SBI Research

Prelude to MPC Meeting: February 5-7, 2025

We expect a 25-basis point rate cut in Feb'25 policy. Cumulative rate cut over the cycle could be at least 75 basis points, with 2 successive rate cuts over February and April 2025…. With an intervening gap in June'2025, the second round of rate cuts could start from October'2025…RBI Liquidity Framework needs to be revisited…Monetary Fiscal coordination will require a delicate handholding as Government navigates on the FRBM path..

Issue # 30, FY25   04-February-2025

Executive Summary….

- **Global economy** continues to exhibit resilience and is expected to grow in the range 3.2-3.3% for 2025. The global inflation has continued to soften and is expected to approach inflation targets for most of the central banks albeit with different speed across geographies
- **The impact of trade wars** on global growth and in turn on inflation remains uncertain at this stage. While the new US administration's tariff decision are so far confined to North America and to some extent on China, the impression of full-scale tariff across all countries has so far not materialized
- The general impression is that fresh round of **trade wars will cost 30-50 bps for global GDP growth with differing regional impacts**. **The regional impact will be more nuanced and conditional on regional economic structure and the stage of business cycle**
- The regional impact of tariffs on domestic inflation of exporting country will be conditional on whether 'exchange rate' factor or 'negative demand shock' factor outweighs the other and what is pricing power in general. Given this, Canada expects higher inflation in the long run if the trade war persists. **The impact on China will be limited as its export basket is well diversified in comparison to Canada and Mexico**
- **Domestic economy in this global backdrop is entering the fourth quarter in the shadow of the Union Budget 2025-26**. With fiscal stimulus to support consumption, and an overall fiscal consolidation, the net market borrowings of the Centre is estimated at Rs 11.5 lakh crore for FY26
- With credit growth showing moderate trend despite the sequential slowdown, the durable liquidity position in the banking system at the end of the FY25 may come around ~Rs 0.6 lakh crore and system liquidity may be around ~Rs 1 lakh crore surplus

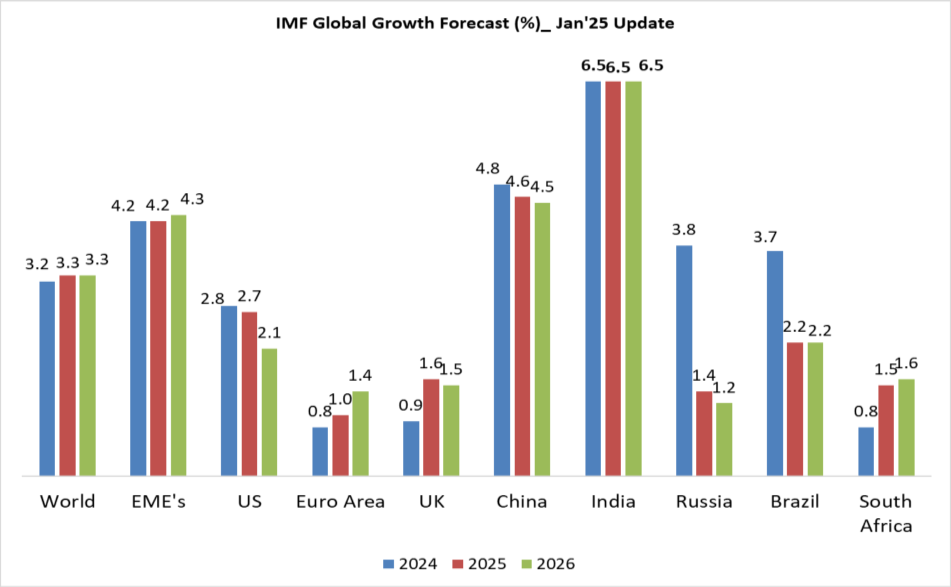
Executive Summary….

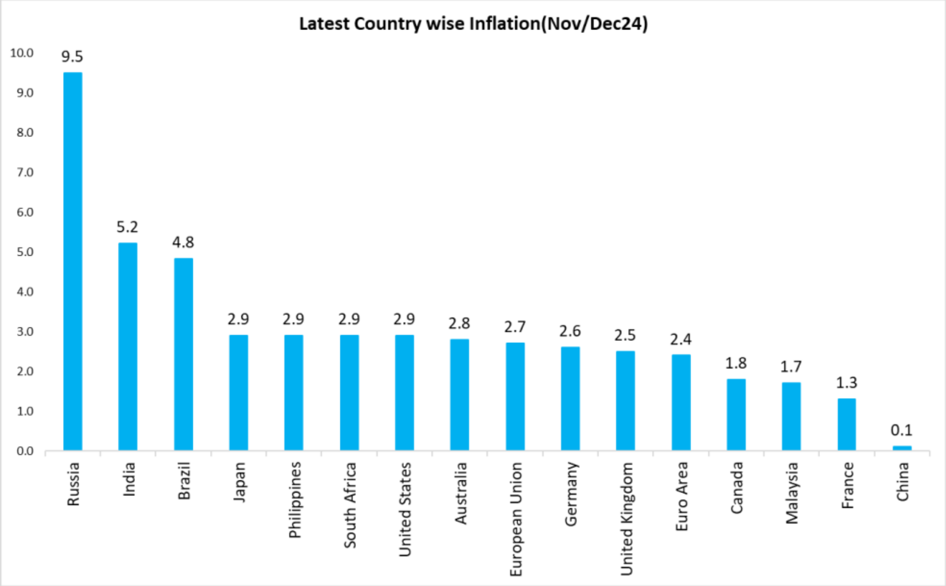
- **We therefore feel that overall financing of the fiscal deficit will remain comfortable**. We believe that 75% of the total financing may be completed through long-term instruments. The current OMO purchase of RBI, i.e. Rs 60,000 Cr is 3.8% of available AFS securities as of Sep 2024.
- **The domestic CPI inflation is expected to come down to 4.5 % in Q4 FY25 and average to 4.8 % in FY25. January inflation numbers trending closer to ~4.5%..FY26 average inflation at 4.2%-4.5%..October-December 2026 inflation numbers could see a fall below 4%.....Core inflation might overtake Headline by Sep'2025**
- **This base line trend in CPI is subjected to two caveats**
  - One is the impact of the recent exchange rate volatility and its pass through to final consumption and intermediate consumption. Analysis suggests that domestic growth factors (real GDP growth, leading indicators etc.) dominantly explain the rupee's volatility in long run (72%), while non-growth factors (such as Dollar index, call money market rate etc.) significantly explain over short duration (45%).
  - The import content of private final consumption is around 10% and current weighted contribution of imported inflation in total CPI inflation is around 0.9% is rising
  - The second factor is the downward pressure on the domestic price due to tariffs. Given that currently profits margins are healthy and given the time lag for fiscal stimulus to play out, the pass-through impact on producer prices will be limited in the short run.
- Given the fiscal stimulus and the uncertain impact of trade wars, RBI faces delicate task of balancing the risks. **As the fiscal stimulus plays out, RBI at least in the short run has room for rate cuts. Current pause by Federal Reserve gives some time for RBI to ascertain the inflationary expectations have been fully anchored**

Global Developments

Global economy is weathering the aggressive restraint of monetary policy, but how long?

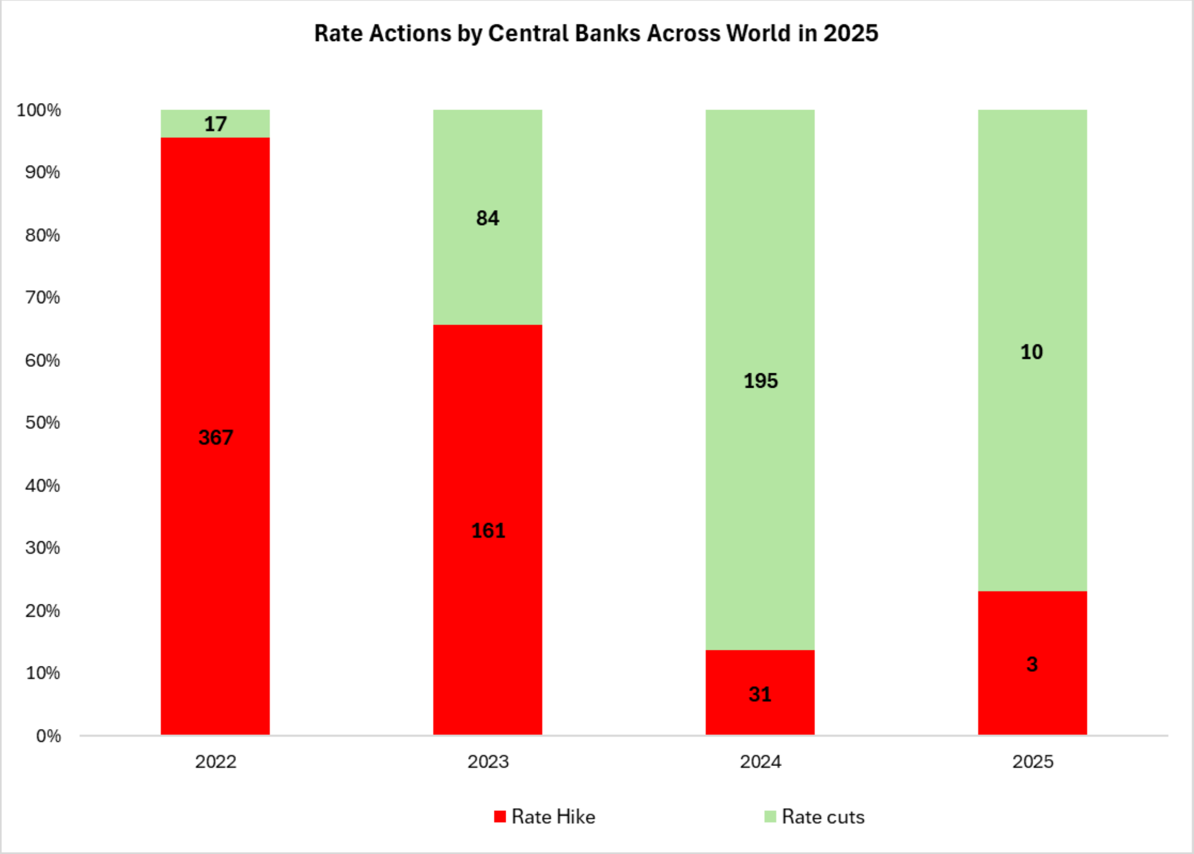
- Global growth is expected to stabilize around 3.2-3.3% without accounting for the Trade War 2.0
- Factoring in the impact of trade wars, global GDP may see downside of 30-50 bps in 2025
- Relatively Canada and Mexico will be impacted more than China given lower share of US in China's total exports in latest episode of tariffs by the US
- Inflation continued to decline, partly due to further declines in food price inflation
- Appreciation in dollar is expected to put exporting country currencies under pressure
- Impact of tariffs on domestic inflation of exporting country will be conditional on whether exchange rate factor and negative demand shock outweighs





Geopolitical risks and central banks rate actions

- Central bank rate action towards accommodation continues in 2025
- Total rate cuts in 2024 stands at 195 far outweighing number of rate hikes at 31
- In China, policy accommodation may accelerate with rising trade protectionism and slower domestic growth
- Trajectory of Federal Reserves interest rates will be decided by the impact of tariff on US inflation
  - Fed decided on a pause in January 2025
  - Evolution of domestic inflation due to tariffs needs to be monitored
- Dollar is expected to strengthen in the near future given the trends in US trade and fiscal policy
- In the emerging markets rate will be conditional on the pass through of exchange rate depreciation on to domestic inflation



Market Borrowing and Monetary/Fiscal Coordination

Market borrowing in FY26 are comfortable for fiscal policy to support monetary policy…

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- Gross market borrowings of the Centre for FY25 stood at Rs 14.0 lakh crore, with Net borrowing at Rs 10.7 lakh crore (almost Rs 90,000 crore less than the BE)The Government undertook switch of Rs 1.5 lakh crore and buyback of Rs 88,000 crore
- For FY26, Gross market borrowing through dated securities has been budgeted at Rs 14.8 lakh crore and repayments estimated at Rs 3.3 lakh crore. The Net market borrowing therefore stands at Rs 11.5 lakh crore (~73% of fiscal deficit) against Rs 10.5 lakh crore in the previous budget
- The Government has also announced switch of Rs 2.5 lakh crore in FY26, but the Government stocks repurchased by means of switch will not have any impact on the fiscal situation
- State Gross borrowing for FY26 is expected at Rs 10.9 lakh crore and with repayment of Rs 3.7 lakh crore, Net borrowing is pegged at Rs 7.2 lakh crore. Thus, the Net borrowing of the Centre and State combined comes to Rs 18.7 lakh crore
- Total borrowing including PSU comes at 6.1 % of GDP in FY25

Market Borrowings through Dated Securities (Rs lakh crore)				
Centre	**FY24**	**FY25 (BE)**	**FY25 (RE)**	**FY26 (BE)**
Gross Borrowing	15.4	14.0	14.0	14.82
Repayments*	3.63	2.38	3.26	3.28
Net Borrowing	11.8	11.6	10.7	11.54
State				
Gross Borrowing	10.1	10.0	10.2	10.9
Repayments	2.8	3.2	3.2	3.7
Net Borrowing	7.3	6.8	7.0	7.2
Total				
Gross Borrowing	25.5	24.0	24.2	25.7
Net Borrowing	19.1	18.4	17.7	18.7

Source: Union Budget Documents, RBI & SBI Research,* FY25 repayment is including a buyback of Rs 88000 cr and excluding switches,adjusted with additional recovery from GST Compensation Fund against back to back loan extended to States/Uts: FY24-Rs 78104cr, FY25-Rs123604 cr and FY26-Rs 67500cr

Total Borrowing Requirements including EBR (Rs lakh crore)			
	FY24	**FY25 (RE)**	**FY26 (BE)**
Net market borrowing of Centre	11.8	10.7	11.5
Net market borrowing of State	7.3	7.0	7.2
Extra Budgetary Resources of Center (through fully serviced bonds & NSSF)	0.0	0.0	0.0
Extra Budgetary Resources for PSUs	1.6	2.2	4.3
Total Borrowing	**20.7**	**19.9**	**23.1**
Total Borrowing (% of GDP)	**7.0**	**6.1**	**6.5**

Source: Union Budget Documents & SBI Research

Government Fiscal path for next 5 years shows challenge in diversifying the borrowing base

- In the Union Budget 2025-26, Government has computed several fiscal scenarios based on GDP growth trends and varying degrees of fiscal calibrations for the 5-year period of FY 2026-27 to FY 2030-31
- Based on the two extreme scenario and the most moderate scenario, we have calculated the gross market borrowing requirement for the next 5 fiscals (FY27 to FY31)
- As per our calculations, the Gross market borrowing for the next 5 fiscals would be in the range of Rs 93.8-95.2 lakh crore (on an average Rs 18-19 lakh crore per annum, higher than the current run rate at Rs 15 lakh crores)….**It is thus imperative that Government also looks at borrowings through alternative sources like small savings……**

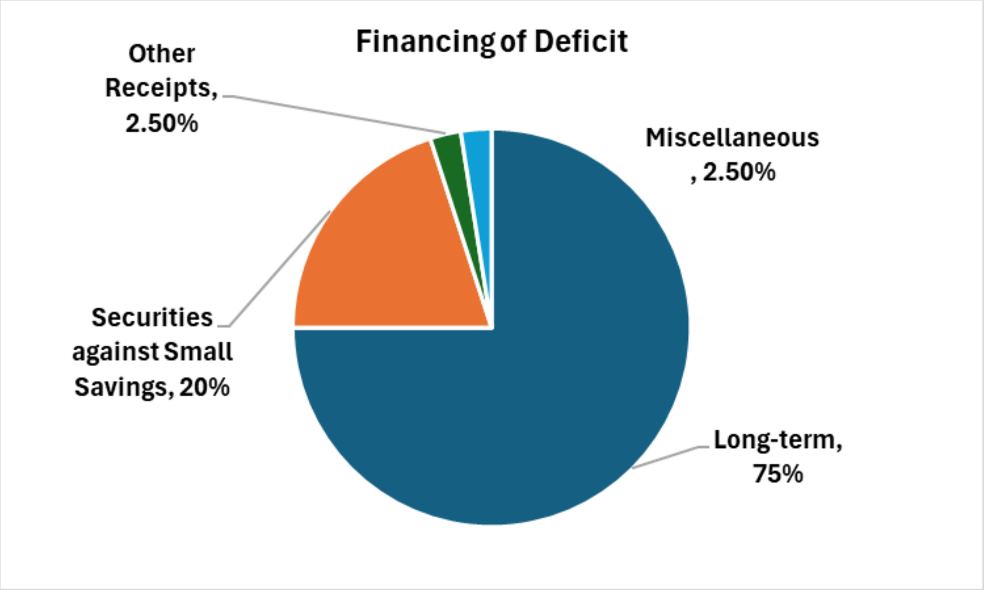
Gross Market Borrowing Requirement (FY27 to FY31) under different scenarios

Scenarios		FY31 Debt/GDP	FY31 FD % of GDP	Gross Market Borrowing Requirement (FY27 to FY31) Cumulative
Extreme 1 (Most Pessimistic)	Nominal GDP @ 10% with Mild fiscal calibration	52.0%	3.4%	Rs 95.2 lakh crore
Most Moderate	Nominal GDP @ 10.5% with Moderate fiscal calibration	49.7%	3.2%	Rs 94.4 lakh crore
Extreme 2 (Most Optimistic)	Nominal GDP @ 11% with High fiscal calibration	47.5%	3.1%	Rs 93.8 lakh crore

Source: Union Budget document, SBI Research; Assuming Borrowing = 70% of FD

Financing of Deficit and Fiscal/Monetary Coordination

- Now the question is how this borrowing would be financed given the current market absorption capacity
    - We believe that 75% of the total financing may be completed through long-term instruments only
    - Of the remaining 25%, major chunk may be financed through securities issues against small savings
    - This indicates the need for a vibrant and deep bond market in India
    - Reliance on small savings will be possible only when savings rate are attractive enough to encourage savers to save



- As per RBI, “*the debt path over the next five years, even under the best-case scenario, will further squeeze fiscal space unless strategic policy efforts covering both taxes and expenditure aim at targeted consolidation, without relying perpetually on the wobbly comfort from a favorable interest rate minus growth condition of debt sustainability*”

Source: RBI FSR

With an unchanged ownership in G-sec in FY26, OMO gap in FY26 could still be around Rs 1.7 trillion

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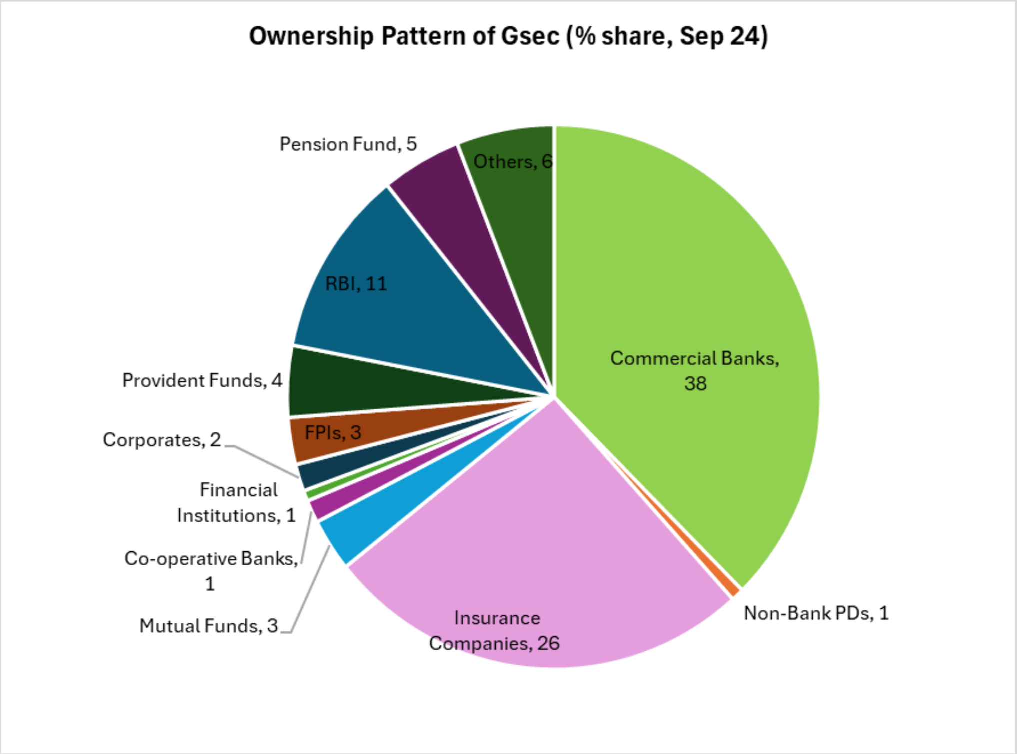
- Assuming the % share of ownership is same as that of Sep'24, with slight increase in FPI's, the minimum gap to be filled is Rs 1.66 lakh Crores.

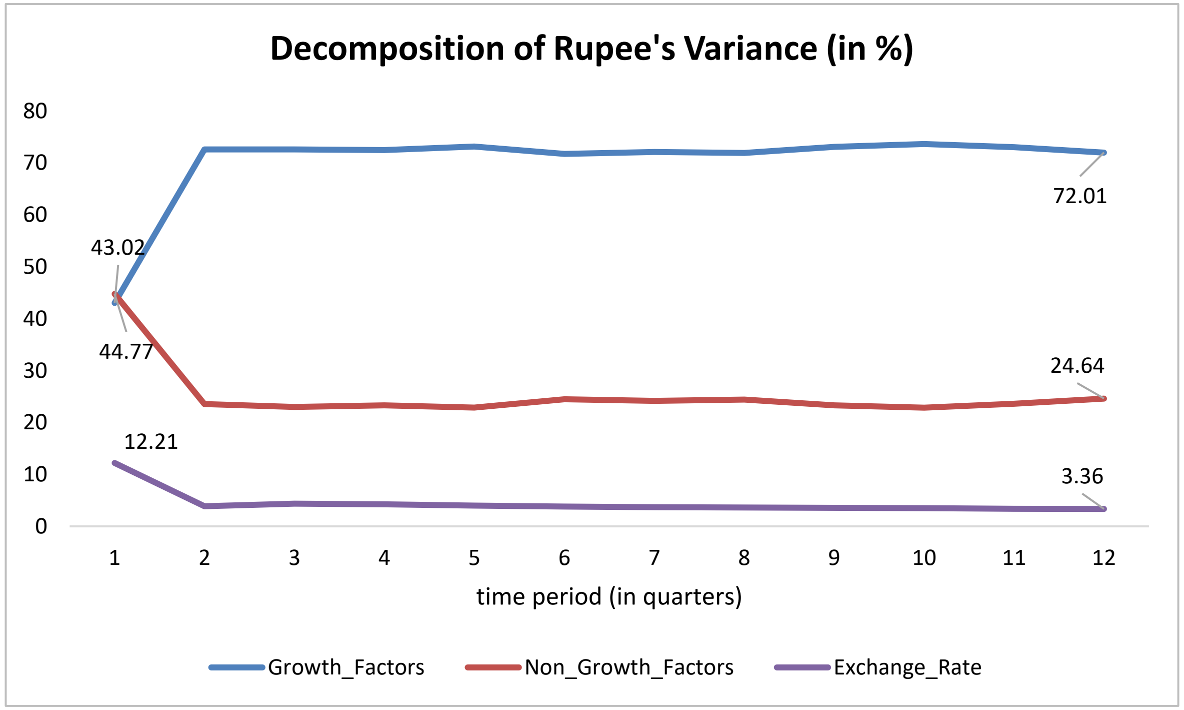


SLR Demand - Supply (Rs cr)	
	FY26
Demand from Banks	6,58,124
Demand from non-Bank PDs	15,023
Demand from PFs	1,93,426
Demand from Insurance cos	4,69,481
Demand from MFs	60,094
FPI Demand	31,925
Demand from Co-op banks	39,436
Demand from others	97,652
Financial institutions	26,291
Corporates	33,803
Pension fund	86,385
Total Demand from various players	17,11,639
Total Supply(Net borrowing from central and states)	18,77,924
Minimum Gap to be filled (through RBI OMO Purchases)	**1,66,285**

Domestic Economy

Delving into the Rupee's Volatility shows the importance of growth factors….

- We tried to understand the sources of variation in Rupee-Dollar Exchange rate using **Variance Decomposition**. Using quarterly data from FY18 to FY24, we partitioned the total variation into Self, Growth and Non-growth factors
- We found that Growth factors (such as growth rate of Real GDP, Leading indicators etc.) dominantly explain the rupee's volatility in long run (72%), while Non-growth factors (such as Dollar index, Call money market rate etc.) significantly explain over short duration (45%)
- **Also, 12% variation in exchange rate in initial period can be attributed to its own past values due to the phenomena of persistence and market expectations. Exchange rate often exhibit trends or momentum where past values influence expectations about the future. However, in the long run this share is reduced to marginal 3.4% delineating the dominance of other factors in explaining variations in exchange rate dynamics**

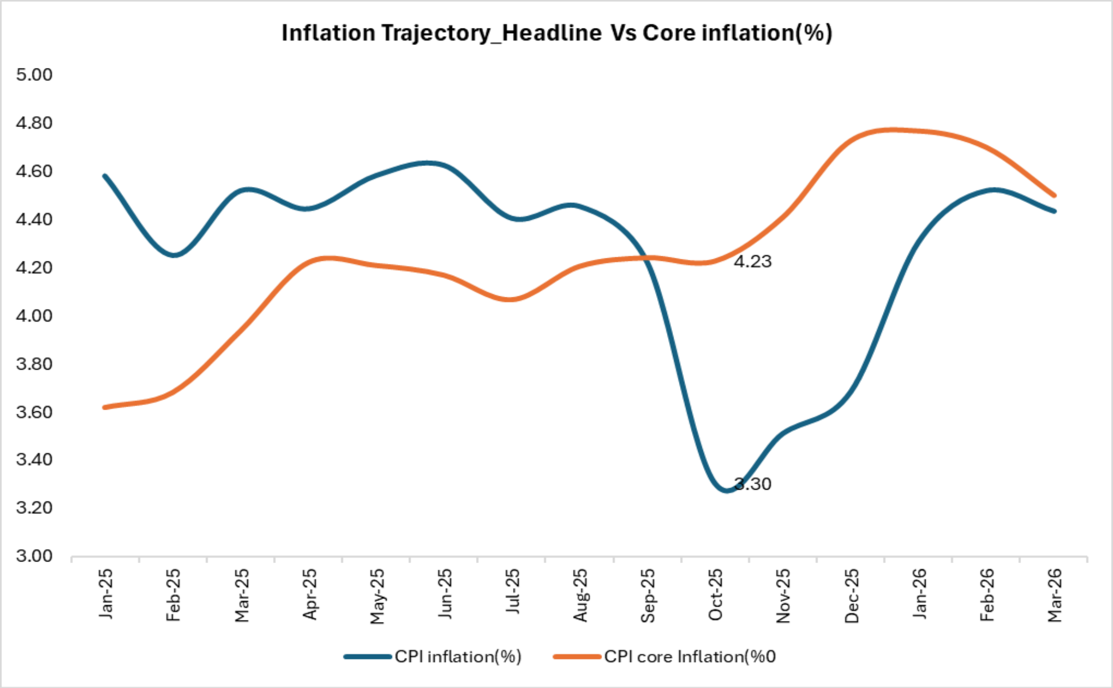


CPI expected to come down at 4.5 % in Q4 FY25

- CPI inflation may come down to 4.5 % in Q4 FY25 and averaged to 4.8 % in FY25

- Based on this trend, we expect FY26 inflation may come 4.2-4.4 % and core inflation in the range of 4.4% to 4.6 %

- By Sep'25 , core inflation may surpass headline inflation. Because of the base effect, headline inflation may average 3.6% to 3.8 % in Q3 FY26



Liquidity Position

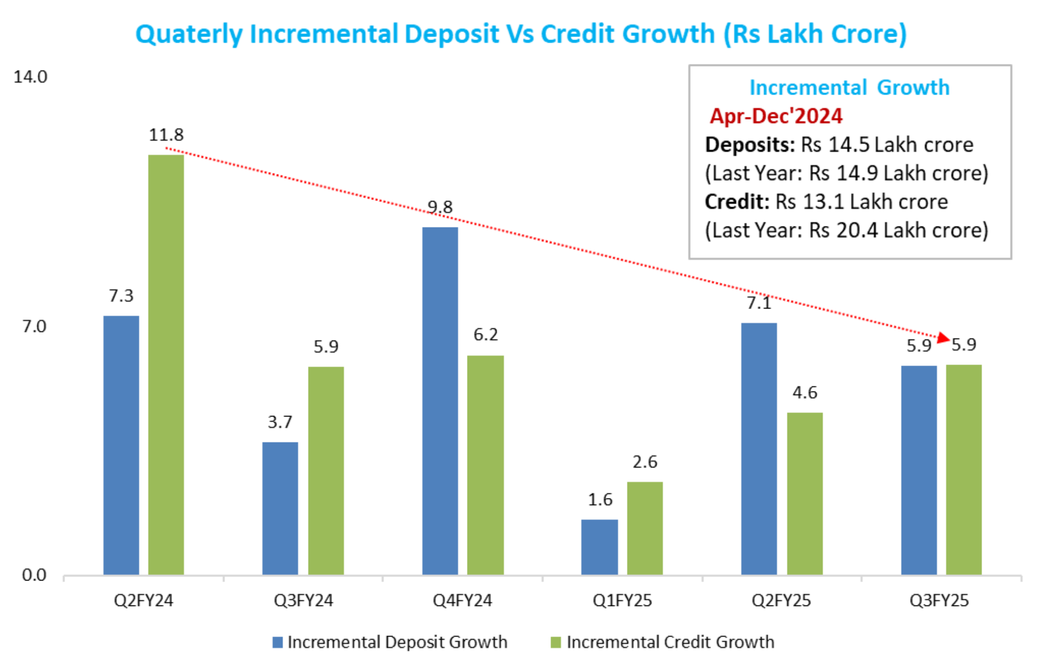
- Average liquidity deficit from 16th Dec 24 stands at Rs 1.96 lakh cr as on 31st Jan 25
- Average GoI cash balance of the same period came at Rs 2.1 lakh cr
- Based on the RBIs recent liquidity injections, we are estimating the durable liquidity at the end of the FY may come around ~Rs 0.6 lakh cr and System liquidity may be around ~Rs 1 lakh crore surplus

Liquidity Estimate by Mar'25 (Rs billion)	
Autonomous factors	Rs bn
1. Currency in circulation withdrawal	-1700
2. GoI Cash Balances drawdown	520
3. Forex intervention by RBI	-1700
Policy driven (Discretionary) factors	
4. VRR auction 56 days	500
5. Open Market Operations by RBI	600
6. USD/INR buy sell swap	428
7. Required CRR at 4% (drawdown)	50
8. Core liquidity change(1+3+4+5+6+7)	**-1,823**
Memo items:	
System liquidity Net Absorption (+) / Injection (-) as at end-period	~ 1000
Net durable liquidity [surplus (+)/deficit (-)] as at end-period	~600
Source: SBI Research	

Average Liquidity Position (Rs lakh crore)			
Indicator	**FY25 Average**	**Post policy (09 th Dec - till date) average**	**31-Jan-25**
Repo Outstanding	0.88	2.33	2.62
Reverse Repo Total	0.35	0.00	0.00
SDF	0.87	0.83	1.03
MSF	0.07	0.07	0.06
Net LAF (-absorption)	-0.18	1.66	1.75
Government Cash Balance (System liquidity-core liquidity)	2.54	1.94	1.67
Core Liquidity (-Surplus)	-2.71	-0.26	0.40
Source: SBI Research, RBI			

Credit Growth Continue to Decline

- As per the latest data (up to 10 Jan'25) of SCBs, bank credit grew YoY by 11.5% (Last year: 20.3%) and deposits by 10.8% (Last year : 13.1%). However, on YTD basis, credit crew by 8.3% (Last year: 16.8%) and deposits by 8.2% (last year 10.8%). The sectoral credit growth indicates a decline in across the board, however, during Q3, credit growth picked-up. By looking at the trend growth, both deposits and credit may grow in the range of 11-12% during FY26
- In response to the 250 bps increase in the policy repo rate since May 2022, banks have revised their repo linked external benchmark-based lending rates (EBLRs) up by a similar magnitude
- On the deposit side, the weighted average domestic term deposit rates (WADTDRs) on fresh and outstanding deposits increased by 254 bps and 193 bps, respectively, during the same period
- Asset quality of SCBs improved further with their GNPA ratio declining to a 12-year low of 2.6% in Sep'2024. CRAR and CET1 ratios of SCBs displayed similar movements and stood at 16.7% and 14.0%, respectively, in Sep'2024, which were much higher than the regulatory minimum requirements



ASCBs Sector-Wise Credit Flow (Rs bn):December 2024

Sectors	(Apr-Dec'23)FY24 YTD		MoM			(Apr-Dec'24) FY25 YTD		YoY %	
	Rs bn	%	Oct-24	Nov-24	Dec-24	Rs bn	%	FY24 (Dec)	FY25 (Dec)
Agri. & Allied	**2646**	**15.3**	**380**	**182**	**156**	**1678**	**8.1**	**19.4**	**12.5**
Industry	**2278**	**6.8**	**-274**	**388**	**413**	**2016**	**5.5**	**8.0**	**7.2**
MSE (Priority)	2712	16.5	191	152	531	1711	8.7	20.3	12.1
Infrastructure	786	6.4	-13	140	18	103	0.8	5.8	1.0
Services	**7250**	**19.5**	**480**	**689**	**1086**	**3703**	**8.1**	**23.3**	**11.7**
NBFCs	1777	13.2	76	387	465	737	4.8	15.0	6.7
Personal Loans	**9905**	**23.7**	**508**	**874**	**600**	**4636**	**8.7**	**28.4**	**12.0**
Housing (Including Priority)	6466	32.5	263	368	231	2130	7.8	35.3	11.1
Other Personal Loans	1915	16.5	60	382	70	754	5.4	23.2	9.2
Gross Bank Credit	**22867**	**16.7**	**1129**	**2709**	**2337**	**13107**	**8.0**	**20.0**	**11.2**

Source: RBI, SBI Research

Indian Inc. shows early sign of EBIDTA growth in Q3FY25….

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- Early results from Indian Inc., more than 1000 listed entities ex BFSI, for Q3FY25, suggest positive EBIDTA growth of around 5% y-o-y, after a consecutive two quarters of negative EBIDTA growth

- Revenue growth, ex-BFSI, continued to be lower, single digit in Q3FY25 also (FY25 - Q3, early trend – 3.4%, Q2 – 3.9%, Q1-5.9%)

- Sectors such as Capital Goods, Edible Oil, Realty, Pharma, Retail etc. reported better growth number across key parameters (see table)

Corporate Results - Growth in Key Parameters Q3FY25 vis-a-vis Q3FY24				
Sector	No of Cos.	Net Sales	EBIDTA	PAT
Cables	6	13	19	10
Capital Goods - Electrical Equipment	19	43	90	99
Capital Goods-Non Electrical Equipment	23	15	15	10
Chemicals	45	11	22	17
Consumer Durables	20	17	15	9
Edible Oil	5	30	29	49
Fertilizers	5	27	113	161
Healthcare	16	13	7	10
Hotels & Restaurants	13	14	32	35
IT - Software	66	7	10	7
Non Ferrous Metals	8	19	26	28
Pharmaceuticals	44	15	36	61
Power Generation & Distribution	11	8	18	2
Realty	37	30	29	10
Retail	13	17	16	15
Source; Cline more than 1000 listed entities; SBI Research				

Final Thought

- So, what will be the RBI's policy look like:

Indicator	Our View
Global Economy and RBI	Global economy continues to exhibit resilience and is expected to grow in the range 3.2-3.3% for 2025 Global inflation to soften despite the regional uncertainty due to impact of trade wars Fresh round of trade wars will cost 30-50 bps points for global GDP growth with differing regional impacts. The regional impact will be more nuanced and conditional on regional economic structure and the stage of business cycle The regional impact of tariffs on domestic inflation of exporting country will be conditional on whether 'exchange rate' factor or 'negative demand shock' factor outweighs the other and what is pricing power in general. Given this, Canada expects higher inflation in the long run if the trade war persists. The impact on China will be limited as its export basket is well diversified in comparison to Canada and Mexico
Repo Rate & Liquidity	**We expect a 25-basis point rate cut in Feb'25 policy. Cumulative rate cut over the cycle could be at least 75 basis points, with 2 successive rate cuts over February and April 2025. with an intervening gap in June'2025, the second round of rate cuts could start from October'2025** **We found that growth factors (such as growth rate of Real GDP, Leading indicators etc.) dominantly explain the rupee's volatility in long run (72%), while Non-growth factors (such as Dollar index, Call money market rate etc.) significantly explain over short duration (45%)..This substantiates that using interest rate as an alibi of protecting exchange rate in an inflation targeting regime is inconsistent with the mandate….** With an unchanged ownership in G-sec in FY26, OMO gap in FY26 (?) could still be around Rs 1.7 trillion. Thus more liquidity measures could be required on a sustained basis. The RBI could look into using CRR more as a regulatory intervention tool / countercyclical liquidity buffer rather than as a liquidity tool in future. There is an urgent need to revisit the existing liquidity management framework by RBI by replacing the WACR as a policy rate as it does not serve the intended purpose….

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