

RBI's Policy Preview: Lower Inflation Paves the Way for Another Rate Cut

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MPC's Focus To Shift from Inflationary Concerns to Supporting Growth

The upcoming monetary policy meeting in April takes place amid a significant moderation in headline inflation over recent months, aided by lower food inflation. Inflation is expected to remain closer to the 4% target over the next three quarters. While growth momentum rebounded in Q3 FY25, with a 6.2% growth rate, up from 5.6% in Q2 FY25, it remains below potential. Moreover, external factors such as global policy uncertainty, risks from reciprocal tariffs, slower global growth, and geopolitical tensions will continue to pose challenges to domestic growth momentum.

Against this backdrop, we expect the MPC's focus to shift from concerns about inflation to supporting growth. As a result, the MPC is likely to continue the rate-cutting cycle that began in February, with another 25-basis-point reduction in the repo rate during the April MPC meeting, while maintaining a neutral stance amidst global headwinds. Furthermore, the policy statement is expected to prioritise liquidity management, as liquidity conditions have remained tight despite several measures implemented by the RBI to support liquidity. We expect the policy statement to have a dovish undertone, even while remaining cautious about global developments.

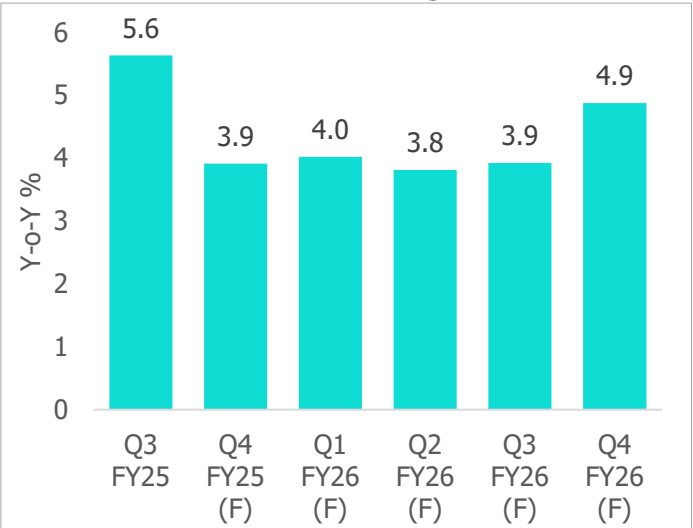
Moderating Inflation to Give Comfort to MPC

CPI inflation fell to 3.6% in February, marking the lowest level in seven months. The sustained decline in food and beverage inflation contributed to this lower inflation rate. Inflation in the food and beverages category decreased to 3.8% in February, down from a peak of 9.7% in October 2025, marking the lowest figure since May 2023. Vegetable inflation, a key driver of overall inflation, turned negative at -1.1 %, reversing the trend seen in the previous six months, where it averaged ~26%.

Additionally, deflation in pulses, at -0.3% compared to 2.5% the previous month, further supported the reduction in food inflation. The encouraging prospects for agricultural output, the arrival of fresh Rabi harvests, and comfortable reservoir levels are positives for food inflation. Healthy reservoir levels would also provide the essential cushion for Kharif sowing. However, inflation in edible oil, at 16.4%, remains a crucial factor to monitor, particularly given the contraction in oilseed sowing and the rise in global edible oil prices.

Core inflation remains comfortable at 4%, despite a slight uptick in recent months, driven by the lower base of last year. Overall, headline inflation is expected to remain within a comfortable range, closer to the 4% target, over the next few quarters (Exhibit 1), providing the RBI with the necessary flexibility to prioritise growth concerns. We expect the RBI to retain its FY26 CPI inflation projection of 4.2%. However, as highlighted by the

Exhibit 1: CPI inflation to Average 4.2% in FY26



Source: MOSPI, CareEdge

last Economic Survey, it will be essential to closely monitor weather-related disruptions, such as heatwaves, whose frequency has increased in recent years.

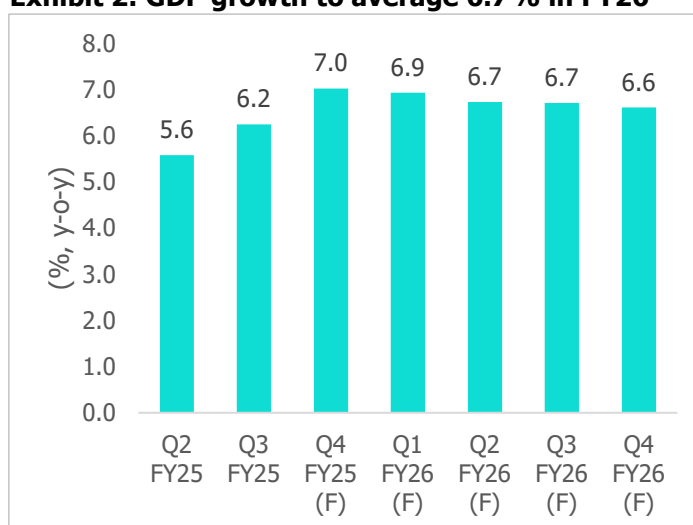
Globally, commodity prices have begun to rise, driven by a notable increase in industrial metal prices. In Q4 FY25, average Bloomberg's commodity price index recorded a growth of ~ 6.5%, reversing the 3.3% decline observed in the previous quarter. While average Brent crude prices fell by 8.8% in Q4, industrial metal prices surged by 6.9%, primarily driven by uptick in key base metals such as copper, aluminum, and tin. The WPI inflation increased slightly to 2.4% in February 2025, up from 2.3% in January, thereby remaining at a comfortable range. Going forward, global commodity prices are unlikely to pose a significant threat as global demand remains subdued. However, there remains risk of supply disruptions in midst of escalated geo-political conflicts. Recent depreciation of rupee against USD raises the risk of imported inflation, However, with domestic inflationary pressure subdued, RBI is likely to focus on supporting growth.

Growth Improves but Remains Below Par

The second advance estimates (SAE) of GDP growth, released by the National Statistical Office (NSO), projects India's real GDP growth at 6.5% for FY25, reflecting an upward revision of 10 bps from the previous estimates. However, 6.5% growth for FY25 looks ambitious, as that would imply a growth of 7.6% in Q4 FY25. We expect a growth of ~6.4% for FY25 with a growth of 7% in Q4. Festivities amidst 'Maha-Kumbh' celebrations in Q4 should also support consumption demand and sectors such as trade, hotel and transport. High Frequency indicators largely show improvement in certain segments of the economy. Rural economy continues to do well aided by robust agricultural activities, with fertiliser sales (-7.3% YoY in Q2 vs 6.1% YoY in Q3 FY25), domestic tractor sales (0.7% in Q2 vs 4.5% in Q3) and growth in centre's expenditure on agriculture (-21.2% in Q2 vs 1.2% in Q3) showing improvement. Improvement in central capex growth (10.3% in Q2 vs 72.7% in Q3) has supported growth in highway construction (6.5% in Q2 vs 11% in Q3). Growth in IIP Manufacturing (3.3% in Q2 vs 4.4% in Q3), GST collections (8% in Q2 vs 8.9% in Q3), petrol consumption (7.3% in Q2 vs 10.3% in Q3) and services exports (12.2% in Q2 vs 15.3% in Q3) also shown an uptick. Additionally, our analysis shows a recovery in the corporate performance for a sample of non-financial firms in Q3 FY25, following a contraction in H1 FY25.

However, the recovery remains uneven, with certain indicators such as merchandise exports, real estate sales, and credit demand continuing to show weakness. Merchandise exports have contracted for four consecutive months since November 2024, primarily due to a decline in Indian exports of refined petroleum. Stamp duty collections of major 21 states, as a proxy for real estate sales, also contracted by 17.3% in Q3. Additionally, a slowdown in retail loans and loans to the services sector has impacted non-food credit growth, which grew by 12.5% in January 2025, down from 16.2% in the same period last year.

Exhibit 2: GDP growth to average 6.7% in FY26



Source: MOSPI, CareEdge

While economic activity has improved compared to H1 FY25, it remains essential to assess whether the recovery is broad-based, and the recovery in the growth momentum sustains especially amidst global uncertainties. Factors such as recovering rural demand, lower tax

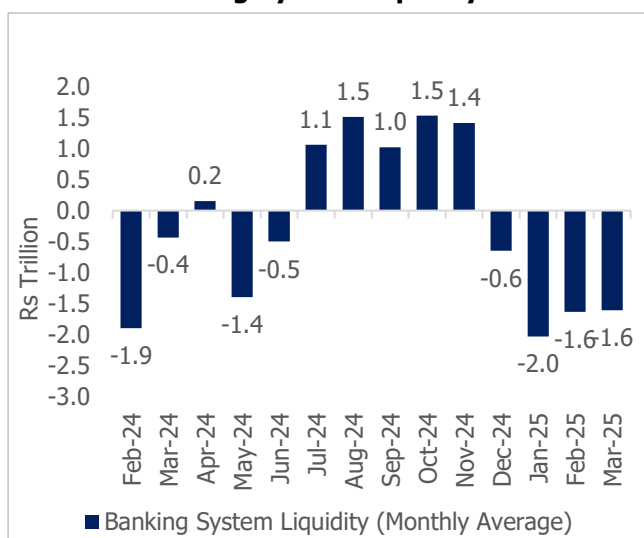
burden, policy rate cuts, falling food inflation, and recovery in public capital expenditure should support improvement in economic activity. Going ahead, we expect consumption demand to further strengthen as inflationary pressures ease and the benefits of lower tax burden take effect in the next financial year. A sustained recovery in consumption will be critical to drive a meaningful uptick in corporate capex. At this juncture the MPC should look to compliment the fiscal measures to boost demand by further lowering its policy rates. We expect the FY26 growth at 6.7% (Exhibit 2), in line with RBIs projections in December MPC meeting.

Focus on Liquidity Management to Continue

In addition to the policy rate cuts, the governor's statement is expected to focus on liquidity management. Average systemic liquidity has remained in deficit for the past four months (Exhibit 3), leading to the weighted average call rate hovering near or above the MSF rate for specific periods over these months. Despite CRR cuts, OMO purchases, dollar swaps and VRR auctions, the deficit in liquidity continues to persist. Excise duty collections, advance tax payments and GST outflows has kept systemic liquidity in the deficit. In Q4 FY25, RBI has injected total durable liquidity worth Rs 6.8 trillion to support overall liquidity conditions so far (OMO purchases worth Rs 2.8 trillion, term repo worth Rs 1.8 trillion and currency swaps of Rs 2.2 trillion). Despite deficit in systemic liquidity, banks parking money in standing deposit facility (SDF) remained high with average monthly SDF rising from Rs 0.8 trillion in January to Rs 1 trillion in February and Rs 1.2 trillion in March so far (Exhibit 4). The coexistence of deficit liquidity conditions and substantial fund placements under the SDF indicates an asymmetric distribution of liquidity within the banking system, alongside an increased liquidity preference among banks. The governor has previously expressed concerns over banks preferring to park funds in the lower-cost, uncollateralized SDF rather than extending credit, despite overnight call money rates remaining 5–10 basis points above the repo rate.

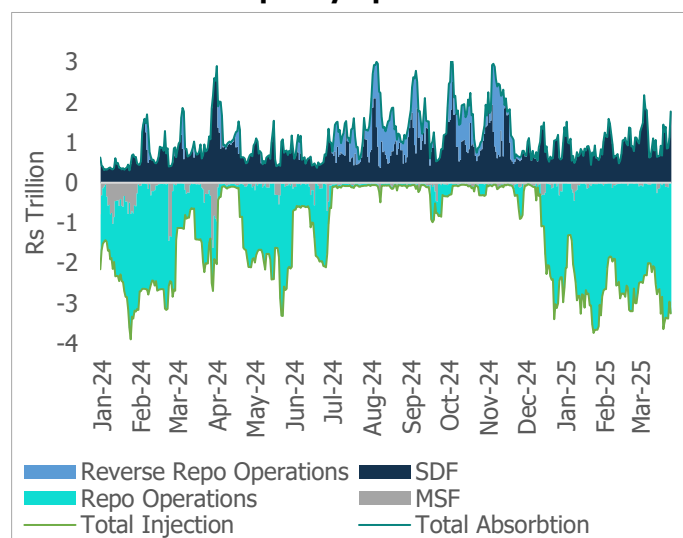
The RBI will continue to use tools like OMO purchases, currency swaps and VRR auctions of higher tenor/quantum to address the liquidity concerns. An uptick in government expenditure and RBI's dividend payout in Q1 FY26 should also support money market conditions as liquidity deficit stands close to Rs 1.4 trillion as of the last week of March. We expect that the RBI will continue to focus on liquidity management, ensuring favourable money market conditions.

Exhibit 3: Banking System Liquidity in Deficit



Source: RBI, CEIC, CareEdge. Data as of 24th March 2025.

Exhibit 4: RBI's Liquidity Operations



External Volatility Remains a Challenge

The financial markets continue to experience volatility amid trade policy uncertainties and ongoing geopolitical risks, keeping the external environment unpredictable. While FPI outflows from the Indian market have moderated and the U.S. dollar index has softened, the risk of a global economic impact from a potential trade war remains high. Uncertainty surrounding trade policy has grown due to fluctuating tariff announcements and the potential for further tariff hikes. Moreover, retaliatory measures from countries like the EU, Canada and China have raised risks for global trade and growth.

Following the imposition of tariffs on Canada, Mexico, and China, the Trump administration is expected to announce reciprocal tariffs on several other nations, including India. India's goods trade surplus with the US has doubled over the last decade, reaching USD 35 billion in FY24. Additionally, India imposes higher tariffs on imports, with a simple average tariff rate of ~12%, while the US imposes a tariff of ~3% (average tariff rate) on Indian imports. This makes India vulnerable to reciprocal tariffs from the US. If we make the simplistic assumption of additional tariff of 8% imposed by US on all imports from India, our analysis suggests that India's direct export loss from such reciprocal tariffs could be limited to around USD 3.1 billion annually, which is around 0.1% of the GDP (assuming an elasticity of 1). However, the indirect impact can be higher, stemming from the risk to global growth and dampened sentiments.

Recent macroeconomic indicators and survey data, including the PMI, consumer confidence, and retail sales, suggest a slowdown in the US economy. Additionally, household inflation expectations have risen as higher tariffs increasingly impact domestic consumption. While rising inflation expectations are a concern, market pricing suggests the Fed may cut rates to support the economy. Markets now expect two to three rate cuts in 2025, up from one initially expected at the start of the year. These cuts are expected in H2 2025 and will be in addition to the 100bps of rate cuts in 2024. The March Fed dot plot indicates two rate cuts in 2025, unchanged from December's projection. Expectations of a lower policy rate in US on the back of growth concerns will be a crucial factor for the global monetary policy cycle. The RBI's monetary policy would be largely driven on the domestic growth and inflation dynamics while keeping a close eye on global developments.

After trading in a narrow range of 83-84 in H1 FY25, supported by the RBI's interventions, the Indian rupee has weakened by 2.3% against the dollar since October (up to 26 March 2025). The rupee's depreciation has been largely due to FPI outflows. However, recent trend suggests a reversal in trend. As of 26th March, rupee has appreciated by ~2.1% against USD in March after depreciating by ~0.9% and 1.2% in February and January respectively.

Recent data suggests that RBI's interventions in the forex market to manage the rupee's depreciation is slowing. Nonetheless, the RBI is still expected to intervene in the foreign exchange market to contain any sharp rupee volatility. India's forex reserves remain healthy to support RBI's interventions. As of 14 March 2025, India's forex reserves stood around USD 654 billion. While this marks a notable decline from the peak of USD 705 billion in September 2024, the reserves remain at comfortable levels, offering an import cover of around 11 months (based on the goods trade deficit). After accounting for the RBI's forward position and its USD/INR buy/sell swaps, India's forex reserves are estimated to be lower, at around USD 552 billion, but still provide a comfortable import cover of around 9 months (based on the goods trade deficit).

India's current account deficit is also likely to remain comfortable, projected at 0.7% of GDP in FY25. India's current account deficit is expected to remain manageable in FY26 at 1.1% of the GDP. However, FPI outflows are likely to

stay volatile, putting pressure on India's balance of payments and the rupee. Additionally, external factors such as tariff wars and geopolitical tensions remain key monitorables.

Way Forward

Falling inflation will provide the RBI with the necessary flexibility to prioritize growth concerns. Looking ahead, we expect the RBI MPC to cut policy rate by another 25bps in its April meeting. However, the MPC is likely to maintain its neutral stance amidst global uncertainty. With food inflation moderating and core inflation under control, the RBI could overlook concerns around imported inflation in midst of the global trade war. Another 25-bps rate cut in FY26 is also possible depending on the monsoon situation and domestic inflation. RBI will also take cue from global developments, for instance if the Fed cuts rates to support its economy, the pressure on Indian rupee may ease, giving the RBI more room for further rate cuts.

Overall, both global and Indian markets are expected to remain volatile till trade policy uncertainty remains elevated. A key event to watch will be President Trump's highly anticipated announcement on reciprocal tariffs on 2nd April, which could have implications for the Indian economy and financial markets.

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