RBI Maintains Status Quo on Policy Rates, Cuts CRR by 50 bps

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In its December 2024 meeting, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) maintained the policy repo rate and stance with a 4:2 majority. Notably, the majority in favour of maintaining the status quo fell to 4:2, from the previous 5:1 vote. However, the RBI has decided to reduce the cash reserve ratio (CRR) by 50 bps, aligning it with pre-pandemic levels, and thereby supporting systemic liquidity and money market rates. Adverse recent growth and inflation prints have led the RBI to adopt a "wait and watch" approach. While the RBI has reduced the FY25 growth projections downwards by 60 bps to 6.6%, closer to our expectation of 6.5%. CPI inflation projection was increased by 30 bps to 4.8%, in line with our projection.

Growth Projections Lowered Sharply

The GDP growth in Q2FY25 moderated sharply to a seven-quarter low of 5.4%, from 6.7% in the last quarter. The agriculture sector continued its recovery, and the services sector maintained its broad momentum. However, industrial growth faltered, slowing sharply to 3.6% in Q2 from 8.3% in Q1FY25. we expect the GDP growth slowdown to be temporary, with projected growth of 6.8% YoY in H2. The GDP growth is likely to pick up in the second half of the year as the government increases its capex spending, leading to an improvement in investment. Healthy agricultural production should further bolster rural consumption. The recent high-frequency indicators have shown some improvements. PV sales have risen by 0.9% YoY in October after contracting in the previous three months. Similarly, improvements were visible in tractor sales (22.4% YoY in October vs 3.7% YoY in September), diesel sales (8.7% YoY in October vs 3.0% YoY in September) and domestic air traffic (9.6% YoY in October vs 7.4% YoY in September).

RBI's Growth Outlook (%)					
	FY25	**Q3 FY25**	**Q4 FY25**	**Q1 FY26**	**Q2 FY26**
Dec-24	**6.6**	6.8	7.2	6.9	7.3
Earlier Oct-24	**7.2**	7.4	7.4	7.3	--

The RBI has revised its growth forecast for FY25 to 6.6% from its earlier projection of 7.2%. This is marginally higher than our GDP projection of 6.5% for FY25.

Inflation Projections Revised Upwards

Inflation pressures in the economy have risen sharply over the past couple of months. The CPI inflation increased to 6.2% in October, higher than RBI's upper tolerance level, driven by a sharp spike in food inflation. While core inflation remains benign at 3.7%, food inflation is the main source of apprehension. Within the food basket, inflation has remained high for vegetables, cereals, pulses and edible oil. Vegetable inflation specifically rose by a sharp 42% YoY in October. Just by excluding vegetables, headline inflation stands at 3.9% in October, staying below the 4% threshold for the past 10 months. Even core inflation has been largely benign averaging 3.4% over the past 6 months.

We expect food prices to ease in the coming months driven by seasonal corrections. Conditions remain conducive for rabi sowing with healthy reservoir levels and good soil moisture content from extended monsoons. As a result, we expect food inflation to moderate by the end of the fiscal year.

The central bank has raised its average inflation estimate for FY25 to 4.8% from its earlier estimate of 4.5%. This is in line with our inflation projection for FY25.

RBI's Inflation Outlook (%)					
	FY25	**Q3 FY25**	**Q4 FY25**	**Q1 FY26**	**Q2 FY26**
Dec-24	**4.8**	5.7	4.5	4.6	4
Earlier Oct-24	**4.5**	4.8	4.2	4.3	--

External Situation Remains Comfortable

Strong FII outflows to the tune of ~ USD 13 billion over the past couple of months have intensified pressure on the Indian rupee. Markets anticipate fewer Fed rate cuts now, as the new administration's proposed policies, such as tax cuts and higher tariffs, are likely to be inflationary. The US Federal Reserve is now expected to reduce policy rates by a further 25 bps in 2024 and by ~50-75 bps in 2025, lower than previous estimates. FII outflows and consequent RBI's intervention in the forex market have resulted in a USD 45 billion fall in forex reserves to USD 657 billion. However, India's external situation remains comfortable with sufficient forex reserve and a manageable current account deficit.

While volatility in the equity market may continue, FII inflows would be supported by passive inflows into the debt market following India's inclusion in major bond indices. To further strengthen capital inflows, the RBI has increased the interest rate ceiling on Foreign Currency Non-Resident Account (FCNR) deposits for maturities between 1 year and less than 3 years. Additionally, RBI expanded the FX-Retail platform to increase transparency in forex pricing. The RBI will continue to remain vigilant of external developments mainly on the geopolitical front as it may impact global supply chains and impact energy prices. The recent increase in global commodity prices in response to the stimulus measures announced by China is also a key monitorable. However, broadly commodity prices, including Brent Crude, are likely to remain subdued due to weak demand from China and anticipated increases in US petroleum production under the new administration.

Financial Stability and Liquidity Management

Systemic liquidity surplus averaged ~Rs 0.1 trillion in the last week of November, down from an average of ~USD 1.5 trillion over the past couple of months. As a result, the weighted average call money rate has risen sharply, nearing the MSF rate and averaging 6.7% at the end of November. Increased forex interventions, higher government cash balances with the RBI and seasonal fluctuations in currency circulation, have reduced systemic liquidity. Ongoing volatility in capital flows and future tax outflows can further tighten liquidity conditions. Hence, the RBI decided to cut the CRR rate. This would increase liquidity and cool down the money market rates, potentially adding ~ Rs 1.2 trillion to the systemic liquidity. This measure would reduce the deposit rates. We expect that the RBI will continue to remain nimble and flexible in its liquidity management ensuring favourable money market conditions. The RBI will continue to ensure ample liquidity is available to support the credit demand. This will also prepare the ground for a rate cut going forward. The Governor reiterated the significance of financial stability in ensuring the stability of long-term economic growth.

Way Forward

We expect RBI to go for a shallow rate of 50 bps in CY2025. CPI inflation is likely to moderate below 5% in Q1 CY2025 and that will provide the window for RBI to start the rate-cutting cycle. There is no denying that there are some concerns on the growth front and as RBI gets comfort on the food inflation front, they would initiate a shallow rate cut cycle.

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