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RBI FEB'25 MONETARY POLICY: WILL THE RATE SOFTEN?

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The beginning of the month February, in the new year 2025 remains full in fascinating events. Just after the announcement of the Union Budget 2025, the RBI monetary policy is awaited on 7 Feb'25, with market expectation of a 25-bps rate cut amid heightened borrowing costs and subdued growth. The shifted policy focus towards the middle-class consumers in the Union Budget'25 and the recent RBI liquidity measures have ignited the expectations for a further boost for the economy by softening the policy rate.

Nonetheless, the global scenario remains somewhat hostile as on 3 Feb 2025, global markets reacted negatively after Trump's tariff threats, with Asian stocks falling sharply. Initially, Trump threatened to impose a 25% tariff on imports from Canada and Mexico and an additional 10% tariff on Chinese imports.

However, the subsequent news that the Mexican tariffs were postponed for one month following the conversations between Trump and Mexican President Claudia Sheinbaum helped markets regain some composure. Canada has also managed to postpone US tariff for one month following some temporary agreement. The illegal immigration and fentanyl trafficking remain the bone of contention.

On the other hand, the heat is very much sustained between US and China, and going forward, tariffs would dominate in shaping economic expectations. The potential inflationary impact with strong US economic data may undermine the Fed rate cut expectations.

Despite calling India a 'tariff king', Trump's top hit list would not immediately include India, rather the European Union (EU) seems to be the next on the firing line with Trump saying, "the US will definitely impose trade tariffs on the EU." But this cannot be the solace for India since substantial uncertainty would prevail in future from a volatile Trump.

After previously crossing the 86 marks, the Indian rupee has crossed the 87 (USD/INR) nominal exchange rate by settling at 87.12.

Date	USD	GBP	EURO	YEN
04/02/2025	87.1206	108.0081	89.7011	56.1100
03/02/2025	87.1162	107.0490	89.2674	56.0500
31/01/2025	86.6414	107.6202	90.0094	55.9600
30/01/2025	86.5842	107.6848	90.1821	55.9900
29/01/2025	86.5768	107.8493	90.3896	55.7600
28/01/2025	86.5358	107.6782	90.3347	55.5700
27/01/2025	86.4175	107.6439	90.4031	55.3300
24/01/2025	86.2904	107.0887	90.2149	55.5900
23/01/2025	86.4593	106.4798	89.9897	55.2300
22/01/2025	86.5661	106.7031	90.0807	55.5200

Source: RBI.

The RBI is facing a classic phenomenon of the "impossible trinity" that implies that a Central Bank (CB) cannot maintain three things at the same time -independent monetary policy, exchange rate stability and open capital account. The RBI intervenes time to time to protect the downward pressure on the rupee, that takes away the monetary policy autonomy and vice versa. Nevertheless, the decline in rupee is largely due to the strengthening of the US dollar index that takes a toll on the emerging market (EM) currencies. Moreover, rupee needs to decline at the point to stabilise the overvalued real effective exchange rate (REER).

The current scenario is ripe with both optimistic and pessimistic factors in favour of the rate cut. On the optimistic front, the vegetable inflation softened and likely to be range-bound. Further the borrowing costs are elevated, and RBI has recently taken measures to inject liquidity in the system to ease the fund crunch. The budget has also tried to augment aggregate demand by focusing to incentivise the middle-class. Such measures are necessary given the weak GDP growth.

The RBI is continuously trying to ease liquidity situations via several measures started from reducing CRR and then VRR, OMO etc. The RBI's change in stance in the last monetary policy is also an indicator that the central bank is in favour of rate softening.

On the other hand, there are some caveats, so if we consider the pessimistic factors, there is a fear of imported inflation due to the Trump's tariffs. However, such pessimistic fears are somewhat overvalued since, India is not immediately in the hit list of Trump, who is more concerned with China, Mexico, and Canada.

Moreover, Indian exporters are eyeing more markets in US due to US-China trade war, where electrical machinery, auto components, mobile, pharma, chemicals, apparel, and fabrics are the top beneficiaries according to exporters feedback survey. China has already reduced their soyabean and aircraft imports from US, where countries like Vietnam is increasing their share in exportable to US. India could also enhance their share in US exportable. India has already reduced customs duties on motorcycles and automobiles from US, whereas such policies would help improving trade relations with US.

Therefore, considering the above factors, market is keeping their fingers crossed for a rate softening in the imminent monetary policy of the RBI. There is also possibility of announcement of certain supportive measures regarding liquidity and regulatory aspects.