

Implications of February 2025 MPC

The Monetary Policy Committee (MPC) announced a cut in key policy rate, the repo rate by 25 bps from 6.50% to 6.25% for the first time in 5 years. Majority of market participants had expected a rate cut after the series of liquidity injection measures of Rs 1.5 lakh crore announced in January and the fiscal glide path set forth in the 2025 Union Budget.

The MPC also forecast CPI inflation of 4.2% for FY26, a sharp 60 bps lower than FY25 estimate of 4.8%. Growth projections have been only slightly upended from 6.6% in FY25 to 6.7% in FY26 reflecting upside risks from global uncertainties.

Table 1: MPC Growth forecasts

MPC	FY25	Q1FY26	Q2FY26	Q3FY26	Q4FY26	FY26
December 2024	6.6	6.9	7.3	-	-	-
February 2025	6.6	6.7	7.0	6.5	6.5	6.7

Source: RBI MPC documents

Table 2: CPI inflation forecasts

MPC	FY25	Q1FY26	Q2FY26	Q3FY26	Q4FY26	FY26
December 2024	4.8	4.6	4.0	-		-
February 2025	4.8	4.5	4.0	3.8	4.2	4.2

Source: RBI MPC documents

Other key measures/announcements

- Deferment of additional LCR provisions, ECL norms and higher provisioning for infrastructure finance at least until March 2026 after due consultations.
- Forward contract in government securities for long term players
- Exhorting banks to be more active in the call money market
- Widening participation in NDS-OM to non-bank brokers
- Greater emphasis on digital fraud prevention

Implications

- Though LCR norms have been deferred by at least one year, CPI inflation estimates have seen significant easing and liquidity has been injected the stance of the policy has remained 'neutral' instead of 'accommodation'. This shows uncertainty over the pace of future rate cuts.
- The MPC has stated unambiguously the intent to allow the rupee to find its fair value. If we assume the historical average real effective exchange rate of INR at 104, the fair value of the rupee would be 90.8. However, the impact of a weaker INR on inflation has to be monitored as India imports 80% of crude apart from gold, edible oil, palm oil, EVs, active pharmaceutical ingredients among others.
- Though MPC has stated that INR will be left to market forces, it may be difficult to keep a totally

hands-off approach due to the multi- faceted consequences of Rupee depreciation for many stakeholders. As shown in table below, INR has weakened in line with major currencies.

Table 3: INR vs other currencies

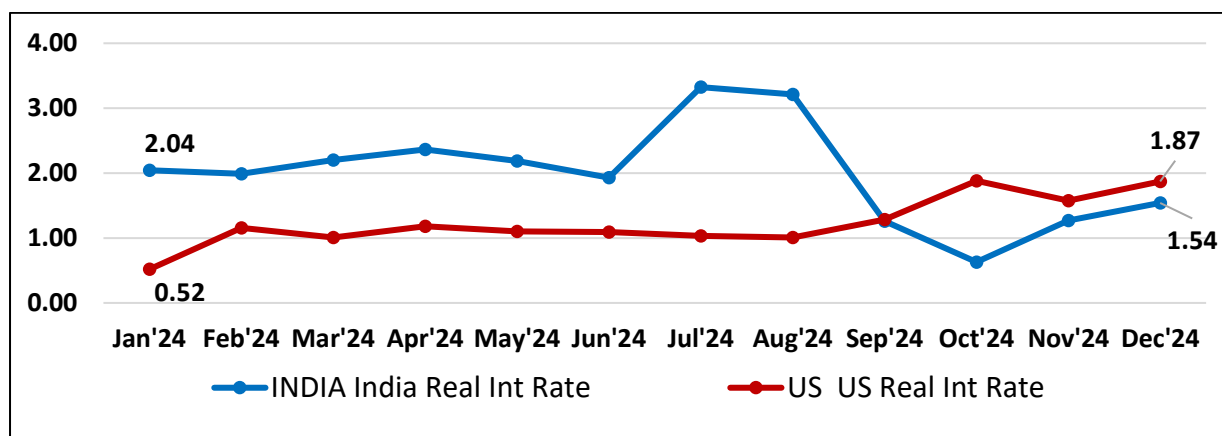
	Nov-24 (Avg)	Feb'25 (Avg)	Var %
USD/INR	84.38	87.10	-3.20
USD/CNY	7.20	7.27	-0.97
USD/KRW	1393.9	1454.09	-4.32
USD/IDR	15827.8	16321.10	-3.11
Eur/USD	1.06	1.03	-2.83
GBP/USD	1.27	1.24	-2.36

Source: x-rates.com

There is significant uncertainty on US trade policies. If tariffs are hiked for its trading partners like China and EU, inflation there could go up by 100 bps which could force the US Fed for a sharp re-think of its outlook on policy rates. It should not come as a surprise if the Fed decides to hike rates. The high levels of US debt could also lead to elevated US Treasury yields

The chart below shows real interest rates in the US and India. It is evident that post September 2024, real interest rates have been higher in the US which explains sub-optimal foreign investments in our debt papers despite JP Morgan bond index inclusion. A rate cut could further erase attractiveness of Indian bonds.

Fig 1: India Vs US Real Interest Rate



Source: Cogencis

About 40% of loans in the banking system are linked to EBLR which will see an immediate reduction in rates. On gross bank credit of Rs 170 lakh crore (latest reporting fortnight), this comes to Rs 68 lakh crore and the reduction in interest income due to a 25-bps reduction will be Rs 17,000 crore. However, loans linked to MCLR will see a rate reduction only on reset. To protect margins, banks will have to cut deposit rates but the competition to raise resources might slow down the pace of rate cuts. Moreover, if rates on small savings schemes stay rigid, it will make deposit mobilization more difficult for banks. Easing of LCR will however ease some pressure on liquidity.

Table 4: Key policy rates and CPI inflation in major economies

Country	Key policy rate (%)	CPI inflation (%)	10 Yr bond yield (%)	Real rate (10Yr yield CPI) (%)
United States	4.25-4.50	2.9	4.51	1.39
England	4.50	2.5	4.46	1.96

China	3.10	0.5	1.62	1.57
Japan	0.50	3.60	1.31	-2.29
Indonesia	5.75	1.57	6.89	5.32
Korea	3.00	2.20	2.85	0.65
Europe	2.75	2.40	2.60	0.20
India	6.25	5.22	6.70	1.48

Source: Central banks, Canara Bank Economic Research calculations

Banks have been exhorted to trade more in the call money market. However, liquidity is thin in this market and in the current scenario of deficit liquidity more activity would be in Treps etc. where liquidity is comfortable. Moreover, call market is available only for a very limited duration unlike Treps which is available throughout the day. Moreover, banks would be rather comfortable parking with RBI under SDF (Standing Deposit Facility) even at lower rate of interest as the counterparty is RBI which is more attractive from a credit worthiness point of view.

Introduction of bond forwards should help long term players like insurance who are in search for suitable hedging avenues though the Forward Rate Agreement (FRA) route is available. This is helpful when seen along with the general intention to increase insurance penetration in India.

Despite the liquidity easing steps and deferral of regulatory measures, more OMO purchases are expected going forward. The fact that OMO of Rs 20,000 Cr scheduled for February 13 has been revised to Rs 40,000 Cr shows that liquidity is still not comfortable. Global uncertainty and tariff wars mean that interventions in the forex market would be necessary which will add to further strains on liquidity.

Private capex might bear the brunt of trade wars. Recently US has threatened to impose reciprocal tariffs and has been repeatedly hinting that India is a very high tariff country. Our steel and aluminium exports could face renewed tariffs which could hinder profitability and capex plans even if demand were to revive.

Conclusions

- As the policy tone was not dovish the extent and pace of future rate cuts are uncertain
- More OMO purchases would be needed to maintain liquidity comfort.
- Two-wheeler interest rates could dip and may lead to slight uptick in demand
- Though repo linked loan rates could be cut soon MCLR linked interest rates to reduce in the next reset period.

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