Infomerics Ratings

Infomerics Valuation And Rating Ltd.

SEBI REGISTERED / RBI ACCREDITED / NSIC EMPANELLED
CREDIT RATING AGENCY

Dr. Manoranjan Sharma
(Chief Economist)

# RBI'S FEBRUARY 2025 POLICY - RIGHT CALL, GOVERNOR!

**28 February 2025**

"*Monetary policy is like juggling six balls... it is not 'interest rate up, interest rate down.' There is the exchange rate, there are long-term yields, there are short-term yields, there is credit growth*". Raghuram Rajan

RBI's February 2025 Policy, which was entirely in conformity with our expectations articulated in multiple sections of the print and electronic media, was formulated against the backdrop of the global setting of "*divergent and uncertain*" growth of 3.3 per cent both in 2025 and 2026 and global headline inflation of 4.2 per cent in 2025 and 3.5 per cent in 2026, the Russia-Ukraine war, and the uncertainty in the Middle East. To be sure, achieving central bank inflation targets is a protracted and multiyear process. There are, however, possibilities for "*significant progress*" in 2025.

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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*" (IMF, WEO, January 2025). This is a tall order because of geopolitical risks, President Donald Trump's accent on tariffs, growing protectionism, currency volatility, and checking inflationary impulses while raising growth.

## Sluggish Macro Backdrop and Policy Action

"*Looking past the immediate crisis, a more resilient system must be built on stronger and better-designed shock absorbers, both in the major institutions and in the infrastructure of the financial system*". Timothy Geithner

Domestically, India's GDP is expected to decline to 6.4 per cent 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 in the wake of 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 per cent. Heightened global uncertainty and elevated spillover risks hamper the revival of stock markets, *inter-alia* because of subdued Q3 corporate earnings.

Without detracting from the significance of inflation targeting and macroeconomic stability, the MPC cannot be oblivious to the concern of growth. 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 basis points (bps) from 6.5 per cent to 6.25 per cent.

The current Repo rate is 6.25 per cent while the Reverse Repo rate stood unchanged at 3.35 per cent. The Bank rate and the Marginal Standing Facility (MSF) rate decreased to 6.50 per cent from 6.75 per cent. The Standing Deposit Facility Rate also decreased from 6.25 per cent to 6.00 per cent.

Mixed signals, as highlighted by the RBI Governor, 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 in quick succession will provide tailwinds to the macroeconomy. This changing scenario provided the MPC space to focus on reviving underwhelming growth.

As the RBI Governor Mr. Sanjay Malhotra justifiably pointed out "*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. This will provide MPC the flexibility to respond to the evolving macroeconomic environment*".

## Banking System

"*As financial markets continue to broaden and deepen, the behavior of asset prices will play an important role in the formulation of monetary policy going forward, perhaps a more important role than in the past*". Timothy Geithner

Strong RBI measures, regulatory warnings, and "*moral suasion*" tempered personal loan growth from 15.2 per cent in September to 13.7 per cent 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 per cent, with term deposits rising significantly.

Private banks pruned CD ratios amid tight liquidity and banks intensified their efforts to enhance their liability franchises by offering higher rates on term deposits in FY 26. Private lenders 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 ₹ 1.5 lakh crore to change the liquidity deficit banking ecosystem on top of ₹1.16 lakh crore of liquidity infusion in December 2024 because of 50 bps reduction in cash reserve ratio (CRR).

## Inflation

"*My bottom line is that monetary policy should react to rising prices for houses or other assets only insofar as they affect the central bank's goal variables - output, employment, and inflation*". Janet Yellen

The Flexible Inflation Targeting Framework (FITF) was introduced in India post the amendment of the Reserve Bank of India (RBI) Act, 1934 in 2016. Per the RBI Act, the Government of India sets the inflation target every 5 years after consultation with the RBI. The Government mandated the RBI to fix the policy rate to maintain the Consumer Price Index (CPI) (it corresponds to a basket inclusive of food, fuel, manufactured goods, and select services) within the target range of 4 per cent (+/- 2 per cent).

Inflation fell steadily to a four-month low of 5.22 per cent in December, down from 5.48 per cent in November and 6.21 per cent in October. Food inflation, which weighs around 40 per cent in CPI, is impacted predominantly by supply side/seasonal factors whereas monetary policy instruments work on 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 RBI projected retail inflation at 4.2 per cent for FY26 while retaining the forecast for FY25 at 4.8 per cent. Hence constant vigil on inflation is needed.

## Transmission Mechanism - How Much and How Fast?

Banks slashed lending and deposit rates. This rate cut was passed to the borrowers, particularly in the interest-rate segments like home loans, consumer loans, education loans, vehicle loans, etc., and thus made borrowing cheaper for individuals and businesses. State Bank of India (SBI) lowered its home loan rates by 25 bps, bringing its external benchmark lending rate (EBLR) down to 8.90 per cent. Punjab National Bank (PNB) followed suit with cuts across home, car, and personal loans.

Similarly, Bank of Maharashtra (BoM) reduced retail lending rates and waived processing fees to attract borrowers. 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 receive attractive rates, with some banks still offering FD returns close to 9 per cent.

## 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 pricing and profitability in the industry.

## 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*". A neutral stance suggests policy flexibility to respond to changing scenarios and further rate cuts in FY 26.

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 inflation moving south to 4 per cent without any disruptive supply shock. We see the policy rate settling at 5.75 per cent by the end of FY 26. "*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 per cent for the last year, which slowed investment growth.