Economics

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RBI: Focus shifts to bolstering growth

7 February 2025

Key takeaways: Against the backdrop of weakening domestic growth momentum and an uncertain global macroeconomic environment, the RBI's Monetary Policy Committee (MPC) today, cut the repo rate by 25bp to 6.25%, in line with our expectations. A Neutral policy stance was retained, reflecting likely concerns over the Rupee's depreciation (of more than 2% this calendar year to date). The tone of the policy was neutral, but Governor Sanjay Malhotra's remarks regarding deferred implementation of macro-prudential draft guidelines, such as ECL, LCR and project finance, suggest the current RBI dispensation is likely to be more pragmatic and consultative. <u>We expect the MPC to cut the repo rate by another 50bp this easing cycle and expect continued measures, such as OMO purchases and FX swaps, to address systemic liquidity</u> vs Cash Reserve Ratio cuts. <u>Peaking of macro-prudential tightening momentum, RBI's readiness to provide liquidity and measures taken in the Budget (tax rebate and higher tax deduction limit on Senior Citizen's interest income) bodes well for the NBFC sector.</u>

Balance tilts toward supporting growth: The RBI MPC was of the view inflationary pressures are on a decline as the concerns on food inflation are easing. This has opened policy space for the MPC to undertake growth-supportive measures (rate cuts and liquidity operations). While the neutral stance suggests data dependency, the post policy conference and Governor's opening remarks suggest that the RBI is taking comfort from reducing inflationary risks, notwithstanding Rupee depreciation.

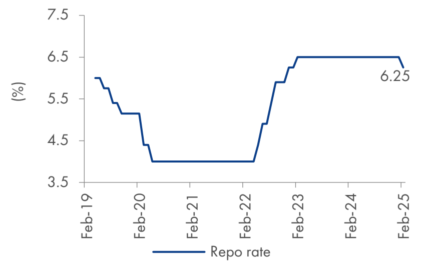
In FY26, based on the trajectory the RBI has provided for inflation, we conclude that in all likelihood, in the absence of huge shocks, inflation will likely be on a receding trend. We expect FY26E CPI inflation to average ~4.5%, barring any unforeseen supply shocks, a tad higher than RBI's own estimate of 4.2%. With growth likely to undershoot RBI's FY26E estimate of 6.7% (Elara estimate of 6.4%), we anticipate another 50bp rate cut. We however do not rule out another 25bp rate cut towards end-FY26E (overall 100bp) if growth risks rise incrementally and inflation risks remain tepid.

Growth optimism and ebbing inflation risks: The RBI projects FY26 growth at 6.7% YoY vs our estimates of 6.4%, while lowering Q1-Q2 estimates by 20bp and 30bp to 6.7% YoY and 7% YoY, respectively, vs December 2024 projections. RBI remained positive on growth drivers, led by uptick in private consumption demand in the backdrop of tax cuts, healthy agricultural activity bolstering rural demand, and external demand buoyed by services exports. Global risks, however, continue to impart uncertainty into FY26 growth outlook, as per the RBI.

On the inflation side, the RBI held its confidence that food inflation is likely to subside, aiding in moderation in headline inflation owing to healthy *Kharif* production and favorable seasonality leading to lower vegetable prices, and a healthy sowing outlook for the *Rabi* crop. The RBI retained FY25 CPI at 4.8% YoY matching our estimates of 4.8% and expects FY26 CPI at 4.2% YoY vs our estimates of 4.5% with Q1 at 4.5%, Q2 at 4.0%, Q3 at 3.8%, and Q4 at 4.2%. For FY26 RBI projected a much lower CPI inflation of 4.2%.

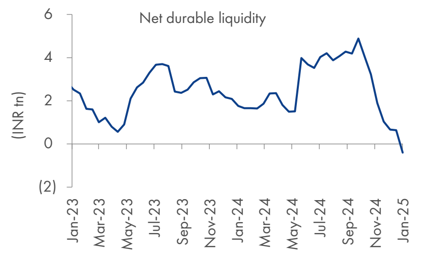
No decision on liquidity today but guidance comforting: The RBI recognized the liquidity strain in the system on the back of advance tax payments, capital outflow, and forex operations. While the market was disappointed with regards to lack of any new measures for liquidity infusion, the post policy statements of the Governor offered succor, as it acknowledged the need to be responsive to the needs of the banking system and indicated readiness to act when required. The deferred implementation of LCR guidelines is a net positive for banking sector which is already constrained by higher cost of funds. We expect the RBI to continue to be proactive in providing liquidity through open market purchases and term Variable Rate Repo auctions (VRRs). The weighted average call rate was ~6.5% as on 6 February vs ~6.6% a month ago.

MPC's first rate cut after five years



Source: CEIC, Elara Securities Research

Liquidity in the system has been in deficit



Note: data as on 10 January 2025; Source: CEIC, Elara Securities Research

RBI downgrades FY26 Q1-Q2 growth projections...

Period (%)	MPC Dec-24	MPC Feb-24
Q1FY26	6.9	6.7
Q2FY2	7.3	7.0
Q3FY26		6.5
Q4FY26		6.5
FY26		6.7

Source: RBI, Elara Securities Research

...but remains upbeat on inflation risks ebbing

Period (%)	MPC Dec-24	MPC Feb-24
Q4FY25	4.4	4.4
FY25	4.8	4.8
Q1FY26		4.5
Q2FY26		4.0
Q3FY26		3.8
Q4FY26		4.2
FY26		4.2

Source: RBI, Elara Securities Research

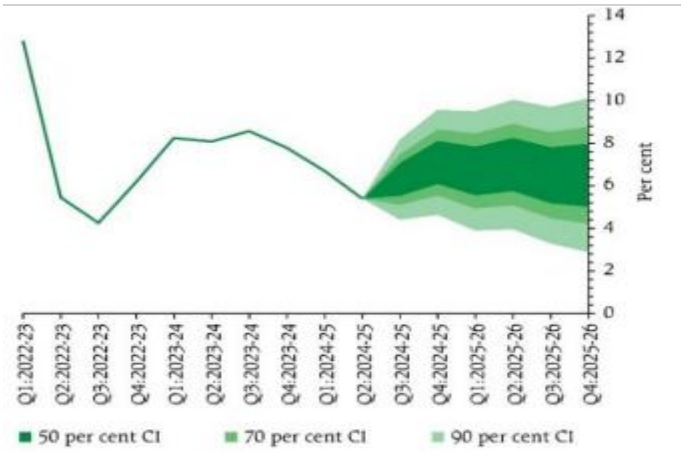
Garima Kapoor
Economist
+91 22 6164 8527
garima.kapoor@elaracapital.com

Associates
Subhankar Sanyal
Shweta Roy

Monetary Policy Outlook – we expect another 50bp cut in FY26E: We expect the MPC to cut the repo rate by another 50bp in FY26E with a total of 75bp rate cut in this easing cycle. We expect FY26E GDP growth of 6.4% vs RBI's 6.7%. As food inflation pressures ease durably, headline inflation is likely to be closer to 4.5% in our view, giving the MPC space to address growth concerns. We also price in moderation in momentum of macro prudential policy tightening in FY26, a move that may be growth supportive.

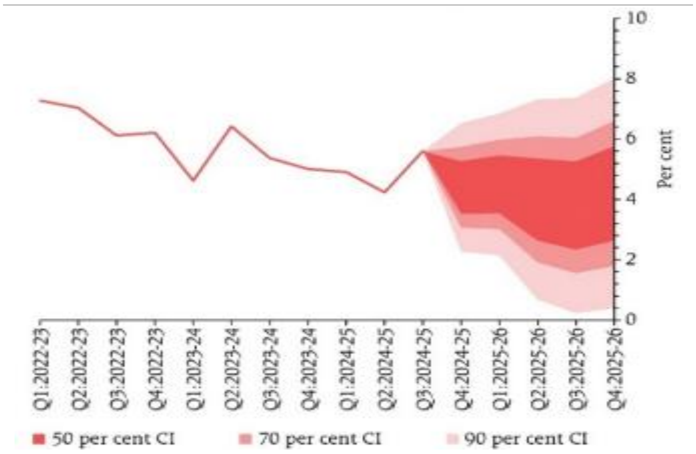
The key risk to FY26 projections emerges from global backdrop especially on the trade front. Rising tariff incidences, continued geopolitical risks, and their spillover on global monetary policies, divergent Bank of Japan monetary policy vs Developed Markets (DM) peers are the key factors that warrant attention. If the global central banks (mostly Western DM central banks) fail to deliver the projected rate cuts in CY25 due to inflationary impulses, spillover on Emerging Markets (EM) financial conditions is likely to tie the hands of EM central banks including the RBI.

Exhibit 1: Quarterly GDP projection; FY26 at 6.7% YoY



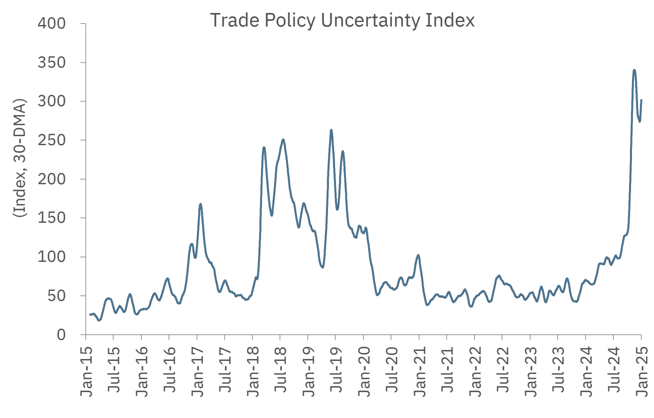
Source: RBI

Exhibit 2: FY26 CPI projected at 4.2% YoY



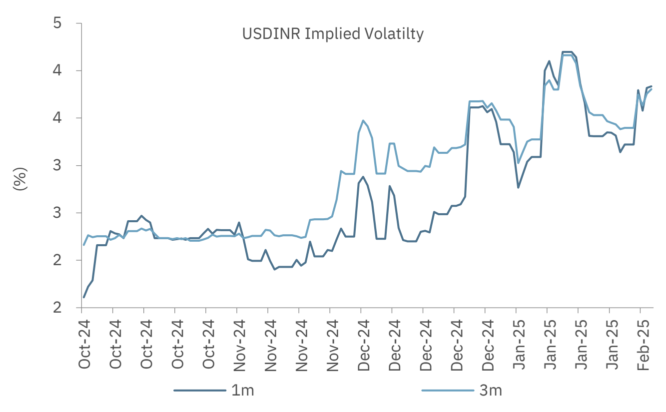
Source: RBI

Exhibit 3: Trade risks increase multifold



Source: Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2020), "The Economic Effects of Trade Policy Uncertainty," Journal of Monetary Economics, 109, pp.38-59, Elara Securities Research

Exhibit 4: USD-INR volatility on an uptrend



Note: Data until 6 February 2025; Source: Bloomberg, Elara Securities Research

Exhibit 5: Additional measures related to developmental and regulatory policies

Introduction of forward contracts in Government securities	Forward contracts will enable long-term investors, such as insurance funds, to manage their interest rate risk across interest rate cycles. They will also enable efficient pricing of derivatives that use bonds as underlying instruments
Access of SEBI-registered non-bank brokers to Negotiated Dealing System – Order Matching (NDS-OM)	To widen access in the secondary market transactions in government securities, it has been decided that non-bank brokers registered with SEBI can directly access NDS-OM, on behalf of their clients. These brokers may access NDS-OM subject to the regulations and conditions laid down by the Reserve Bank
Comprehensive review of trading and settlement timings across various market segments	It has been decided to set up a Working Group with representation from various stakeholders to undertake a comprehensive review of trading and settlement timing of financial markets regulated by the Reserve Bank. The Group is expected to submit its report by April 30, 2025
Enhancing Trust in the Financial Sector through 'bank.in' and 'fin.in' domains	RBI is introducing the 'bank.in' exclusive Internet Domain for Indian banks. This initiative aims to reduce cyber security threats and malicious activities like phishing, and, streamline secure financial services, thereby enhancing trust in digital banking and payment services
Enabling Additional Factor of authentication in cross-border Card Not Present transactions	It is proposed to enable AFA for international card not present (online) transactions as well. This will provide an additional layer of security in cases where the overseas merchant is enabled for AFA. Draft circular will be issued shortly for feedback from stakeholders
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Source: RBI, Elara Securities Research

Appendix

ECL = Expected Credit Loss

LCR = Liquidity Coverage Ratio

OMO = Open Market Operations

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Managing Director	**Harendra Kumar** | harendra.kumar@elaracapital.com | +91 22 6164 8571
Head of Research	**Dr Bino Pathiparampil** | bino.pathiparampil@elaracapital.com | +91 22 6164 8572

Sales Team

India	**Hitesh Danak** - hitesh.danak@elaracapital.com - +91 22 6164 8543 **Ashok Agarwal** - ashok.agarwal@elaracapital.com - +91 22 6164 8558
India, APAC & Australia	**Sudhanshu Rajpal** - sudhanshu.rajpal@elaracapital.com - +91 22 6164 8508 **Joshua Saldanha** - joshua.saldanha@elaracapital.com - +91 22 6164 8541 **Shraddha Shrikhande** - shraddha.shrikhande@elaracapital.com - +91 22 6164 8567
India & UK	**Prashin Lalvani** - prashin.lalvani@elaracapital.com - +91 22 6164 8544
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