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RBI Shifts Focus to Growth, Cuts Repo Rate by 25 bps for the First Time in Nearly Five Years

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- As expected, the RBI's Monetary Policy Committee (MPC) unanimously decided to reduce the policy repo rate by 25 bps to 6.25%, marking the first rate cut since May 2020.
- The RBI Governor highlighted that inflation has declined and is expected to moderate further, while economic growth will recover but remain much below last year's level.
- The RBI projects headline inflation to moderate to 4.2% in FY26 from 4.8% in FY25. It estimates economic growth to improve slightly to 6.7% in FY26 from 6.4% in FY25 as per the First Advance Estimates.
- These growth-inflation dynamics provide policy space for the MPC to support growth while staying focused on aligning inflation with its target. It felt a less restrictive monetary policy is more appropriate at the current juncture.
- The MPC also decided to maintain a neutral policy stance, focusing on aligning inflation with the target while supporting growth and providing flexibility to adjust rates should the economic or inflation conditions worsen.
- On liquidity management, the RBI did not announce any additional liquidity measures and kept the Cash Reserve Ratio (CRR) unchanged at 4%. The RBI had earlier announced a series of measures to ease the liquidity pressures in January.
- Further, the RBI reassured that it remains committed to ensuring sufficient system liquidity and will proactively take appropriate measures to maintain orderly liquidity conditions. We believe the RBI will need to inject additional liquidity in the coming months, as systemic liquidity could worsen without further interventions.
- The governor's remarks on the need to strike the right balance between stability and efficiency in regulations suggest that the RBI will take a pragmatic and calibrated approach to regulatory norms implementation.
- Accordingly, the RBI has extended the implementation of the proposed changes to the liquidity coverage ratio (LCR) norms by at least 12 months, which will help support liquidity management in the near term.
- We anticipate a shallow rate-cut cycle, with another 25-bps reduction, possibly in April. However, the exact timing of the next cut will depend on evolving data, growth conditions, and the global trade environment.

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RBI delivers the first rate cut in nearly five years

As expected, the RBI's Monetary Policy Committee (MPC) unanimously decided to reduce the policy repo rate by 25 bps to 6.25%, marking the first rate cut since May 2020. *As a result, the standing deposit facility rate and marginal standing facility rate have been adjusted to 6.00% and 6.50%, respectively, with immediate effect. The Cash Reserve Ratio has been left unchanged at 4%.* While the RBI did not announce any additional liquidity measures in today's policy statement, the RBI Governor reassured that the central bank remains committed to ensuring sufficient system liquidity. Further, the RBI extended the implementation of the proposed changes to the liquidity coverage ratio (LCR) norms by at least 12 months, which will support liquidity management in the near term.

The governor highlighted that inflation has declined and is expected to moderate further, while economic growth will recover but remain much below last year's level. Inflation moderated in December, driven by improving food inflation, while core inflation remains contained. The outlook supports further moderation in inflation, underpinned by healthy Kharif production and Rabi sowing tracking above last year's levels. Meanwhile, real GDP growth disappointed in Q2, mainly due to a slowdown in consumption and investment spending. High-frequency indicators suggest improvement in government capital spending, but consumption-related indicators have yet to show a broad-based pick-up. ***These growth-inflation dynamics have created policy space for the MPC to support growth while staying focused on aligning inflation with the target.*** The RBI also considered the depreciating rupee and its inflationary implication when deciding on the rate cut and stance. However, it also raised concerns about global uncertainties and their implications for growth, investment, and consumption.

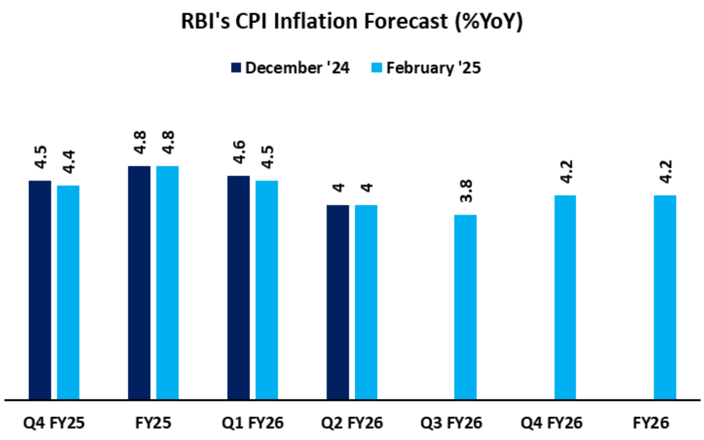
Market Reaction: While the rate cut was in line with expectations, the absence of additional liquidity measures led to a modest increase in G-sec yields post the policy announcement. The rupee was range bound, trading around 87.5 level against the USD.

Neutral policy stance aligns with expectation of a shallow rate cut cycle

The MPC unanimously decided to continue with the neutral stance and remain unambiguously focused on achieving a durable alignment of inflation with the target while supporting growth. This aligns with our expectation of a shallow rate cut cycle. Moreover, volatility in global financial markets, uncertainties in global trade policies, and adverse weather events pose risks to growth and inflation. This stance provides the RBI with the policy space to shift gears should the economic or inflation outlook worsen, especially amidst ongoing concerns regarding the global trade war.

Given the RBI's estimate of the neutral real rate of 1.4%-1.9%, we believe the policy space for additional rate cut is limited. Using the RBI's estimate of a neutral real rate and inflation projection of 4.2% for FY26, this would imply policy space of around ~65 bps (based on average policy space of 40-90bps), out of which 25 bps has been announced today. ***We anticipate a shallow rate-cut cycle, with one more 25 bps reduction, possibly in April. However, the exact timing of the next cut will depend on evolving data, growth conditions, and the global trade environment*.**

RBI projects inflation to moderate to 4.2% in FY26 from 4.8% in FY25

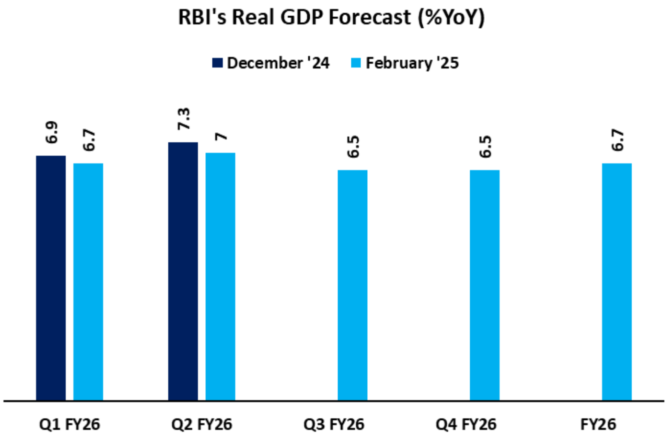


Source: RBI; Note: December '24 and February '25 refer to projections given by the RBI in its December 2024 and February 2025 MPC updates, respectively.

The RBI revised its forecast for headline inflation slightly in Q4 FY25 to 4.4% from 4.5% earlier, likely driven by a decline in food prices. We expect inflation in January to print around 4.6% (vs 5.2% in December) due to an expected sharp fall in vegetable prices and moderation in pluses prices, partly offset by higher edible oil prices. The RBI expects headline inflation to moderate further in FY26 to 4.2%, with Q1 at 4.5% (revised down from 4.6%), Q2 at 4.0%, Q3 at 3.8%, and Q4 at 4.2%. This moderation is expected to be driven by healthy Kharif production and favourable Rabi crop prospects. Meanwhile, core inflation has likely bottomed out and is expected to gradually move upwards. That said, inflationary risks remain. The governor's statement highlighted that rising uncertainty in global financial markets, coupled with continuing volatility in energy prices and adverse weather events, pose an upside risk to inflation.

Turning to growth, the RBI acknowledged the slowdown in domestic growth with the First Advance Estimates (FAE), projecting FY25 real GDP growth at 6.4% YoY, compared to a growth of 8.2% YoY in FY24. Growth in H1 FY25 stood at 6.0%, with Q2 growth disappointing at 5.4%. High-frequency indicators for Q3 FY25 suggest a sequential recovery, with rising government expenditure, signs of milder recovery in corporate profitability, and expansionary PMI readings for the manufacturing and services sectors.

RBI projects FY26 growth at 6.7%, indicating moderate recovery



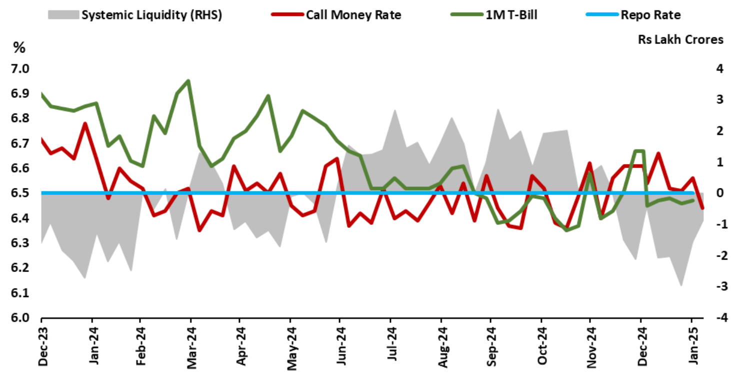
Note: December '24 and February '25 refer to projections given by the RBI in its December 2024 and February 2025 MPC updates, respectively.

On the consumption front, data has been mixed. Urban consumption is likely to remain subdued, while rural demand indicators continue to improve, supported by a thriving agriculture sector. According to Nielsen IQ data for Q3, FMCG sales volume grew by 7.1% (vs 3.9% in Q2), with rural sales volume once again outpacing urban counterparts (8.0% in Q3 vs 5% in Q3). The RBI expects consumption to improve amidst recently announced tax relief measures, improving employment conditions, and healthy prospects for agriculture. Investment is also expected to pick up, supported by healthy capacity utilization levels (74.7% in Q2 FY25 vs the long-term average of 73.8%) and the government's continued focus on capital spending. However, downside risks from global headwinds will persist. Overall, the RBI projects FY26 growth at 6.7%, with Q1 at 6.7% (6.9% earlier), Q2 at 7.0% (7.3% earlier), and Q3 & Q4 at 6.5%, respectively.

RBI commits to providing sufficient system liquidity

Liquidity deficit intensified in January, with the deficit crossing Rs 3 lakh crore in the third week of the month, compared to an average liquidity deficit of Rs 0.5 lakh crore in December. This was driven by the RBI's foreign exchange interventions, foreign capital outflows, fluctuations in currency in circulation, and tax advance payments in December. This occurred despite the CRR cut announced in the December policy, which injected Rs 1.2 lakh crore into the system. With tightening liquidity, the overnight call rate hovered above the policy rate for most of January. To alleviate these pressures, the RBI unveiled a series of measures to inject Rs 1.5 lakh crore—through OMO purchases, 6-month USDINR buy-sell swaps, and Long-term Variable Rate Repo (56 days)—in addition to the short-term VRR auctions to manage overnight liquidity. These measures helped ease liquidity pressures, with the liquidity deficit moderating to Rs 1 lakh crore in the first week of February. Looking ahead, liquidity is expected to continue facing pressures from foreign capital outflows, year-end demand, and the need for forex interventions. However, some of this pressure is likely to be alleviated through a potential rise in government spending.

Liquidity deficit improved in February after sharp widening in late January



Source: CMIE; Note: Data is till 6th February and weekly.

The RBI reassured its commitment to ensuring sufficient system liquidity and stated that it will proactively take appropriate measures to maintain orderly liquidity conditions. We believe the RBI will need to inject additional liquidity in the coming months, as systemic liquidity could worsen without further interventions. Ensuring sufficient liquidity is crucial for the effective transmission of rate cuts into lending rates. The governor further urged the banks to participate in overnight call money market instead of passively parking the funds with the RBI to ensure deeper and more vibrant market for better signal extraction from the WACR.

RBI to adopt a pragmatic approach to regulatory measures

Today, in the post-meeting press conference, ***the governor's remarks on the need to strike the right balance between stability and efficiency with regard to regulations and the resultant trade-offs suggest that the central bank will take a pragmatic and calibrated approach to regulatory implementation***. In this context, the governor stated that the RBI will extend the timeframe for implementing liquidity coverage ratio norms, as the previous deadline did not provide sufficient time. ***According to the fresh guidance, the new liquidity coverage ratio norms will not be implemented before March 31, 2026, and will be rolled out in a phased manner***. The draft norms proposed by the RBI included imposing an additional runoff factor of 5% on retail deposits enabled with internet and mobile banking facilities, which were initially slated for implementation from April 1, 2025. Further, the RBI also indicated that project finance norms and ECL norms are not likely to be implemented before March 31, 2026.

The RBI also announced the developmental and regulatory policy measures listed below:

Financial Markets & Cybersecurity

- **Introduction of forward contracts in government securities:** The RBI will introduce forward contracts in government securities to help long-term investors like insurance funds, manage interest rate risks and improve the pricing of derivatives linked to bonds.

- **Access of SEBI-registered non-bank brokers to Negotiated Dealing System – Order Matching (NDS-OM):** The RBI has decided to allow SEBI-registered non-bank brokers to directly access the NDS-OM platform, enabling them to facilitate secondary market transactions in government securities on behalf of their clients, subject to RBI regulations. At present, access to NDS-OM is available to regulated entities and to the clients of banks and standalone primary dealers.

- **Review of trading and settlement timings across various market segments:** The RBI has announced the formation of a working group to review the trading and settlement timings across various financial market segments, aiming for efficient price discovery and optimized liquidity. The group, with diverse stakeholder representation, will submit its report by April 30, 2025.

- **Enhancing trust in the Financial Sector through 'bank.in' and 'fin.in' domains**: To enhance trust in digital banking and payment services, the RBI is introducing the exclusive 'bank.in' domain for Indian banks to reduce cybersecurity threats and fraud. Registrations will begin in April 2025, and a similar domain, 'fin.in,' will be introduced for non-bank financial entities.

Payment Systems

- **Enabling Additional Factor of Authentication in cross-border Card Not Present transactions:** The RBI proposed to introduce Additional Factor of Authentication (AFA) for cross-border card-not-present (online) transactions to enhance security, aligning safety standards for online international transactions using cards issued with that for domestic payments. This will provide an additional layer of security in cases where the overseas merchant is enabled for AFA. A draft circular will be issued soon for stakeholder feedback.

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