5 Feb 2025

Dipanwita Mazumdar
Economist

Starting of a shallow rate cut cycle

A lot has changed since the last monetary policy meeting of RBI. The most notable among them is the rising volatility visible in major asset classes, especially for INR. Most of it is attributable to rising geopolitical tensions emerging from anticipated tariff and counter tariff by US and major economies such as Canada, Mexico and China. This has propped up the dollar, thus impacting all currencies. The spillover effect was felt on domestic liquidity conditions as well where considerable tightening was noticed. Banking liquidity also witnessed strain as deposits growth showed moderation albeit normalisation in credit growth. Domestic growth continued to show patchy recovery with premiumization continuing to take the front seat. Q3 financial results of corporates again mirrored the trend of moderation in sales. The same will be reflected in manufacturing GVA. Inflation the main monetary policy objective, however, is expected to provide the desired comfort. The Dec print showed moderation. Even Jan print is expected to be lower in the range of 4.5-4.7%. Considerable correction in TOP (Tomato, Onion and Potato) vegetables along with better arrivals have driven prices of these volatile items of CPI lower. Thus, it gives RBI the bandwidth to embark on its rate cut journey, albeit at a shallow data dependent pace in the future. Cumulatively we expect 50-75 bps cut in the current cycle.

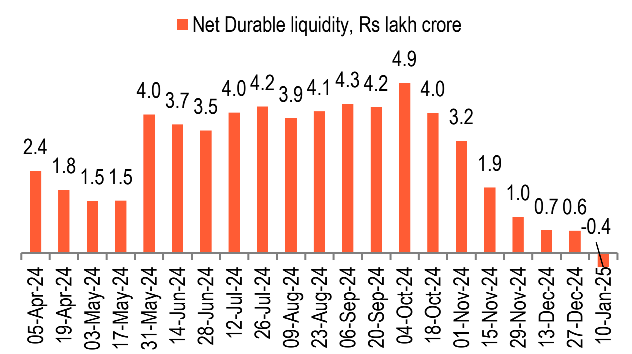
What has changed since the last policy?

RBI in its upcoming policy is expected to encounter a trilemma encompassing 1) tighter liquidity conditions 2) depreciating INR and 3) heightened geopolitical uncertainty. The risks were not so profound in the last policy which expressed concerns about missing growth forecast and transient risks of inflation resulting in the misalignment of the 4% target. Let's chart out the three risks in detail:

1) **Tighter liquidity:** The liquidity situation started getting tighter in Jan-25 when durable liquidity went into deficit. A plausible explanation could be tighter dollar and resulting drawdown of foreign exchange reserves. In Jan-25 itself, forex currency assets have fallen by US$ 14bn. Durable liquidity went into a deficit of Rs 40,000 crore as on 10 Jan 2025, which was not visibly present in the series since RBI started publishing the data of durable liquidity. Hence, the host of measures ranging from long term VRR and OMOs are targeted towards retaining the durable liquidity in surplus mode. On Banking liquidity front as well, incremental deposits and borrowings net of incremental investment and credit has fallen as deposits growth has shown loss of momentum albeit correction in credit growth. Hence overall tighter liquidity conditions build up case for an easier monetary policy response on part of RBI.

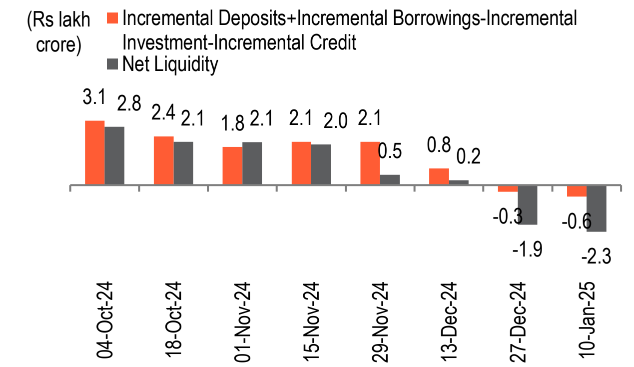
   RBI's recent liquidity measure is expected to address ~ Rs 1.5 tn of deficit liquidity in the system. Going forward, if depreciation of INR intensifies, drain of liquidity through foreign exchange reserves cannot be ruled out entirely, hence some pressure on liquidity would persist in the near term. We expect it to remain in the range of 0.6-0.9% of NDTL.

Figure 1: Durable liquidity under pressure



Source: CEIC, Bank of Baroda Research

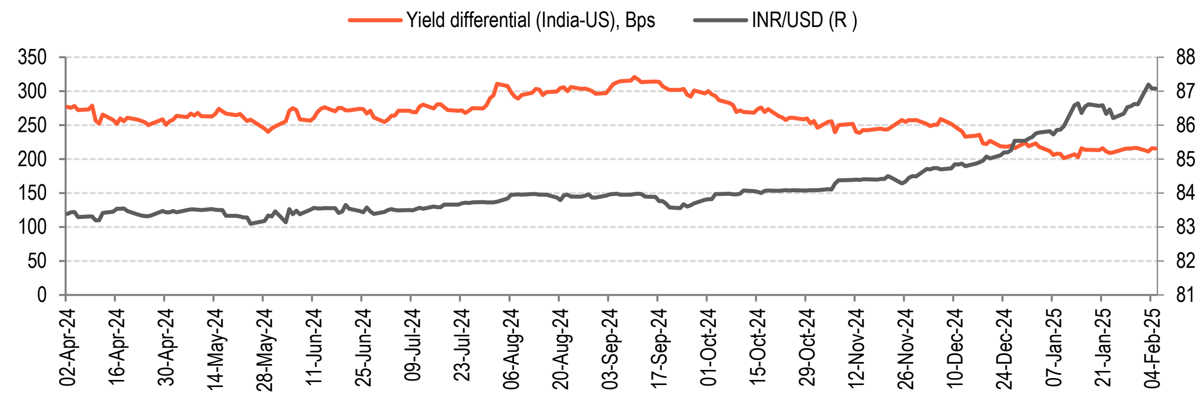
Figure 2: Banking liquidity and system liquidity



Source: CEIC, Bank of Baroda Research

2) **Depreciating INR:** Strengthening DXY, firmer US 10Y yield amidst expectation of heightened trade spats have impinged on INR. Post November onwards, when US election results were announced, the yield differential between India and US has started falling **(Fig 3)**, even pressure on INR exacerbated during the same period. A falling interest rate differential between Indian and US on account of sharper increase in US 10Y yield during the same period has resulted in capital outflow and the resulting impact has been one of a depreciating INR. From Nov-24 onwards, FPI outflows amounted to US$ 7.5bn (till date). Ideally, in times of volatility, RBI should stand pat on rates. However, since the downward arrest in INR is more acute, thus, to arrest drain on domestic liquidity, a softer interest rate regime would provide more comfort.

Fig 3: Falling interest rate differential with the US and movement of INR/USD



Source: Bloomberg, Bank of Baroda Research

3) **Heightened geopolitical uncertainty:** There have been growing risks of a tariff war with every passing day. Over and above, the uncertainty and the scale of it cannot be accounted for. As of now, US on 1st February has imposed a 25% additional tariff on imports from Canada and Mexico and a 10% additional tariff on imports from China. However, for Canada and Mexico, there has been a reprieve in tariff, while China was prompt enough to retaliate the same on some US goods. India as of now is insulated, with share in US export basket at 18% and merchandise trade balance with the US at US$ 36bn (FY24 data). However, there do arise downside risks to growth from heightened uncertainty as pointed out by IMF in its latest report. Thus, pass through of the same in terms of downside risks to exports and then GDP

cannot be ruled out. Thus, to support growth, RBI is expected to embark on the rate cut cycle. For other economies since the rate cut has started much earlier, they have the degree of freedom to go in for a “wait and watch” approach.

Table 1: Movement of major macro and market variables in between two policies

Major variables	6-Dec-24 Policy	Current
DXY Index	106.06	107.96
US10Y yield (%)	4.15	4.51
India 10Y yield (%)	6.75	6.67
Gold, USD/troy ounce	2633	2854
Brent, USD/bbl	76.3	76.2
Sensex	81,709	78,584
INR/USD	84.70	87.08
Liquidity, Rs crore	61,154	(38,216)*
Credit, % YoY	11.5	11.5
Deposit, % YoY	11.5	10.8
WADTDR-SCBs#	6.44	6.57
WALR-SCBs#	9.54	9.25

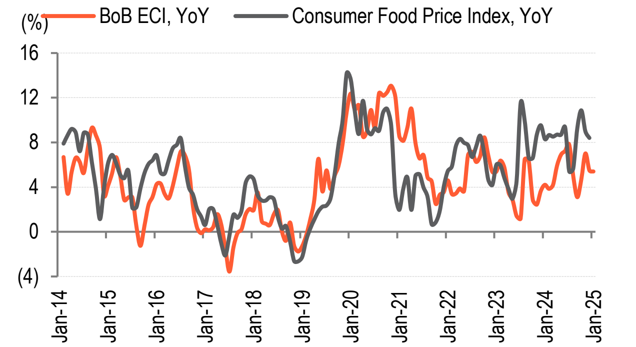
Source: Bloomberg, CEIC, Bank of Baroda Research, *(-) means deficit,,# Fresh

Have the guards of inflation come down?

In terms of inflation, this month gives the flexibility of a reduction in policy rate. Buoyed by seasonality factors and better arrival statistics of TOP vegetables, inflation is expected to soften. As per World Bank data, global commodity prices especially food prices such as cereals, edible oils are tempering down. This coupled with rangebound commodity prices, provides RBI the headroom to lower rates. The favourable base is also reversing from Mar-25 onwards. **Fig 5**. shows that coinciding with the harvesting season of major vegetables, even arrivals have picked pace. The recent measures in the Union Budget targeted at self-sufficiency of certain food crops and efforts aimed at improving and addressing supply chain bottlenecks, is welcoming. This will help narrowing down the transient volatility episodes that India’s food inflation has been witnessing for the past few years.

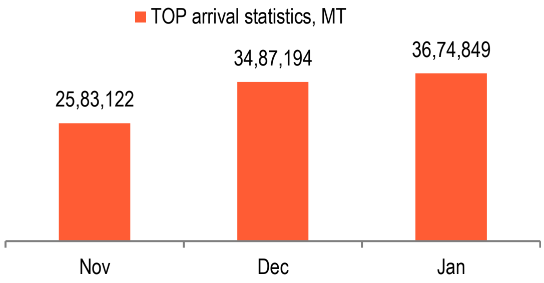
Our in-house BoB ECI which tracks high frequency price data is also showing considerable moderation tracking at 4%. Thus, against this backdrop, we expect it is the opportune time for beginning of the rate cut cycle of India, albeit at a softer pace on a cumulative basis. We expect inflation to average at 4.9% in FY25, marginally higher than RBI’s forecast of 4.8%. However, risks remained balanced. On the downside, if TOP vegetables continue to exhibit considerable correction in the coming months, a lower print might emerge. Upside risks emerge from depreciating INR and the risk of imported inflation.

Figure 4: YoY basis, BoB ECI moderates to 4% in Jan'25 from 5.4% in Dec'24



Source: CEIC, Bank of Baroda Research

Figure 5: TOP arrival improves



Source: UPAJ.GOV, Bank of Baroda Research, TOP: arriavls of tomato, onion and potato have been summed

How is Growth faring?

High frequency data of Q3 and start of Q4 showed some regaining of momentum albeit at a softer pace. Financial results of Q3 again mirrored the trend of Q1 and Q2 which were of muted sales and moderation in profit. Transcript of few companies have again pointed out that demand is skewed and the same trend of premiumisation driving sales have continued in Q3 as well. However, manufacturing continues to be a laggard dragged down by muted government spending and a laggard private capex cycle. Still certain macro indicators of consumption and services sector such as air passenger traffic, vehicle registrations, and diesel consumption are showing softening. Also, significant downside risks to growth might emerge from rising geopolitical risks which might weigh down exports. Our estimate of 6.6% for FY25 are also tilted to the downside. Hence at this current juncture, growth requires the desired handholding of monetary policy when inflation risks are still contained, and fiscal consolidation of the government is underway.

What the current situation calls for?

Thus, balancing and counterbalancing all macro and geopolitical factors, we believe there remains space for 25bps rate cut by RBI in the upcoming policy. The cumulative cut in the entire cycle could be ~50-75 bps. The underlining fiscal consolidation and softening inflation provides further headroom for RBI to focus on growth. Financial results of Q3 have again pointed out skewed recovery on growth front with muted sales number. Rising risks of retaliatory measures of higher tariff by US to major economies also pose considerable significant peril on external front, which may again cut the pie of domestic growth. Further, depreciating INR pose threat of draining of durable liquidity which again requires some support in terms of lower borrowing cost. The volatile components of CPI such as vegetables, edible oils, amongst others are also losing steam and exhibiting considerable downward correction. Hence beginning of a shallower rate cycle by RBI seems appropriate.

Disclaimer

Visit us at www.bankofbaroda.com

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com
dipanwita.mazumdar@bankofbaroda.com