RBI Cuts Repo Rate by 25 bps, Maintains Stance at 'Neutral'

February 07, 2025 l Economics

In its February 2025 meeting, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI) reduced the policy repo rate by 25 bps to 6.25% and retained neutral stance unanimously. This decision to lower the policy rate comes amidst moderating growth momentum, increasing challenges from external factors, and a slowdown in inflationary pressures. The decision to retain the neutral stance will enable the RBI to adjust its policy according to the evolving macroeconomic conditions amid heightened uncertainty, especially from the external sector. In line with our expectations, the GDP growth for the upcoming year (FY26) is projected at 6.7%. However, the RBI anticipates a lower inflation rate of 4.2% for FY26, below our projections of 4.5%.

FY26 Growth Projected at 6.7%

In Q2 of FY25, GDP growth slowed to 5.4%, a decrease from 8.1% in the same period last year, mainly due to disruptions linked to the election period and unfavourable weather conditions. Consequently, the growth forecast for FY25 has been revised to 6.4% (First Advance Estimate). The concerning aspect has been a sharp deceleration in the investment growth and headwinds to consumption especially in the urban areas. For FY26, the RBI has projected a GDP growth of 6.7% with stronger rebound in H1 growth averaging 6.9% followed by an average growth of 6.5% in H2. RBI's growth projection for FY26 is in line with our projection.

Our analysis reveals a contraction in corporate profitability during H1 FY25. Early corporate results for Q3 FY25 remain mixed, showing marginal recovery at an aggregate level. Demand conditions are expected to improve with moderating inflation, income tax relief and healthy agricultural activity. While services exports have performed well, global headwinds from uncertainty in trade policies, geopolitical risks and volatility in financial markets continue to pose a challenge. High-frequency indicators present a mixed outlook on economic momentum.

The Economic Survey's estimate along with the RBI's projection show that below potential growth will likely continue into FY26 and hence the shift in the RBI's focus from inflation related concerns to growth is justified. Going ahead, the RBI will remain watchful of the global uncertainties and their impact on the Indian economy.

RBI's Growth Outlook (%)					
	FY26	**Q1 FY26**	**Q2 FY26**	**Q3 FY26**	**Q4 FY26**
Feb-25	**6.7**	6.7	7.0	6.5	6.5
Earlier Dec-24	**--**	6.9	7.3	--	--

FY25 Inflation Projection Retained at 4.8%, FY26 Inflation at 4.2%

In December, the CPI inflation moderated to 5.2% from 5.5% in November, primarily due to a slowdown in food inflation. The inflation rate for vegetables continued to ease, dropping to 26.6% in December from 29.4% in November. The arrival of fresh harvests has led to a seasonal correction in food prices. Good Kharif production has brightened the outlook of the inflationary environment along with good progress of rabi sowing. We expect food prices will continue to ease in the coming months driven by seasonal corrections. Healthy reservoir levels will also provide the essential cushion for Kharif sowing if the monsoon lags next year. Core inflation as well as WPI has remained benign so far. Even though WPI inflation is expected to remain at comfortable levels, we expect it to inch up marginally in the coming months as favourable base wanes. Just by only excluding vegetables, the CPI inflation stands at 3.9%, well below the RBI's target of 4%.

However, it will be essential to monitor the inflation in edible oil, as it can reduce the extent of disinflation in food basket. Contraction is rabi sowing of oil seeds and rise in global edible oil prices amid hike in customs duty can keep inflation in edible oils elevated. Furthermore, it will also be essential to closely monitor weather-related disruptions, such as heatwaves, whose frequency has increased in the recent years. RBI anticipates a lower inflation rate of 4.2% for FY26, below our projections of 4.5%. The RBI expects inflation to average 4.3% and 4%, respectively, in H1 and H2 FY26.

RBI's Inflation Outlook (%)					
	FY26	**Q1 FY26**	**Q2 FY26**	**Q3 FY26**	**Q4 FY26**
Feb-25	**4.2**	4.5	4.0	3.8	4.2
Earlier Dec-24	**--**	4.6	4.0	--	--

External Situation Remains Comfortable but Risks Remain

The current volatility in the financial markets, uncertainty regarding trade policy, and ongoing geopolitical risks have kept the external environment uncertain. Sustained FPI outflows and strengthening of the dollar index amid falling interest rate differential with the US have accentuated pressure on the Indian rupee. Since October, net FPI outflow stands at USD 21 billion. Recent data indicates that the RBI has taken a calibrated approach to loosen its control over the rupee, resulting in a gradual depreciation against the US dollar. The Governor has reiterated that the RBI will ensure orderly exchange rate movement, limiting its volatility, without targeting a specific number.

However, India's current account deficit remains comfortable with CAD, projected at 0.9% of GDP in FY25. Forex reserves remain sufficient despite the recent fall, covering ~10 months of merchandise imports. Going forward, monitoring the implementation of the trade and fiscal policies under the new administration in the US will be crucial, as these will play a key role in shaping market dynamics. Geopolitical risks also remain a key monitorable amidst the ongoing war in Ukraine and the Middle East. Risks of a trade war remain elevated, with the US recently imposing sanctions on key neighbouring countries and China. This could adversely impact trade and India's CAD in FY26.

Financial Stability and Liquidity Management

Systemic liquidity has remained in deficit during December-24 and January-25, leading to the weighted average call rate hovering near or above the MSF rate for specific periods over these months. Despite the CRR cut leading to an infusion of Rs 1.2 trillion in the December policy meeting, the systemic liquidity deficit has averaged Rs 650 billion and Rs 2 trillion in December and January, respectively. Increased forex interventions, advance tax payments, and seasonal fluctuations in currency circulation, have impacted liquidity conditions. On the liquidity front, the Governor has assured proactive measures ensuring comfortable liquidity conditions. We expect the RBI to continue upholding favourable money market conditions by elongating tenor and higher quantum of repo auctions, currency swaps, and OMO purchases. These liquidity measures should ensure a smoother transmission of rate cuts in the money market. The RBI to ensure ample liquidity is available to support the credit demand.

Regarding regulations aimed at promoting financial stability, the Governor emphasized that an effort would be made to strike the right balance, considering the benefits and costs of regulations. In the post policy interaction, the governor has stated that the proposed Liquidity Coverage Ratio (LCR) and the project financing norms will get implemented in a phased manner but not before 31st March 2026.

Way Forward

The RBI will continue to remain watchful of the global uncertainties and their impact on the domestic economy. The global trade war will adversely affect India's growth, inflation, and trade dynamics. However, there is still a lack of clarity on the extent of this impact. Sharp FII outflows and rupee weakening have further complicated the task for the RBI. However, moderating food inflation and benign core inflation will provide some comfort. The governor has stressed the 'flexible' aspect of the inflation targeting framework and improving forecasting models, plausibly signalling a more forward-looking approach towards the policy decisions. This will also prepare the ground for rate cuts in the future. We expect additional rate cuts of 25-50 bps in FY26, depending on how growth-inflation dynamics play out. Global factors and their implications for the domestic economy will be critical for RBI in FY26.

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