7 February 2025

Sonal Badhan
Economist

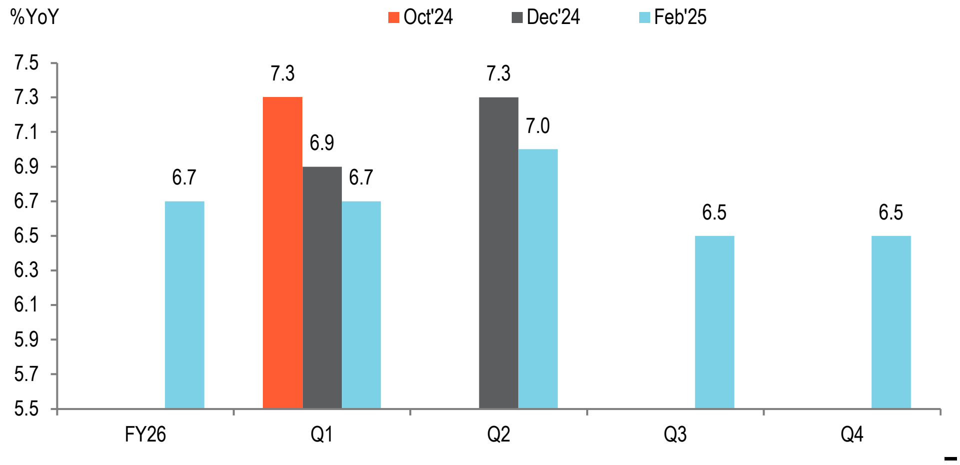
RBI delivers a rate cut

The MPC unanimously lowered the repo rate by 25bps from 6.5% to 6.25%. Stance was kept at neutral to allow the MPC flexibility on future path of policy action. RBI Governor noted the need for "less restrictive" monetary policy to support growth as inflation remains within RBI's targeted band (4-6%). The central bank expects growth to improve in FY26 to 6.7% from 6.4% in FY25. Inflation is projected to come down to 4.2% next fiscal year from 4.8% in FY25. CPI will remain broadly sticky in Q4FY25 (4.4%) and Q1FY26 (4.5%). These projections also take into account rupee volatility. From Q2 onwards, inflationary pressures are expected to ease significantly, giving room to RBI to lower rates further. We expect up to 75bps (cumulative) reduction in rates in this calendar year. At the time of next rate cut, we also expect change in stance from neutral to accommodative.

1st rate cut in 5 years: In line with our expectations, the monetary policy committee unanimously decided to cut repo rate by 25bps to 6.25% from 6.5%. Consequently, the SDF rate now stands at 6% and MSF at 6.5%. This is the first rate cut since Covid-19 period. Stance of the monetary policy was retained at neutral, also by a unanimous vote. On liquidity, the central bank has urged banks to lend in the un-collateralised call market, instead of parking that money with RBI.

GDP growth: Following 6.4% growth in FY25 (as per NSO's advanced estimates), RBI has projected 6.7% growth in FY26. Quarterly projections for Q1 and Q2 have been revised lower compared to the previous policy estimates. Growth in Q1 is now expected at 6.7% versus 6.9% in Dec'24 and in Q2 it will be at 7% versus 7.3% projected earlier. In Q3 and Q4 both, GDP is expected to expand by 6.5%. The central bank noted that healthy agriculture growth, lower inflation, boost to consumption through tax relief measures, and higher services exports will push growth higher in the next fiscal year. However, Governor in his statement also cautioned that only mild recovery is seen in corporate results of the manufacturing sector so far. Limited support will also be provided by government consumption expenditure, as centre's revenue spending (net of interest payments and subsidies) is expected to increase by 5% in FY26 (BE) versus 7.9% in FY25 (RE). Certain high frequency indicators in the services sector are also giving mixed signals regarding growth. Downside risks may emerge due to global headwinds.

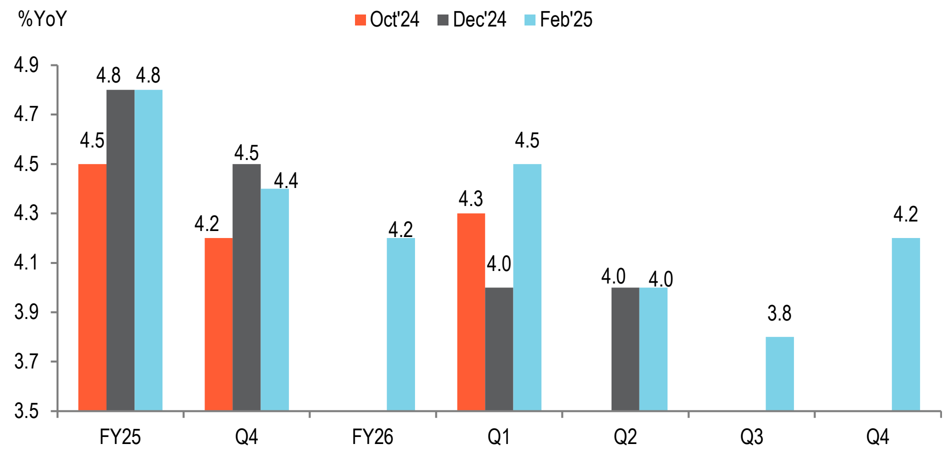
Figure 1: RBI expects 6.7% growth in FY26



Source: RBI, Bank of Baroda Research

Inflation projections retained: For FY25, RBI has held its inflation projection at 4.8% but sees significantly lower inflation in FY26 at 4.2%. In Q4FY25, inflation is estimated to come in slightly lower at 4.4% versus 4.5% expected earlier. In Q1, CPI is expected to remain sticky as it settles at 4.5% (50bps higher than what was estimated in Dec'24 policy). RBI Governor in the press conference clarified that these projections do incorporate the impact of imported inflation due to rupee volatility. From Q2 onwards, CPI will hit the lower end of RBI's targeted inflation band and will even fall below it in Q3. In the final quarter of FY26, inflation is estimated to inch back up, but will still remain near the lower end of RBI's band. The central bank stated that these projections have been made taking into account significant easing seen in vegetable prices, healthy water reservoir levels and bright prospects of Rabi sowing. However, upside pressures may emerge from volatility in global commodity prices and adverse weather conditions.

Figure 2: Headline CPI forecasts for FY26 at 4.2%



Source: RBI, Bank of Baroda Research

Key regulatory developments:

- Forward contracts have been introduced in government securities. This 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. This is expected to improve liquidity to some extent.

- SEBI-registered non-bank brokers (on behalf of their clients) will now be able to access NDS-OM platform. This decision has been taken to widen accessibility, which until now was available to regulated entities and to the clients of banks and standalone primary dealers.

- RBI will 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 will submit its report by 30 Apr’25.

- Keeping in mind cyber-security risks, RBI has introduced 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. Registrations for the same will begin from Apr’25. RBI also plans to have an exclusive domain—“fin.in” for other non-bank entities in the financial sector.

- RBI will introduce additional Factor of authentication (AFA) in cross-border Card Not Present transactions. This aims to provide safety for online international transactions using cards issued in India.

Outlook: As RBI embarks upon the rate cut cycle, it can be expected that more cuts are also on the cards, while the timing can be debatable. Cumulatively, we are pricing in 75bps cut in this calendar year. The April policy would review the economic situation and depending on the growth-inflation dynamics could opt for another cut or change in stance.

Disclaimer

Visit us at www.bankofbaroda.com

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
chief.economist@bankofbaroda.com