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RBI MONETARY POLICY: FURTHER SOFTENING IS LIKELY

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The Global Context

Amid the RBI's June'25 forthcoming monetary policy, the global economic & political scenario remains volatile due to Trump's uncertain policies including trade protectionism and tariff related aspects. For instance, Trump highlighted that he was unhappy with European negotiating tactics, announced his intention to impose 50 percent tariffs on goods imported from the European Union, a rate that would effectively eliminate trans-Atlantic trade.

However, after talking with Ursula von der Leyen, the president of the European Commission, he announced that the tariffs would be postponed until 9th July 2025.

The Fed's FOMC minutes have highlighted that the market-implied path of the federal funds rate (FFR) over the next few meetings have shown a net increase, but declined somewhat towards the end of the year, as the announcements on new U.S. tariffs left investors more concerned about the near-term outlooks for both inflation and growth. Near-term inflation compensation rose notably, while longer-term inflation compensation appeared to remain well anchored.

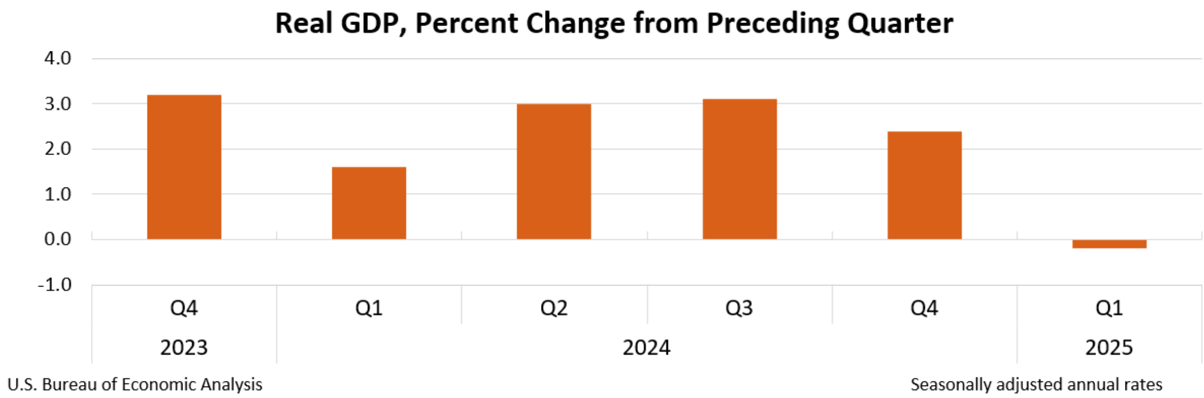
Against the backdrop of heightened volatility, yields on shorter- and medium-term nominal Treasury securities declined, but longer-term rates have increased, which is partly attributable to higher term premiums.

The "Big, Beautiful Bill" does not remain 'beautiful' between Elon Musk and Trump, as the former exited the DOGE, after criticising the bill by highlighting that the bill cannot be both big and beautiful at the same time. The ugly part of the bill can be many, including imminent increase in US's already ballooned deficit (due to extended tax cuts impacting US government revenue) and enhancing inequality further between the wealthiest and poorest group.

A US Federal court has blocked Trump's "Liberation Day' tariffs by highlighting that Trump's use of the 'International Emergency Economic Powers Act' (IEEPA) to support the tariffs violated constitutional limits on presidential authority. Market experts and research firms have already highlighted that the Trump administration would also move at the US Supreme court in this matter. This will lead towards a 'legal uncertainty.'

The US GDP has also decreased at an annual rate of 0.2 percent in the first quarter of 2025 (January, February, and March), according to the second estimate released by the U.S. Bureau of Economic Analysis.

Chart 1: US GDP (Second Estimate), Corporate Profits (Preliminary Estimate), 1st Quarter 2025



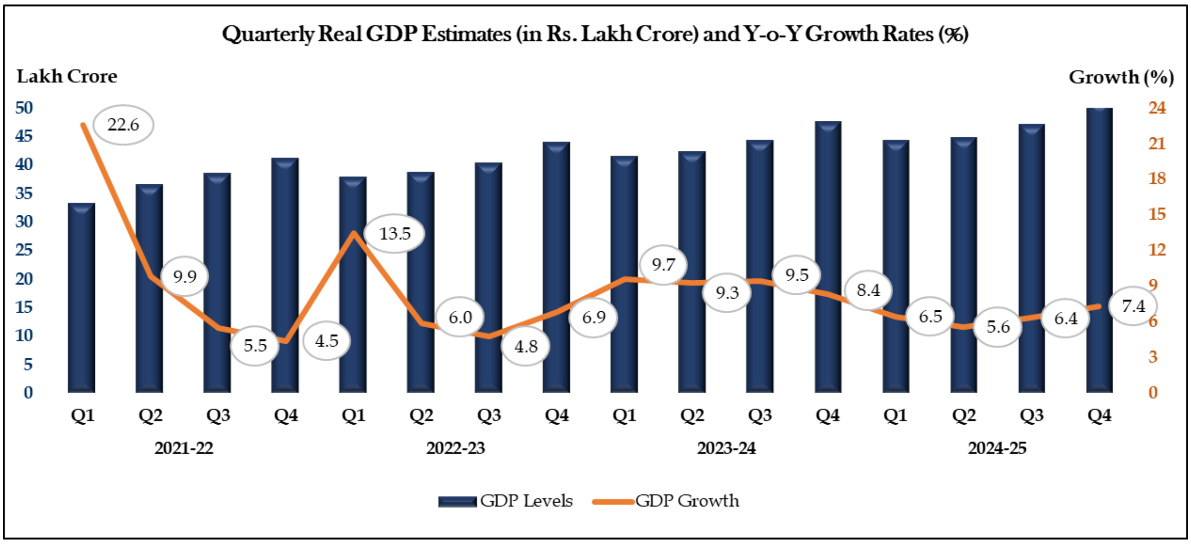
Source: US BEA [https://www.bea.gov/news/2025/gross-domestic-product-second-estimate-corporate-profits-preliminary-estimate-1st-quarter].

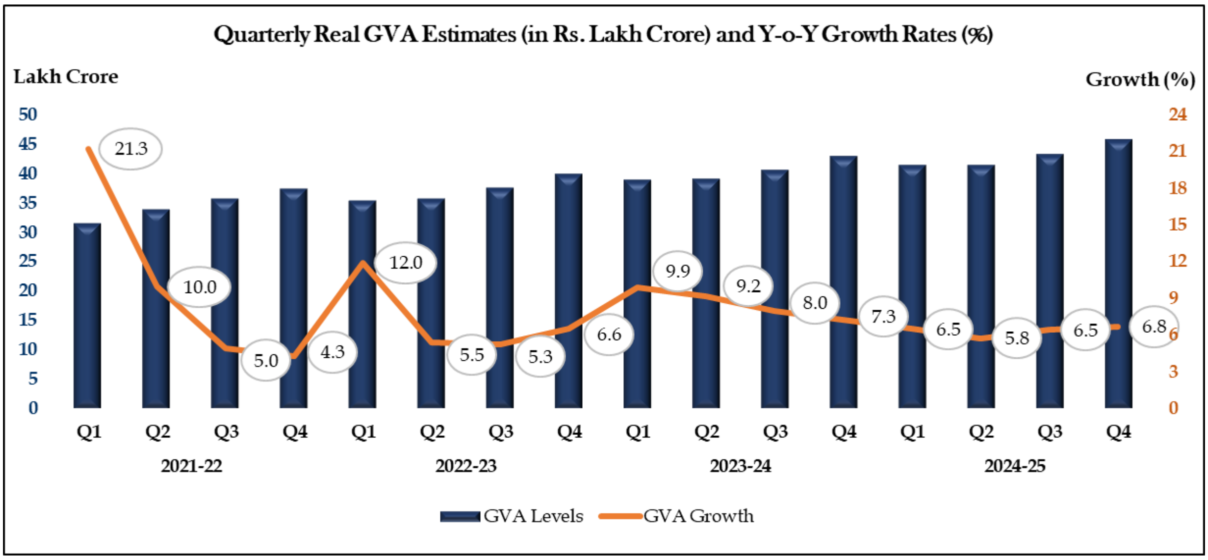
The decline in real GDP in the first quarter primarily revealed an increase in imports, (which are a subtraction in the calculation of GDP) and a decrease in government spending, which were partly offset by increases in investment, consumer spending, and exports. Moody's Ratings have recently downgraded the rating of the US government citing concerns over fiscal profile.

The Indian Context

According to the Provisional Estimate (PE) of the full year GDP for FY25 and Quarterly Estimate (QE) for the 4th quarter (Q4), the Real GDP has been estimated to grow by 6.5% in FY 2024-25 (for the whole year), whereas the Nominal GDP has witnessed a growth rate of 9.8% in FY 2024-25. In Q4 of FY 2024-25, Real GDP and Nominal GDP has been estimated to grow by 7.4% and 10.8% respectively. Real GVA is estimated at ₹171.87 lakh crore in the FY 2024-25, against the FRE for the FY 2023-24 of ₹161.51 lakh crore, registering a growth rate of 6.4%.

Chart 2: Quarterly GDP and GVA Estimates along with Y-o-Y Growth Rates from Q1 FY 2023-24 to Q4 FY 2024-25 at Constant Prices





Source: MOSPI.

The construction sector has shown substantial growth from the q3~q4 (FY25) growth from 7.9 ~10.8 per cent reflecting considerable capex momentum. The manufacturing sector has also grown from 3.6~48 per cent during this period. The electricity and gas sector have shown modest growth from 5.1 to 5.4 during the period. Overall, the secondar sector has shown impressive growth from 5.1 to 6.8 during q3~q4 of FY25.

Earlier, the National Statistics Office (NSO) has estimated real Gross Domestic Product (GDP) growth at 6.5 per cent for 2024-25, on top of 9.2 per cent in 2023-24. The services sector, with a share of 64.1 per cent in GVA, remained the mainstay of aggregate supply with a growth of 7.5 per cent in 2024-25. Despite moderation, construction activity remained resilient with its share reaching the highest level since 2012-13. Real Gross Value Added (GVA) grew by 6.4 per cent in 2024-25 compared to 8.6 per cent a year ago. Industrial activity slowed partly due to an unfavourable base. On the other hand, an improvement in agriculture helped sustain the momentum supported by an above normal south-west monsoon (SWM).

Inflation remains within the target during 2024-25 aided by easing vegetable prices. Headline inflation moderated to an average of 4.6 per cent during 2024-25 from 5.4 per cent in the previous year, largely driven by a moderation in core (CPI excluding food and fuel) inflation to 3.5 per cent and deflation in fuel at 2.5 per cent. However, the uptick in the core inflation in the second half of the year is largely driven by the surge in the global gold prices. Crude oil prices are expected to remain at $65/barrel in FY26.

The above normal monsoon would also likely be supporting the ease of inflation. The early arrival of the southwest monsoon is likely to improve the agricultural production. The elevated reservoir level along with favourable rainfall outlook would help in easing the food inflation. The forecast by the India Meteorological Department (IMD) has also been upgraded for the 2025 monsoon season. India’s foodgrain production is estimated to have increased 6.6 per cent to reach a new high of almost at 354 million tonne (MT) in 2024-25, including record production of all major crops, rice, paddy, maize, wheat etc.

Nonetheless, a recent RBI survey has shown that food sub-groups that have seen an increase in expenditure on animal proteins (i.e., egg, meat, fish, and milk), fruits, oils and fats, and processed food and beverages, have also become more persistent in recent years. Cereals, however, show a diverging trend; a rise in persistence despite a fall in expenditure shares indicating the dominance of supply side factors. The mapping indicates that, the overlapping supply shocks coupled with the evolving demand dynamics for food products, driven by change in dietary habits, underscore the need for careful monitoring of food inflation.

The Monetary Policy Committee (MPC) changed the policy stance from withdrawal of accommodation to neutral in October 2024. However, in this latest April'25 policy, the RBI has altered its previous stance from 'neutral' to 'accommodative', while acknowledging that the rapidly evolving situation requires continuous monitoring and assessment of the economic outlook. Subsequently, the growth-inflation dynamics remains conducive to support growth. Hence, the MPC reduced the policy repo rate by 25 bps to 6.25 per cent in February 2025 after maintaining status quo since February 2023 at 6.50 per cent.

The transmission of policy repo rate changes to banks' deposit and lending rates remained healthy during 2024-25. The percentage of external benchmark linked loans in total outstanding floating rate loans increased further during the year, with accompanying fall in marginal cost of funds-based lending rate (MCLR) linked loans.

The liquidity situation remains volatile due to advance tax and GST outflows and government cash balances with the RBI. Nonetheless, considering the whole year, liquidity conditions remained in surplus as reflected in average daily net absorption under the liquidity adjustment facility (LAF) increasing to ₹1,605 crore during 2024-25 from ₹485 crore in the previous year. The Reserve Bank conducted a suite of market operations, including open market operation (OMO) purchases, USD/INR buy/sell swaps, and longer tenor variable rate repo (VRR) operations, besides reducing the cash reserve ratio (CRR) by 50 bps (in two tranches of 25 bps each), to provide durable liquidity to the system.

Notably, RBI transferred a whopping ₹2.69 lakh crore in surplus to the government a 27% jump over the previous year and its highest ever so far. Among other reasons, RBI earned significantly more from foreign investments and interest on domestic securities. Further, a sizable chunk of the income came from the sale and smart revaluation of foreign exchange reserves. The RBI's capital buffer as a percentage of its balance sheet has raised at 7.5 per cent under the revised Economic Capital Framework, and the Contingency Fund added additionally ₹1.13 lakh crore.

Concluding Remarks:

The Indian economy remains resilient amidst global uncertainties. Domestic growth is driven by robust domestic consumption, increased government spending and strong services sector. Despite global headwinds and Trump tariff related challenges, the Indian economy grew by 7.4% in Q4 FY25 as against 8.4% growth in same quarter last fiscal.

The above normal monsoon, strong arrival of crops, and subdued crude oil prices are likely to keep the headline inflation range bound. Given the India's foodgrain production is estimated to have increased 6.6 per cent to reach a new high of almost at 354 million tonne (MT) in 2024-25, including record production of all major crops, rice, paddy, maize, wheat etc, the food inflation appears to remain soft coupled with favourable monsoon prediction.

The bank credit remains somewhat softened due to the decelerated growth in credit to 'non-banking financial companies' (NBFCs). Moreover, credit growth in the infrastructure segment decelerated. On the other hand, credit to agriculture and allied activities registered a growth of 9.2 per cent (y-o-y), whereas credit to industry recorded a growth of 6.7 per cent (y-o-y), compared with 6.9 per cent in the corresponding fortnight of the previous year.

In a nutshell, to sustain the growth momentum amid global headwinds and subdued inflationary scenario, we expect RBI to reduce the repo rate by at least 25 bps (the ideal reduction could be in the range of 25~50 bps) with accommodative stance reflecting its apparent intent in supporting the economic growth of the Indian economy.