

Post the GDP data shocker for Q2 FY25, the December 6th MPC decision is under scanner. The MPC faces a tough balancing act of weak growth (sharply lower than their estimates of 7%), elevated inflation (above the upper end of the 4 +/-2% target range in Oct'24), with sharp forex (FX) losses amid global volatility adding to challenges.

On balance, we continue to expect status quo on rates (broad consensus view) and maintain our view of 25bps cut in Feb'25 & Apr'25 with a risk of delay unless global market volatility subsides after Trump joins office on 20th Jan'25. However, we do expect the RBI to announce use of permanent liquidity tools apart from fine-tuning operations. Core liquidity is likely to switch into sustained deficit at least by Q4 FY25 unless FX outflows measures (totalling more than USD 25bn in last two months) reverse. In terms of tools, we have a bias against the use of CRR cut to boost liquidity. We believe that it is a policy signal and would indicate that the inflation horse is fully locked up in the stable and growth concerns are more dire rather than a one quarter blip even as growth recovery is in sight in H2 FY25. Hence, we would closely watch out for reference towards other tools in the RBI's kitty like OMOs, FX swaps among others to support liquidity.

- **Q2FY25 GDP data shock likely to drive MPC to lower growth projections**

The Q2FY25 GDP registering 5.4% growth, which was way below estimates has come as a shocker. In the light of second quarter data, we have revised our growth forecast downwards for FY25 to 6.4% from 6.7% previously. With H1FY25 growing at lower than estimated 6.1%, the economy is likely to recovery in growth to 6.8% in H2 on the back of pick up in govt. spending and recovery in rural demand (Fig 1). (Please see our report [India: Q2FY25 GDP growth shocks, modest recovery seen in H2](#))

We would closely watch out for the MPC's guidance on growth post the surprise from Sep'24 quarter numbers given the MPC's projection was 7% for the quarter. We will also closely watch for the extent of downward revision in the full year growth forecast of 7.2%, even after asserting hopes of recovery in H2. Various high frequency indicators have started to show an uptick since October on the back of festive season effects with pick up in consumption related indicators however, given the weak credit impulse and lagging private capex recovery amid global macro uncertainty we see it challenging for the RBI's H2FY25 growth forecast of 7.4% to be achieved. In the upcoming policy, we expect the MPC to revise downward its GDP projection for FY25. However, the inflation targeting MPC may still not resort to rate cuts at this juncture as inflation remains outside their comfort zone.

- **Inflation and more importantly FX curbing degrees of freedom for the MPC to ease rates**

The size of the hump in October CPI at 6.21% was a source of surprise for the MPC, with the Oct-Dec'24 average inflation tracking close to 5.5%, way above their forecast of 4.8% (Fig 2 & 3). This is likely to remain a cause for concern as inflation is the prime driver of rate decision. With the next reading for November also likely to stay elevated at close to 5.5% levels, the MPC would not want to give up on the efforts to control inflation, till it declines durably towards the 4% mark.

The catch though in our view is that the Q4 FY25 inflation forecast is still tracking close to the MPC's forecast of 4.2%, assuming that the spike in vegetables inflation to record high of 42% in October, squares off by the end of the fiscal as per seasonal trends. (Please see our report [Inflation: Horse likely out of the stable in Oct'24, hopefully back soon](#)) Unless weather again plays spoilsport for food inflation, the overall macro environment is non-inflationary in our view, with weak demand pressures, low fiscal & credit impulse, subdued commodity prices (especially oil) among others. FX channel may play spoilsport though sensitivity is low as RBI estimates 5%-rupee depreciation (FYTD FX move is -1.6%) to drive annual CPI inflation higher by 35 basis points.

We believe that it is not the FX impact on inflation, rather the need for interest rate defence for FX in the wake of persistent depreciation pressures, may also drive monetary policy reaction function. Post Trump victory, the global backdrop is also not supportive. Emerging markets are facing huge outflows, with strengthening of dollar, higher cost of capital, curbing monetary policy flexibility for central banks. Hence, we believe that in an increasingly volatile world, degrees of freedom for the MPC to ease policy to support growth would be constrained more by FX moves rather than inflation. The RBI would want to closely watch for trends in global volatility to decide on timing of its monetary policy shift as during Trump 2.0, it is crucial for policymakers to stay cautious.

- **Liquidity measures are key focus area in December policy**

The RBI has been undertaking efforts to contain volatility even as it has costed it close to USD 50bn of spot reserves (on intervention efforts and valuation effects as of 22nd November) with the liquidity impact estimated at Rs 2.0-2.5 lakh cr. Additionally, to defer the liquidity impact, the RBI has extended the net short forward position to USD 50bn (latest data as of October) from USD 15bn short a month ago. Hence, domestic FX and consequently, banking system liquidity have been the primary channel(s) of impact from Trump trade. Core liquidity which was close to Rs 5 lakh cr as of end September has been squeezed out on FX intervention and currency leakage effects. A slip into sustained deficit is likely in the coming months until FX outflows reverse given that the seasonal currency leakage of Rs 1.5-2 lakh cr is still pending for rest of fiscal (Fig 4).

The RBI has various tools at its disposal to support liquidity - fine tuning operations (variable rate repos and term repos) and permanent tools like CRR cut, OMO buybacks, buy/sell FX swaps among others. In our view, the latter may be preferred given that the loss to liquidity has also been permanent. Also, with the RBI's desired objective of curbing credit excesses in the banking system and credit-deposit growth convergence achieved, the RBI may show some comfort to the banking system via a signal to use steps to infuse liquidity as it likely slips into deficit by Q4. As stated above, we have a bias against the use of CRR cut to boost liquidity and would closely watch out for reference towards other tools in the RBI's kitty like OMOs, FX swaps among others to support liquidity. (Please see our report [INR-Liquidity-Fx-outflows-make-the-pathway-difficult.pdf](#))

- **Expect status quo on stance and rates in December**

In terms of the MPC outcome due on 6th December, we align with the consensus view of no change in rates with a neutral stance. A tough balancing act likely for the MPC and hence our focus is likely to remain on policy guidance (balanced to dovish in our view) and the likely changes in FY25 projections for growth (MPC: 7.2%, UBI: 6.4%) and inflation (MPC: 4.5%, UBI: 4.7%). The bond markets eagerly await announcement of any liquidity measures as well.

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Fig 1: MPC likely to revise FY25 growth forecast lower and inflation projection higher given recent data surprises

UBI vs MPC projection comparison (y/y %)				
	GDP		CPI	
	RBI MPC	UBI	RBI MPC	UBI
Q1	6.7*		4.9*	
Q2	7.0	5.4*	4.1	4.3*
Q3	7.4	6.5	4.8	5.5
Q4	7.4	7.0	4.2	4.2
FY25	7.2	6.4	4.5	4.7

*actuals

Fig 2: CPI inflation spiked above the upper end of the MPC's 4+/-2% band in October

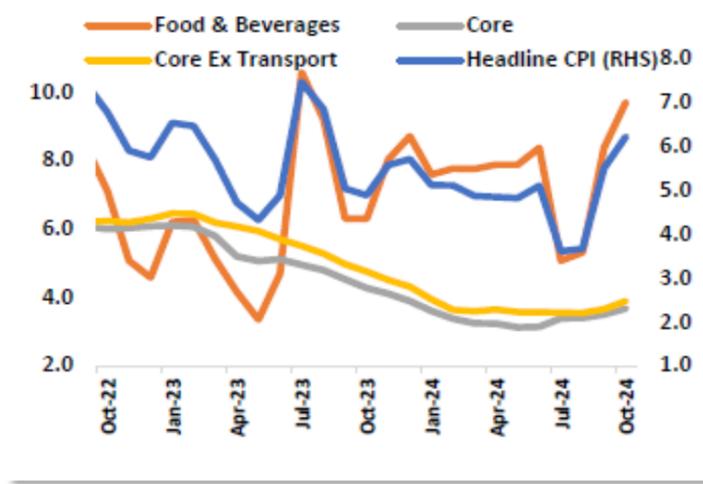


Fig 3: CPI ex vegetables remain subdued at 3.6% implying underlying inflation pressures are subdued

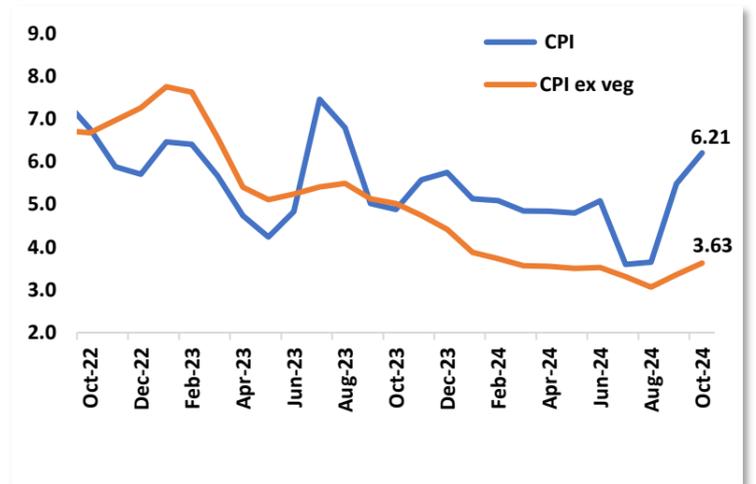


Fig 4: Core liquidity likely to switch into sustained deficit at least by Q4 FY25

Rs bn.	Liquidity subcomponents				Sources of core liquidity					
	Systemic liquidity balance	Govt. balance with RBI	LTRO	Core liquidity	Spot FX intervention	OMO	LTRO	RBI dividend	CIC	CRR deposits
FY19	-992	1,227	-	235	-1,119	2,992	-	499	3,095	316
FY20	3,463	506	1,251	5,220	3,120	1,149	1,251	1,760	2,997	-534
FY21	5,004	2,326	821	8,150	5,105	3,133	-430	571	4,193	1,466
FY22	7,183	354	867	8,404	1,346	2,140	47	991	2,770	1,719
FY23	1,510	-487	732	1,755	-2,173	-350	-135	307	2,429	453
FY24	544	1,722	71	2,337	3,395	-185	-661	874	1,370	871
FYTD (22nd Nov)	94	1,297	-	1,391	-1,640	-241	-39	2,110	417	719
FY25 (Proj.)	?	318	-	?	?	-241	-67	2,110	2,452	?

Fig 5: Credit impulses weakened despite start of busy season in October with growing issue demand vs supply

Sectors	Credit Accretion (Rs trillion)			
	Apr-Sep'23	Oct'23	Apr-Sep'24	Oct'24
Bank Credit	8.8	3.1	7.5	1.2
Non-food Credit	8.8	3.1	7.5	1.2
Agriculture	1.4	0.5	1.0	0.4
Industry	1.1	0.1	1.5	-0.3
Services	3.2	0.8	1.6	0.5
of which: NBFC ex HFCs EX PFIs	0.5	0.4	0.1	0.2
Personal Loans	3.0	0.7	3.0	0.6
of which: Unsecured Retail	1.3	0.4	0.6	0.2

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