

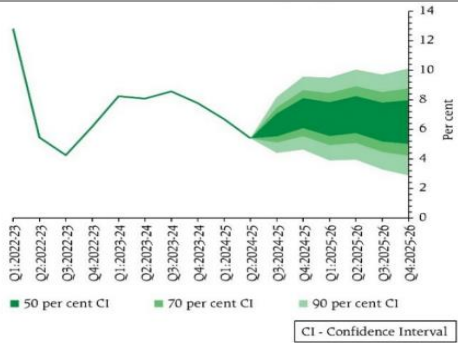
07 February 2025

## India Economy

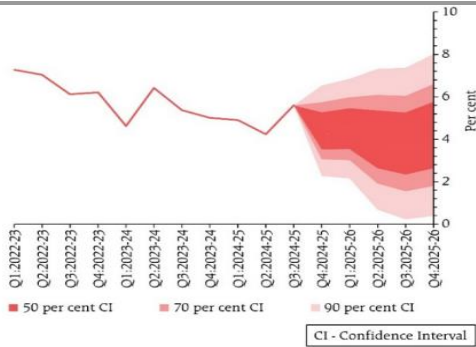
### RBI eventually cedes to rate-cut demand, but will it work?

#### RBI MPC REVIEW

#### Quarterly projection of Real GDP growth (YoY)



#### Quarterly projection of CPI Inflation (YoY)



With the 25bp rate cut, RBI finally relented to the growing demand from quarters that saw the earlier 6.5% policy rate as “very stressful”. It also relays the newfound perception that easing regulatory tightness will resuscitate growth. In our view, banking on counter-cyclical accommodation to address structural growth impediments will likely be ineffectual

**RBI onboard rate cut with a neutral stance:** With the 25bp repo rate cut to 6.5%, RBI finally relented to the growing demand from the government that saw the central bank’s intransigence responsible for causing India’s growth drag. Further signs of alignment are reflected in the governor’s remarks on the economic cost of regulation and the tradeoff between prudence and efficiency, echoing the sentiment from the recently announced Union Budget.

**Growth-Inflation projection mix hints at tentativeness:** RBI’s economic outlook guides for a moderate GDP growth revival, starting in 2HFY24 at 6.7% from 6% in 1H and followed by 6.7% in FY26. This is within the projections made by the Economic Survey of 6.3-6.8% for FY26.

Notwithstanding the guidance of a resilient economy, the projections reflect a sub-par performance relative to the perceived potential growth of over 7%. This is despite the expected moderation in the inflation trajectory. The average inflation for 4QFY25-2QFY26 has been scaled down by 10bp to 4.3% and the full year FY26 at 4.2% compares lower against 4.8% in FY25.

#### RBI’s hypothesis of growth revival lacks solidity:

- It underplays the risks from downscaling in government spending and global trade protectionism; sectors that were the major driver of the post-pandemic recovery.
- Given the tapering of sales and profit growth of Indian corporates in the past three quarters, assumptions of better compensation growth and private capex revival are optimistic.
- The implication of an income tax cut, translating into INR 1tn stimulus to the middle-income households in the formal sector can induce some urban consumption revival and leverage, but impacting just 0.5% of overall household consumption, its impact will be small and some of it can leak out by way of higher imports.
- The impact of tax sop to middle-income consumers can have impetus on retail inflation and so will the pass-through impact of recent currency depreciation on imported inflation and WPI.
- If the rate easing by the RBI induces a revival of retail lending, there can be an upside impetus to core inflation.
- Significantly, the assumption that food inflation will moderate even as core inflation rises is juxtaposed with the assumption of an improved supply of agri-produce, which is contingent on weather conditions and global agri-price trends, both of which are subject to high volatility.

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**RBI underplays global risks:** The RBI also tried to play down the risks from strengthening the US dollar, receding probability of significant US Fed easing with the view to douse concerns on the sharp depreciation in the INR/USD pair recently and criticism of following a rigid exchange rate regime. While the official stance remains, that India follows a flexible currency, the governor emphasized that RBI has a sufficiently large forex buffer to cover imports and bountiful remittance inflows. These assumptions are also conditional, as growth underperformance can translate into capital outflows and sustain the rupee depreciation, especially in the backdrop of the narrow 10-year India-US yield spread at 220bp, which can intensify with the 25bp rate cut announced today. The path towards our 90-92 levels for INR/USD can hasten.

**Transmission of policy rate easing less obvious:** The monetary policy refrained from elaborating on the peak level of credit-deposit ratio at 80.8% of banks, and the prospect of transmission of rate cut announced today. The likelihood of lending rates responding faster than deposit rates, in the context of sustained paucity of deposits implies that banks will see margins falling further.

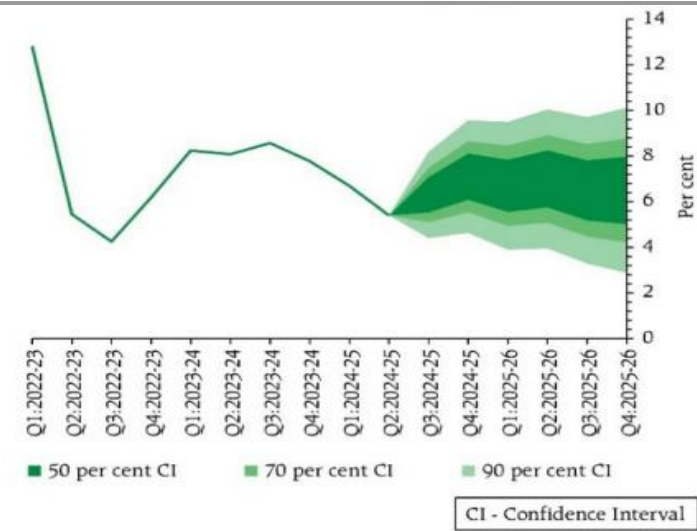
The impression that regulatory tightening on retail lending and the desired results have played out signal possible easing of regulatory rigour and revival in credit demand even at the peak level of CD ratio and household debt/personal disposable income at 52%. The imbalances in the banking sector, both with respect to limitations from peak CD ratio and asset quality can be sustained amid the change in regulatory and policy rate stance.

In sum, the embarking of the rate easing stance of the RBI reflects its acquiescence to the rising demand for monetary policy accommodation. However, there are a multitude of variables that indicate that the counter-cyclical easing may have been induced amid prevailing macro imbalances, which can lead to its ineffectiveness. The discordance between the perceived potential growth of 7%+ and effective lower levels implies that India's growth revival deserves structural policy redressal rather than counter-cyclical monetary easing.

#### **Market impact:**

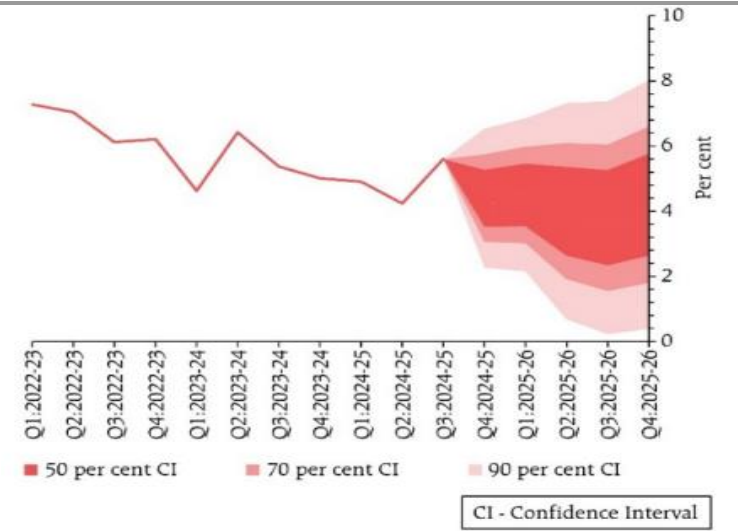
- a) A languid growth outlook portends that earnings growth for Indian companies may remain modest in FY26. The risk to growth is on the downside given the lack of solidity in RBI's projections.
- b) The combination of income tax sops, rate easing and possible relenting of regulatory tightness indicate policy attempts to shore up leveraged consumption again, particularly for middle-income earners. This could reflect in an improved outlook for consumer discretionary like Auto (bikes, entry-level cars), building materials, home decor etc.
- c) Maring pressure for banks can intensify as lending rates will likely respond to rate cuts even as deposit rates remain downward inelastic, scampering for deposits can intensify, and credit risk can get camouflaged and aggravated; adverse for BFSI.
- d) INR-USD can see quicker depreciation towards our target of 90-92; favourable for the export sector, and adverse for lenders.

Exhibit 1: Quarterly projection of Real GDP growth (YoY)



Source: RBI, Systematix Research

Exhibit 2: Quarterly projection of CPI Inflation (YoY)



Source: RBI, Systematix Research

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