Repo Rate Cut – Too little too late; or perhaps too soon?

When the 3-day meeting of the Monetary Policy Committee (MPC) concluded on February 07, 2025, there was little by way of surprise. Markets had been clamouring for a rate cut and the new RBI governor obliged with a 25 basis cut. Just to give a background, between March 2022 and February 2023, RBI had raised the repo rates by 250 basis points from 4.00% to 6.50%. This was largely to curb the headline inflation which had surged to above 9% due to supply chain bottlenecks created in the aftermath of the pandemic. Over the last 2 years, the RBI has done nothing, so the 100 bps cut by the US Fed since September 2024; has put pressure on the RBI.

Central Bank Variable	Pre RBI Policy	Post RBI Policy	Explanation
Repo Rate	6.50%	6.25%	RBI MPC Decision
Standing Deposit Facility (SDF)	6.25%	6.00%	Pegged 25 bps Below Repo rate
Marginal Standing Facility (MSF)	6.75%	6.50%	Pegged 25 bps Above Repo rate
Bank Rate	6.75%	6.50%	Pegged 25 bps Above Repo rate
Cash Reserve Ratio (CRR)	4.00%	4.00%	CRR was cut in Dec-24 policy
Statutory Liquidity Ratio (SLR)	18.00%	18.00%	No Change
Stance of the Policy	Neutral	Neutral	Status Quo Maintained
Data Source: RBI Monetary Policy, Feb-25			

WAS IT TOO LITTLE TOO LATE?

One perspective on the rate cut is that it is a case of too little too late. Here is why. For instance, the US Fed has cut rates by 100 bps since September. In contrast, India took a long time to decide even on a 25 bps rate cut. Also, there has been no guidance on the trajectory of future rate cuts. Secondly, if you look at the repo rates prior to the COVID pandemic, it had stood at 5.15%. Even after the 25 bps rate cut in February 2025, the current repo rate is a good 110 basis points higher than the pre-pandemic repo rate.

One of the guiding forces for the RBI to finally plump for a rate cut in February was that the inflation had tapered to 5.22% and looked poised to fall well below the 5% mark for January 2025. Also, GDP growth in FY25 is likely to be 150 to 180 bps lower than the last year and it is expected that lower rates would trigger capex by the private sector. Overall, the markets felt that the RBI could have, at least, given cut rate guidance!

SURPRISINGLY, THIS COULD BE A PREMATURE RATE CUT

In financial economics, it is almost axiomatic to ask for rate cuts, when there is a growth slowdown. Here is why the rate cuts by RBI were premature. Firstly, if you look at Dec-24 headline inflation, at 5.22%, it is 122 bps above the RBI target of 4%. Also, trade wars can hit exports and contribute to imported inflation. Secondly, there is no empirical evidence to prove that rate cuts spur growth. Japan held rates close to zero, but has hardly grown.

The biggest risk, and why the RBI should have avoided this rate cut, is the highly vulnerable situation that the Indian rupee finds itself in. At ₹87.79/$, it is already at a life time low. This is not only keeping FPIs out of India, but also putting a lot of pressure on borrowers and importers with dollar exposure. A rate cut is rupee weakening and, in this case, it also led to a rush for cover from the banks. It could just worsen the rupee story!

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