted predominantly by supply side/ seasonal factors whereas monetary policy instruments impact the demand side. Food inflation is difficult to predict at best times; in difficult times, food inflation goes through the roof. Scorching heat and consequently, rising summer prices could throw a spanner in the works of an effective inflation containment strategy.

The Reserve Bank projected retail inflation at 4.2% for FY26 while retaining the forecast for FY25 at 4.8%. Hence constant vigil on inflation is needed.

Transmission Mechanism-How Much and How Fast?

This rate cut made borrowing cheaper for individuals and businesses, particularly in interest-rate segments like home loans, consumer loans, education loans, vehicle loans, etc. SBI lowered its home loan rates by 25 bps, bringing its external benchmark lending rate (EBLR) down to 8.90 %. PNB did likewise with cuts across home, car, and personal loans. Similarly, Bank of Maharashtra reduced retail lending rates and waived processing fees. Deposit rates were also lowered. DCB Bank, Shivalik Small Finance Bank, Ujjivan Small Finance Bank, and Suryoday Small Finance Bank reduced fixed deposit (FD) rates by up to 65 bps. While regular depositors face lower returns, senior citizens continue to get attractive rates, with some banks still offering FD returns of 9 %.

Impact

This measure together with the budgetary provisions will enhance consumption and discretionary spending with multiplier effects. However, there are concerns about higher import costs because of imminent currency depreciation and potential inflationary pressures impacting industry pricing and profitability.

Other Policy Measures

The Policy had other contextually significant measures like the introduction of the 'bank.in' exclusive Internet Domain for Indian banks to reduce cyber security threats and malicious activities like phishing, and streamline secure financial services; introduction of Forward Contracts in Government Securities to facilitate long- term investors such as insurance funds to manage their interest rate risk across interest rate cycles and efficient pricing of derivatives that use Government securities as underlying instruments; Negotiated Dealing System-Order Matching (NDS-OM) facility to be extended towards SEBI registered non-bank brokers; and review of trading and settlement timings across various market segments.

Future Policy Move

The RBI retained its "neutral" policy stance because of the "*uncertain global backdrop and volatile global financial conditions*" and stayed "*unambiguously focussed on a durable alignment of inflation with the target, while supporting growth*".

We see two rate cuts cumulatively aggregating 50 bps in FY 26 with another 25 bps rate cut in April 2025 because of languishing growth concerns, the RBI's higher forbearance to Rupee depreciation, and southward inflation to 4 % without any disruptive supply shock. "*Elevated real policy rates*" however, emerge as a manifest concern because real policy rates measured as Repo rate minus core CPI inflation exceeded 2.5 % for the last year, which slowed investment growth. CS