

## **From pause and neutral, what lies ahead for India's monetary policy?**

Aswathy Rachel Varughese

<sup>1</sup> Assistant Professor, Gulati Institute of Finance and Taxation Thiruvananthapuram

### **Abstract**

*The Monetary Policy Committee (MPC), with a 4-2 majority, maintained the repo rate at 6.5 percent in the December policy meeting. The stance remained neutral to provide the MPC with flexibility regarding the future trajectory of policy actions. This is significant, as the Governor's statement emphasized the importance of maintaining a favorable growth-inflation balance, highlighting their strong interconnection. The Reserve Bank of India has revised its GDP growth forecast to 6.6 percent for FY2025, while inflation is projected to rise to 4.8 percent. Nevertheless, with growth expected to recover in the second half and inflation moderating, the market anticipates a potential 25 basis point rate cut in February 2025. The changing geopolitical landscape poses a potential threat to inflation as well as growth trajectory.*

**Keywords:** *Monetary Policy, Inflation, Growth, India*

### **Introduction**

The Reserve Bank of India (RBI), continued to keep key policy rates unchanged at 6.5 percent in its December 2024 Bimonthly policy meeting on account of lingering inflationary pressure in the economy, especially from the food inflation category. The monetary policy stance was also unchanged at neutral to allow the MPC flexibility on the future path of policy action. Notably, in this policy, RBI resorted to reducing CRR by 50 basis points in two equal tranches of 25 bps each to 4 percent of Net Demand and Time Liabilities (NDTL) with effect

from the fortnight beginning 14 December 2024 and 28 December 2024, respectively. The main rationale behind this policy was to rebalance growth and inflation trade-off. This implies that the reduction in the Cash Reserve Ratio (CRR) partially offsets the wide fluctuations in government cash balances.

### **India's growth trajectory**

With continuous economic and non-economic uncertainties putting the ultimate test on the global and domestic economies, growth prospects are bleak across the globe. Global trade dynamics are changing with increasing volumes focused within geopolitical blocs. Financial markets have experienced turbulence due to the rising US dollar and increasing bond yields, resulting in significant capital outflows from emerging markets and volatility in equity markets. Looking ahead, the outlook is clouded by growing protectionism, which could undermine global growth and drive inflation higher.

India's growth story is also influenced by these global events and changing macroeconomic landscapes. As per the First Advance Estimates of the Financial Year 2025, the Gross Domestic Product (GDP) is estimated to grow at 6.4 y.o.y percent vis-à-vis 8.2 percent growth in FY2023-24 (MOSPI, 2025.). This slowdown is primarily due to the expected slower growth rate in investment demand at 6.4 percent, compared to 9 percent in FY2024. Besides, import growth is projected to contract by 1.3 percent, as opposed to a 10.9 percent increase in FY24, reflecting the global economic weakness.

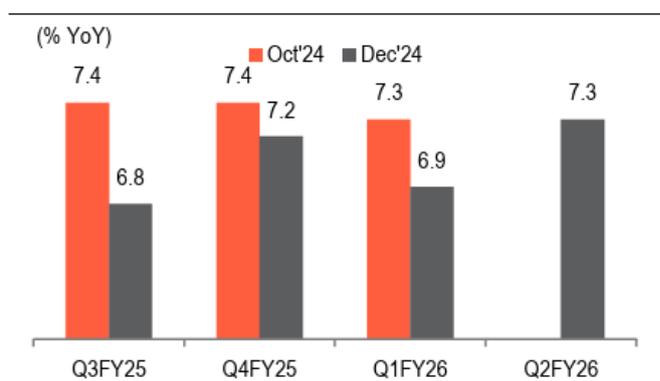
Meanwhile, the Gross Value Added (GVA) growth for the current fiscal year is estimated to moderate at 6.4 percent versus 7.2 percent last year. The slowdown is visible across the sector and manufacturing is estimated to grow at 5.3 growth (down from 9.9 percent in FY24), mining at 2.9 percent (down from 7.1 percent in FY24), and the electricity sector at 6.8 percent (down from 7.5 percent in FY2024). Growth in the construction sector is also expected to slow to 8.6 from 9.9 percent in FY2024.

As per the first advance estimates, within the services sector, the trade, transport, and hotel industries are projected to grow at a slower pace of 5.8 percent, down from 6.4 percent in FY2024, reflecting reduced demand in the tourism and hospitality industry. The financial services sector is expected to record slightly slower growth at 7.3 percent in FY2025, compared to 8.4 percent in FY2024. On the contrary, growth in public administration is anticipated to increase to 9.1 percent, up from 7.8 percent in FY2024, in line with the

expectation of a steady rise in government spending in the second half of the fiscal year. Agriculture growth is also expected to be robust at 3.8 percent in FY25, up from 1.4 percent in FY24, supported by higher rabi sowing.

While acknowledging the slowdown in growth during Q2FY2025, the RBI anticipates resilient growth in H2 FY2025 and FY2026, while emphasizing the need for caution (Figure1). Growth projections have been adjusted downward to account for the Q2 slowdown. For FY2025, the RBI expects growth at 6.6 percent, which is a downward revision of 60 basis points. Quarterly projections have also been revised downward, with the largest revision of 60 basis points occurring in Q3 FY2025. In Q4 FY2025, the RBI forecasts GDP growth at 7.2 percent, compared to the previous estimate of 7.4 percent, and for Q1 FY26, GDP growth is now estimated at 6.9 percent, a reduction of 40 basis points. Our GDP estimate stands at 6.6-6.8 percent, with expected impetus from the agriculture sector and government capital expenditure (RBI, Minutes of December Monetary Policy Meeting, 2024).

**Figure 1:** Growth projections by RBI



Source: RBI, monetary policy statement, December 2024

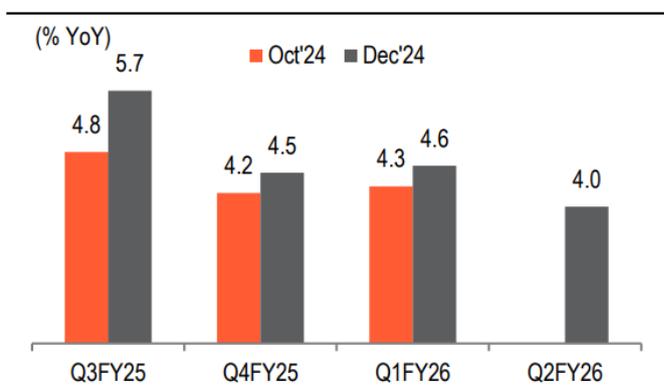
### **Inflationary pressures**

The Consumer Price Index (CPI) in December exhibited a degree of softening from 5.5 percent to 5.2 percent, primarily driven by a favorable statistical base and a reduction in food inflation. The substantial decline in vegetable inflation contributed significantly to this easing. In addition to that, food inflation demonstrated a broad-based respite, attributable to seasonal factors. Core inflation remained largely contained below 4 percent, with most demand-driven sub-components experiencing a loss of momentum. Meanwhile, the fuel and

light category continued to remain in deflation territory. However, within the miscellaneous category, inflation in personal care items remained high at 9.7 percent. Looking ahead, the risks of food inflation are anticipated to be on the downside, as supply conditions have improved due to favorable weather and the arrival of the fresh winter harvest.

RBI has revised its inflation projections for FY2025 upward to 4.8 percent, from the earlier anticipated 4.5 percent (Figure 2). Inflation for Q3 is now estimated to be significantly higher at 5.7 percent, compared to the 4.8 percent projected in the October 2024 policy. For Q4 FY2025 and Q1 FY2026, inflation projections have been adjusted upward by 30 basis points to 4.5 percent and 4.6 percent, respectively. Inflation is expected to moderate to 4 percent only by Q2 FY2026. A favorable rabi season, along with the arrival of the kharif harvest, is anticipated to alleviate price pressures in the near term. In addition to that, global prices of edible oils and vegetables have begun to soften as the seasonal impact diminishes. This development is also favorable for the inflation outlook. The central bank estimated that inflation will average between 4.7 and 4.8 percent in FY2025, assuming the absence of any new external or domestic shocks.

**Figure 2:** Inflation estimates



Source: RBI, monetary policy statement, December 2024

### CRR reduction

To alleviate the anticipated shortfall in system liquidity in the coming months, the Cash Reserve Ratio has been reduced from 4.5 to 4 percent of the NDTL. This adjustment will be implemented in two equal fortnightly tranches of 25 basis points each, commenced since December. It should be noted that the RBI had previously increased the CRR to 4.5 percent in May 2022. This decision is expected to infuse approximately ₹1.16 lakh crores into the

banking system, thereby mitigating the pressures on banks arising from advance tax payments.

### **Challenges from changing geopolitical landscapes**

Challenges from the new global economic and financial settings created by geopolitical conflicts, geoeconomic fragmentation, and financial market volatility thwarted the disinflation efforts of the central banks of the Emerging Market Economies (EMEs). A central component of the United States President Donald Trump's economic agenda is the implementation of tariffs, which he perceives as a mechanism to safeguard US jobs, enhance tax revenue, and stimulate economic growth. He has threatened to impose tariffs on China, Canada, and Mexico, commencing from his first day in office. Furthermore, Trump has proposed a 100 percent tariff on the BRICS nations should they endeavor to establish a currency that rivals the US dollar. These protectionism policies may drive inflation especially among the EMEs. Looser fiscal measures are anticipated to stimulate demand, thereby increasing consumer spending and business activity. On the supply side, tariffs and immigration restrictions could limit trade and reduce the availability of low-cost labor, resulting in negative supply shocks that may exacerbate price pressures. The combination of rising demand and shrinking supply is likely to reignite inflation, posing challenges for price stability across economies.

### **Conclusion**

The latest policy delineates a departure from previous approaches, as the RBI placed greater emphasis on maintaining the balance between growth and inflation. In particular, enduring price stability was identified as a necessary precondition for sustainable growth. Additionally, the importance of the timing of appropriate policy actions was stressed, with an emphasis on being mindful of future trajectories and avoiding reactive measures. A rebound in GDP growth is anticipated in the second half of FY2025. Concurrently, inflation has begun to moderate, with prices of essential commodities, particularly vegetables, returning to normal levels. As a result, a rate cut in February 2025 appears to be the most likely scenario, with an expected total reduction of 50-75 basis points in the current cycle.

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