SOCIO-ECONOMIC VOICES

“RBI Rate Cuts Necessary to Prevent Monetary Tightening Amidst Slowing Inflation and Fiscal Contraction”

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“Election-related-Expenditure Disruptions, Weak Exports and Profit Slowdown Stalling India’s Investment Recovery”

Intro: As India braces for a growth slowdown to 6.5% in 2024/25, **Gaura Sen Gupta, Chief Economist, IDFC FIRST Bank** dissects the real forces at play—cyclical downturns, weak corporate profitability and demand uncertainty. With private capex stalling despite robust balance sheets and looming rate cuts, she unveils the hidden cracks in India’s investment story. Will policy interventions be enough? More such questions and their answers at this week’s **Socio-economic Voices** for sharp insights into India’s economic crossroads. Read on the exclusive interaction with senior journalist **Mahima Sharma** only on **Indiastat.**

MS: Given the projected slowdown to 6.5% in 2024/25, primarily due to a weaker manufacturing sector and sluggish corporate investments, do you view this deceleration as a cyclical downturn or indicative of deeper structural issues?

GS: The slowdown is cyclical, not structural. Fundamentals remain supportive for recovery in private corporate capex with strong bank and corporate balance sheets. The weakness in corporate capex is driven by uncertainty on domestic and external demand conditions. **On the domestic front, urban demand is showing signs of weakness due to slowdown in urban wage growth.** On the external front, tariff wars will keep global growth weak. Another factor which is preventing pick-up in corporate capex is slowdown in companies profit growth. All these factors are cycles in nature.

MS: With gross fixed capital formation slowing to 6.1% in FY25, partly due to reduced government capital expenditure, are the current monetary policies to blame for?

GS: There has been a significant slowdown in government capital expenditure at both Centre and State government level. Central government capital expenditure growth slowed to 5.0% in FYTD25 (Apr-Jan) from 26.5% in FYTD24 (Apr-Jan). The slowdown in state government capital expenditure has been more pronounced, tracking lower by 3.7%YoY in FYTD25 (Apr-Dec) v/s 39% growth in FYTD24 (Apr-Dec). The slowdown in general government capital expenditure is driven by disruption in expenditure patterns caused by elections (General Election and state government election in a few key states). Another factor was heavy rainfall last year which impacted capital expenditure.

MS: If monetary policy isn’t to blame for the growth slowdown then why the need to cut interest rates?

GS: The slowdown in growth is driven by cyclical factors such as moderation in companies profit growth due to lesser decline in input costs. As companies profitability growth slowed, it resulted in softer urban wage growth, which impacted urban demand. Fiscal policy became inadvertently contractionary in FY25 with sharp slowdown in capital expenditure.

The need for monetary policy rate cuts is driven by moderation in inflation pressures, which will result in rise in real rates. Indeed, the estimate for inflation in FY26 is tracking at less than 4%. This implies that the real policy rate will rise to 2.25% or higher. This will make monetary policy contractionary. As per RBI’s assessment, neutral real rates are between 1.4% to 1.9%. Hence further rate cuts are necessary to ensure monetary policy doesn’t become restrictive. **We expect a 25 bps cut in April and 25 bps cut in June.**

MS: Given the current tight interbank liquidity, how effective are the Reserve Bank of India's rate cuts in stimulating economic activity? What other economic measures can further effectively stimulate investment and counteract the growth slowdown?

GS: The effectiveness of the rate cut will depend on whether it's transmitted by the banking system. The RBI rate cut in February hasn’t been transmitted with rise in MCLR rates and deposit rates. Transmission has taken place on loans linked to external benchmarks. This reflects tight interbank liquidity conditions and credit growth outpacing deposit growth.

RBI has infused substantial durable liquidity since December 2024 worth INR4.9tn, via CRR cut, OMO purchase and USDINR buy-sell swap. The durable liquidity infusion measures are expected to reduce system liquidity deficit to mild negative by March-end from INR2tn deficit (average) in January 2025. Apart from durable liquidity infusion RBI has increased the frequency and quantum of VRRs to keep the overnight rates close to repo rate. **The durable liquidity infusion is also expected to support deposit growth** which will ease some of the pressure on cost of funds.

MS: Given the divergence between India’s robust GDP headline numbers and the weakening rural demand, does the RBI risk overestimating growth resilience while underplaying inflation persistence?

GS: RBI has revised down its FY25 GDP growth estimate from 7.0% to 6.5%. The downward revision reflects weakness in GDP growth due to weakness in urban demand and lesser government capital expenditure. The relatively positive assessment on growth resulted in monetary policy remaining focused on inflation and delaying the start of the rate cut cycle to February 2025.

India’s inflation problem was localised within the food component, caused by successive supply-side shocks. **The ability of monetary policy to address supply-driven inflation is limited as it works via demand.** More effective is supply-side management by the government. Moreover, the risk of generalisation of price pressures was low due to the presence of a negative output gap. This was reflected by core core inflation remaining near historical lows, despite elevated food inflation.

Hence in our view policy easing should have begun in December 2024 itself, when growth started showing signs of weakness. However, elevated inflation mainly due to food inflation, prevented RBI from cutting interest rates.

Another factor which made monetary policy tighter than necessary was the focus on USDINR stability. Over October 2024 to January 2025, there was significant FX intervention (dollar selling) by the RBI to limit the depreciation of the INR against the dollar. We estimate that RBI net sold dollars worth US$71.5bn during this period. The large quantum of dollar selling resulted in substantial drain in interbank liquidity, resulting in tightening in monetary policy.

That said over the last few months monetary policy focus has firmly shifted towards growth, with inflation pressures easing. RBI cut policy rates in February 2025 and has undertaken substantial liquidity infusion. Since December 2024, RBI has infused INR4.9tn in durable liquidity via three instruments – CRR cut, OMO purchase and USDINR buy-sell swaps. The liquidity infusion is aimed at supporting transmission of rate cuts via the financial system.

MS: Is the USD/INR exchange rate reflective of its fair value or is there potential for further depreciation, especially in light of recent market volatility?

GS: The overvaluation of INR has reduced on the REER metric to 4.8% as of January 2025 from 8.1% as of November 2024. The reduction in overvaluation is led by depreciation of INR and reduction in inflation pressures in India. In the recent period, INR has usually been in the overvalued territory of 3% to 4%.

We see scope for further limited INR depreciation as capital inflows remain weak. Volatile FPI flows are tracking at -US$2bn in FYTD25 v/s net inflows of US$41bn in FY24, due to outflows in equities.

Meanwhile, FPI inflows into debt is supported by India's inclusion into JP Morgan Bond Index, which is completed by March 2025. The outflows from equities was driven by higher yields in the US and slowdown in India companies profitability. The more stable FDI inflows have also slowed down to US$1.2bn in FYTD25 (Apr-Dec) from net inflows of US$10.1bn in FY24 and US$28bn in FY23.

The slowdown in FDI inflows is due to a jump in repatriation and ODI (FDI by Indian companies abroad). Indeed, balance of payments (current account plus capital account) in FY25 is tracking around -US$20bn to -US$25bn, due to sharp slowdown in capital inflows. This is despite the current account deficit remaining well contained at 0.8% of GDP in FY25. Negative Balance of Payments indicates that capital inflows are not sufficient to fund the current account deficit, increasing the reliance of the market on RBI to supply dollars.

MS: How significant is the risk posed by potential U.S. tariffs on India's growth and inflation outlook, considering that 17.7% of India's exports are U.S.-bound?

GS: President Trump's threat of reciprocal tariffs could have a negative impact as India's tariffs are higher than the US by 6.5% (weighted average basis). Sectors where the tariff differential is 10% or greater are food products, animal, vegetable, textiles, transportation and footwear exports. **That said, direct impact might be limited as exports in these three segments to the US accounts for just 4.5% share in overall India exports.** The impact from tariff wars will be indirect via its impact on global growth. Softer global growth could result in more subdued India export growth. **As per RBI sensitivity analysis a 1% moderation in global growth, reduces 30bps from India's GDP growth.**

The positive factor for India is that its growth is driven from domestic demand, rather than global demand. Another limiting factor is that the elasticity of demand for food products / agricultural exports might be low.

MS: Despite improved bank and corporate balance sheets, private capital expenditure remains subdued. Why hasn't private capex revived, despite both bank balance sheets and corporate balance sheets in better conditions?

GS: Despite strong fundamentals of healthy twin balance sheets (corporate and bank balance sheet) corporate capex remains muted. This is due to uncertainty on demand both domestic and external. Since H2FY24 urban demand has been slowing due to softer growth in urban wages. Meanwhile external demand has also remained subdued with merchandise export growth in nominal terms tracking at -0.1% in FYTD25 (Apr-Feb). Another factor which has prevented recovery in private corporate capex is slowdown in profitability in FY25.

MS: With India's fiscal deficit projected to narrow, do you see this fiscal consolidation as a catalyst or a constraint for private investment, especially given the declining private capex cycle?

GS: The consolidation in fiscal deficit to 4.5% of GDP in FY26 from 4.8% in FY25 is driven by moderation in revenue expenditure. Meanwhile government capital expenditure remains steady at 3.1% of GDP. Hence the consolidation in fiscal deficit shouldn't negatively impact private corporate capex. At the same time moderation in fiscal deficit will not also spur private corporate capex.

The lack of recovery in corporate capex due to **uncertainty on both domestic and external demand. Another factor is the moderation in corporate profit growth in FY25, driven by firming in input cost.**

The last time when strong growth in private corporate capex was between FY05 to FY08. During this period private corporate investment rose to 17.3% of GDP in FY08 from 6.6% in FY04.

A number of factors were supportive during this period –

1. Listed companies profit growth was in double digits
2. There was consistent growth in private consumption average more than 6% in real terms
3. export growth (goods and services) averaged at 20% in real terms.

Hence more than fiscal policy, visibility on demand is more important for private corporate capex to revive.

About Gaura Sen Gupta

She is the Chief Economist of IDFC FIRST bank. She is responsible for Macro and Markets research for the Bank as well as Clients, covering both FX and Fixed Income. She brings with her over 16 years of work experience in Research. She has done her Masters from Delhi School of Economics. Her research work & Market views are regularly covered in Print & Digital media.

About the Interviewer

Mahima Sharma is an Independent Journalist based in Delhi NCR. She has been in the field of TV, Print & Online Journalism since 2005 and previously an additional three years in allied media. In her span of work she has been associated with CNN-News18, ANI - Asian News International (A collaboration with Reuters), Voice of India, Hindustan Times and various other top media brands of their times. In recent times, she has diversified her work as a Digital Media Marketing Consultant & Content Strategist as well. Starting March 2021, she is also a pan-India Entrepreneurship Education Mentor at Women Will - An Entrepreneurship Program by Google in Collaboration with SHEROES. Mahima can be reached at media@indiastat.com

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