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#India / #Monetary Policy / #Growth

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Indian rupee in focus for policymakers in 2025

We forecast India's economy to slow moderately in 2025, meaning a modest rate cutting cycle by the Reserve Bank. However, recent rupee depreciation risks delaying rate cuts, particularly if this is further exacerbated by the policies of the new US administration. That said, we continue to think India is a potential winner from trade tensions between the US and China.

Key Takeaways

- We expect the Indian economy to slow modestly, from 6.3% in 2024 to 6.1% in 2025, undershooting the Reserve Bank of India (RBI)'s expectations.
- While the strong services sector should support activity, we think tight monetary and fiscal policy conditions and a sluggish manufacturing sector will weigh on growth.
- We believe this growth slowdown, alongside a softening of food price pressures, will prompt the RBI to deliver two 25bps interest rate cuts in February and June, taking the key policy rate to 6% by year-end.
- Admittedly, there is a risk that recent rupee depreciation, which could be exacerbated by the policies of the incoming Trump administration in the US, could force the RBI to delay rate cuts until later in the year.
- But we think new RBI governor Sanjay Malhotra will tolerate further rupee depreciation, given reduced domestic inflation risks, domestic liquidity challenges, and the previous loss of export competitiveness from past strength in the trade-weighted rupee.
- That said, we expect the RBI to lean against particularly sharp FX moves, especially if substantial pressure on the currency were to arise from tensions with the US or broader market volatility.
- More broadly, we continue to think India can benefit from US efforts to shift supply chains out of China.

Das out! Malhotra at the crease

The Reserve Bank of India (RBI) ended 2024 with its policy stance broadly neutral. The monetary policy committee (MPC) had voted to change it from a "withdrawal of accommodation to neutral" at its October meeting, balancing inflation targeting and growth.

While at the December meeting this stance was reiterated, there was some evidence of a tentative dovish tilt – which we think will gain traction this year and result in modest rate cuts.

First, Ram Singh joined Nagesh Kumar in voting for a 25bps rate cut, making the vote split 4-2 in favour of keeping the policy rate at 6.5%. Second, the RBI injected liquidity into the system via a combined 50bps of cuts to the cash reserve ratio for banks to 4.0%, seeking to reduce tightening in financial conditions from interbank rates.

The meeting also marked the final votes for outgoing Governor Shaktikanta Das and Deputy Governor Michael Patra. Both were seen as hawks more focused on the upside risks to inflation. Indeed, the meeting minutes showed both putting the emphasis on the need to contain inflation as a means to support the economy.

Das will be replaced by Sanjay Malhotra, while Patra's replacement is yet to be confirmed. While Malhotra's views on the monetary policy stance are not clear, the departure of two committee members favouring a hold potentially raises the possibility of a dovish shift.

Indeed, with both Singh and Kumar still on the committee, and the latest meeting minutes showing Rajiv Ranjan as more open to an adjustment in the policy rate were food inflation to cool, the chance of a 25bps cut in February has risen.

Growth debate: strong or stuttering?

There is an ongoing debate within the committee around the underlying strength of India's economy.

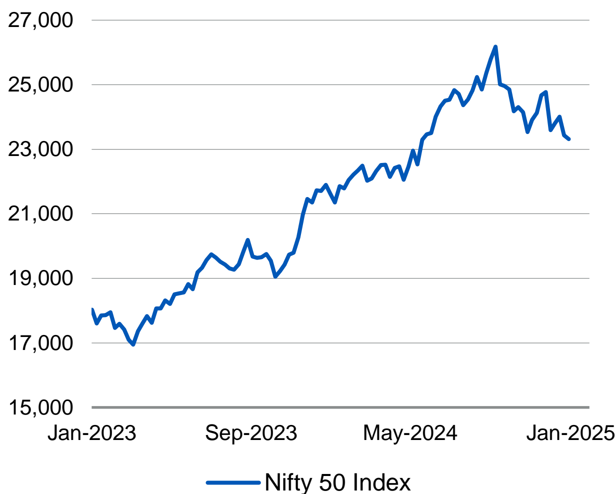
The big undershoot in Q3 GDP growth relative to expectations furthered the argument that the economy was not as strong as the RBI thought. Real GDP grew 5.4% year over year in the quarter, well below the RBI's 7.0% forecast, and defying market expectations for an acceleration in activity.

We think the RBI's revised expectations remain too optimistic, even if we believe that sequential momentum can pick up.

The RBI forecasts year-over-year growth of 6.8% in Q4 and 7.3% in Q1 2025, implying a very strong and sustained rebound in activity. By contrast, we forecast growth of 5.6% and 6.0% respectively. Already the preliminary estimate of growth of 6.4% for FY2024-2025 (April – March) has undershot the RBI's forecast of 6.6%.

Investors have also lowered their expectations around India's economy. The Nifty 50 has fallen around 11% from its high in September, as earnings disappointed and forecasts were downgraded (see Figure 1).

Figure 1: Investors have become less bullish on Indian growth and the stock market

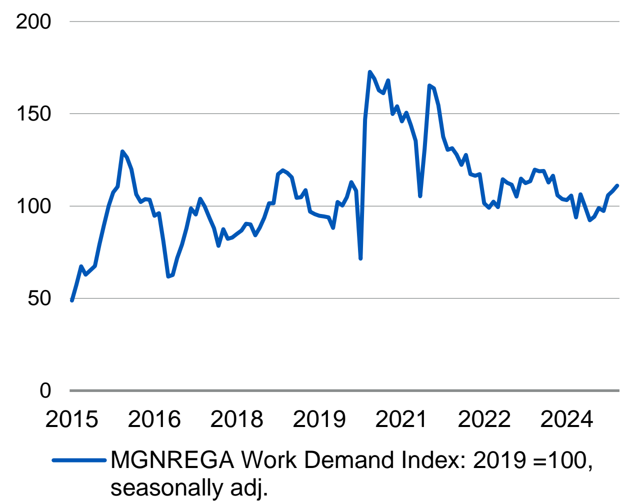


Source: Refinitiv, abrdn, January 2025

One other area in which we're less optimistic than the RBI is the manufacturing sector. Through the final months of 2024, the sector's PMI showed a continuation of the summer slowdown (0.9% contraction in Q3) but ticked up in January.

Even where growth has been improving, such as in the agricultural sector, there have been signs of economic challenges. Demand for work under the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) – a social security scheme guaranteeing 100 days of paid work in rural areas – rose 8.3% year over year in December, marking a fourth consecutive monthly increase in demand (see Figure 2).

Figure 2: Rural employment conditions soften



Source: Haver, abrdn, January 2025

This is in part due to monetary and fiscal tightening. With the former, efforts to contain consumer credit growth and risks in the personal loan sector enacted in November 2023 have softened the pace of lending to households.

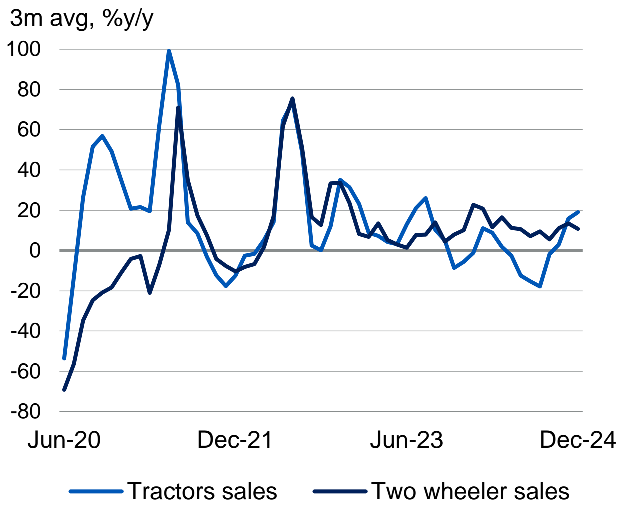
Meanwhile, the government is implementing fiscal consolidation, and we expect further tightening steps in FY2026. The central government's deficit is likely to undershoot the planned FY2025 deficit of 4.9% of GDP, as capital expenditure has fallen short.

However, there remains enough momentum in the key services sector that we do not think growth is set for a further *sharp* slowdown. The services PMI has been strong and business surveys from the Retailers Association of India show an upturn in activity since August.

There was also a surge in tractor sales into year-end, providing some optimism around rural demand (see Figure 3). All of this should mean India's year-average GDP growth rate slows only modestly, from a forecast 6.3% in 2024 to 6.1% in 2025.

This modest slowdown should convince the monetary policy committee that a small adjustment in monetary policy setting is needed. We forecast a 25bps cut in February and another 25bps cut in June.

Figure 3: Domestic demand picks up after Q3 slump

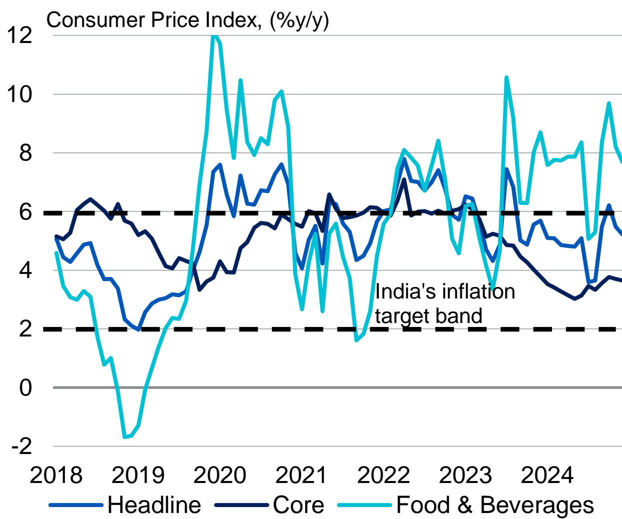


Source: Haver, abrdn, January 2025

Food price relief

Headline inflation fell 0.2ppts to 5.2% year over year in December, slightly lower than consensus expectations of 5.3%. The decline was primarily due to a further easing of food and beverages inflation, which dipped 0.5ppt to 7.7% (see Figure 4).

Figure 4: Food price pressures ease



Source: Haver, abrdn, January 2025

The RBI has consistently pointed to the uncertainty around food prices as a reason to keep its policy rate on hold. But with the effects of the strong harvest feeding through, the committee should feel more confident over the near-term path for food prices. January retail prices indicate further declines in vegetable and fruit prices, which had been a key driver of recent spikes in food inflation.

Core prices growth also came in softer than the previous month, tempering concerns over a recent pickup in underlying pressures. Indeed, our preferred measure of underlying inflation – a three-month average of month-over-month core prices, annualised – fell to 3.7% in December.

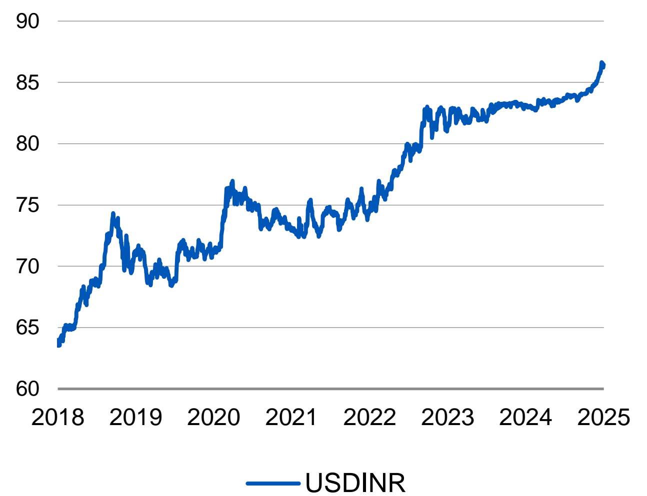
While the recent uptick in oil prices and new US sanctions on Russian oil will mean a slower pace of disinflation in Q1 than we previously expected, we still forecast headline inflation to sit comfortably within the RBI's 4% +/-2ppts target band, averaging 4.4% through the year.

Rupee volatility adds to RBI challenge

This all being said, we would be more certain of an interest rate cut in February if it were not for the recent bout of rupee depreciation, which makes our call for easing a close one.

Having been relatively stable against the US dollar for most of 2024, the rupee has begun to depreciate quickly in the past three months, down around 2.8% against the dollar (see Figure 5).

Figure 5: Rupee takes a tumble

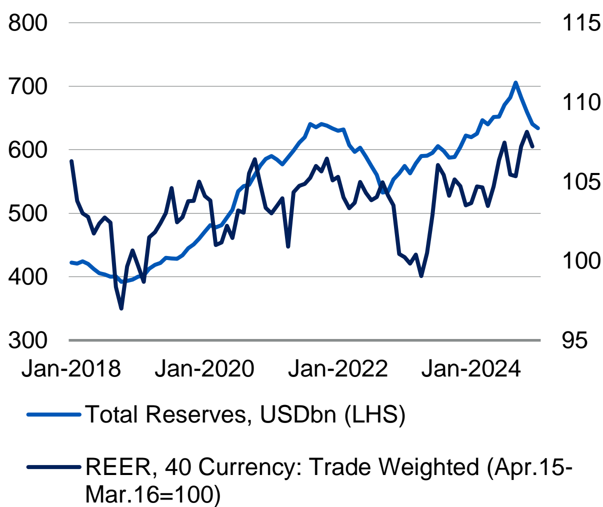


Source: Haver, abrdn, January 2025

The depreciation likely reflects the RBI's acknowledgement that intervention to support the rupee was becoming increasingly costly, drawing down reserves and worsening India's export competitiveness. Moreover, dollar outflows and FX interventions to support the rupee have led to a tightening of banking sector liquidity.

Reserves have fallen around $72bn from their September high. And the intervention from the RBI has led to the rupee appreciating against the currencies of its key trading partners in real terms, suggesting intervention may have been excessive (see Figure 6).

Figure 6: A stronger trade-weighted rupee implies less need for intervention



Source: Haver, abrdn, January 2025

While strengthening the trade-weighted rupee has helped to limit import price pressures, the policy erodes India's export competitiveness, thereby hampering efforts to pivot towards a manufacturing- and export-led growth model.

Moreover, media reports indicate that Governor Malhotra is more open to the recent rupee weakness and understanding of the rationale behind the depreciation. This makes us think that the RBI won't use recent rupee depreciation as a reason not to ease modestly this year.

The Bank estimates a 5% depreciation in the rupee adds around 0.35ppt to headline inflation over several months. The rupee has not moved as sharply and as such, we do not think recent rupee weakness will deter the RBI from a February cut.

A more sustained bout of currency pressure would be needed to delay the timing of a second cut beyond June. In such a scenario, where demand for dollars is rising and bank sector liquidity is being squeezed, the RBI may instead opt to focus on further reserve ratio cuts to bring interbank rates in line with its policy rates before proceeding with rate cuts.

Indian risks and opportunities from the Trump administration

How markets perceive the impact of incoming US President Donald Trump's policies will be important. A more market-friendly mix of policies would likely ease dollar pressures and provide a smoother path to two or more RBI rate cuts.

However, in a 'Trump unleashed' scenario, the tightening of external conditions and imposition of unilateral tariffs could push the RBI to delay or avoid a second rate cut amid market volatility and currency pressures.

Our base case is somewhat in between, with Trump acting on his policy priorities but stopping short of fully implementing his campaign pledges. This will lead to a higher nominal growth path for the US and limit the Fed's scope to cut.

However, this backdrop shouldn't necessarily be painful for India, as we think it is not one of the countries Trump will want to target with tariffs soon, especially since India has a relatively small goods trade surplus with the US ($43bn in 2023).

Moreover, given the relatively good relationship between India's Prime Minister Narendra Modi's and Trump during the latter's previous term in office, we think a trade deal can be struck to circumvent disruptive tariffs.

Indeed, India is an ally as the US continues its efforts to decouple from Chinese supply-chains. As such, the opportunity to benefit from 'friendshoring' provides some upside to India's outlook.

However, were India to face Trump's ire, the focus would likely be on India's protectionist trade policies. Around 18% of India's goods exports directly go to the US and Trump singled out India for its high tariffs during his campaign.

The biggest complication for the RBI would be the impact on the rupee, were India to face sudden investment outflows or a loss export competitiveness through tariffs.

Moreover, potential currency devaluations in other markets in response to US tariffs – most notably China – could complicate monetary policy via their impact on the trade-weighted rupee.

The RBI may opt to look through rupee weakness to maintain export-competitiveness or avoid import-inflationary pressures from rupee weakness. This will remain a challenge the RBI has to increasingly contend with in 2025.

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