ICRA

Interest Rate Outlook

Shallow rate cut cycle of 50 bps expected in H1 CY2025; India's G-sec yield curve to steepen in near term

JANUARY 2025

Agenda

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1 Outlook on Inflation and Policy Rates

2 Liquidity and Short-term Rates

3 Market Borrowings, G-sec yield Outlook and Term Spreads

4 Corporate Bond Yields and Bank Deposit and Lending Rates

Highlights - I

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CPI inflation is estimated to soften to 4.2% in FY2026 from an expected 4.8% in FY2025; outlook remains vulnerable to weather adversities, and potential supply shocks to perishables.

ICRA expects a rate cut in the February 2025 MPC review provided that the December 2024 CPI print eases to 5.0% or lower.

ICRA projects the CPI inflation to soften to 4.2% in FY2026 from 4.8% in FY2025, supported by healthy prospects for rabi crop output, and an assumption of a normal, well-distributed monsoon in 2025, which would boost agricultural output, soften food price pressures and limit transmission of the same to core inflation. We expect the Monetary Policy Committee (MPC) to vote for a rate cut in the February 2025 policy if the December 2024 CPI print eases to 5.0% or lower. Else, it could be pushed out to the April 2025 policy. Besides, the impact of the FY2026 Budget on growth-inflation dynamics and the US-tariff related measures would bring greater clarity for future policy decisions. Overall, we maintain our baseline expectation of two rate cuts of 25 bps each in the awaited rate easing cycle. Further, we expect the RBI to manage liquidity via VRRs in the immediate term and introduce long-term repos and/or forex swaps in the event of sustained liquidity stress. We expect the 10-year G-sec yield to range between 6.65-6.90% in the near term, and the G-sec yield curve to steepen owing to the projection of a rate cut in Q4 FY2025.

- **CPI inflation to soften to 4.2% in FY2026; weather-related adversities pose risk to outlook:** The CPI inflation is projected to soften in Q4 FY2025 and remain benign in Q1 FY2026, supported by healthy rabi output prospects, even as inflation in Q1 is susceptible to risks like heatwaves that may pose a concern to crop yields. Thereafter, a normal monsoon in 2025 will be crucial to boost agricultural output and soften food price pressures. Overall, the CPI inflation is expected to ease to 4.2% in FY2026 from 4.8% projected for FY2025. Nevertheless, the outlook remains vulnerable to any weather adversities and supply shocks related to perishables. Besides, the uptrend in international prices of edible oils and a potential impact of low cotton output on clothing inflation are key monitorables.

- **Rate cut likely in Feb 2025 policy if Dec 2024 CPI provides large comfort; rate cut cycle to be shallow at 50 bps:** The December 2024 policy minutes revealed mixed signals regarding the timing of the onset of a rate cut cycle. In ICRA's view, if the headline CPI inflation eases to 5.0% or lower in December 2024, the likelihood of a rate cut by the MPC in its February 2025 meeting would be very high. We maintain our baseline expectation of two rate cuts of 25 bps each in the awaited rate easing cycle, based on our projection for the potential GDP growth rate for India.

Highlights - II

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Systemic liquidity surplus moderated to Rs. 0.8 trillion in Q3 FY2025 from Rs. 1.2 trillion in Q2, mainly due to sizeable dollar outflows and the typical increase in currency in circulation (CIC).

Liquidity conditions are likely to remain constrained in immediate term, owing to capital outflows and seasonal increase in demand for cash.

We expect the RBI to continue with VRRs and resort to long-term repos and/or a forex buy-sell swap in the event of significant liquidity tightening.

India's 10-year G-sec yield likely to range between 6.65-6.90% in the near term.

- **Liquidity conditions to remain under pressure, amid capital outflows, dollar sales:** The systemic liquidity surplus dipped to Rs. 0.8 trillion in Q3 FY2025 from Rs. 1.2 trillion in Q2 FY2025, led by sizeable dollar outflows, as reflected in the dip in India's forex reserves (by -$52.0 billion vs. +$53 billion in Q2 FY2025). In particular, systemic liquidity slipped into a deficit of Rs. 1.8 trillion in second half of December 2024 from a surplus of Rs. 0.5 trillion in the first half of the month, owing to advance tax payments, and likely dollar sales by the RBI, which led to a surge in the call money rate. Looking ahead, liquidity conditions may remain constrained in the immediate term amid sustained capital outflows and potential dollar sales by the RBI, and the seasonal uptrend in CIC, which may warrant the need to inject liquidity. The RBI is likely to continue with VRRs to manage intermittent liquidity tightness in the near term. In the event of a significant tightening, the central bank is likely to resort to long-term repos and/or a forex buy-sell swap, with the latter likely to be the preferred tool as this would also augment India's foreign exchange reserves.
- **10-year G-sec yield expected to trade between 6.65-6.90% in near term:** The Indian 10-year G-sec yield has largely ranged between 6.68-6.86% in Q3 FY2025, while trailing the levels seen in Q2 FY2025, supported by bond inflows from the index inclusion as well as moderation in crude oil prices. Looking ahead, the upcoming domestic CPI inflation prints and their implications for the MPC's rate decisions, and global cues such as the quantum of easing signaled by the US Federal Reserve for 2025 and incoming news on tariffs actions by the US on various countries including India, would influence the direction of G-sec yields. In ICRA's view, the 10-year G-sec yield will likely range between 6.65-6.90% in the near term.
- **Yield curve to steepen over next few months**: India's yield curve shifted upwards by end-December 2024 compared to end-September 2024, with the uptick in shorter-end of the yield curve being relatively narrower compared to that in longer-end yields, implying that the curve steepened to some extent. Given the expectations of a rate cut by the RBI in February 2025, further downward pressure on the shorter end of the curve is likely, even as long-term yields may remain relatively sticky, which would lead to a further steepening of the yield curve.

Highlights - III

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Corporate bond yields in Q4 FY2025 likely to be influenced by magnitude of rate cuts as well as liquidity conditions.

Notwithstanding the lag in transmission, the ability of banks to raise lending rates further is anticipated to remain constrained given the likely softening in bond yields in Q4 FY2025 as well as expectations of a rate cut cycle commencing in that quarter.

- **Corporate bond yields softened in Q3 FY2025:** The average 10Y and 5Y AAA corporate bond yields fell by 13 bps each in Q3 FY2025, compared to Q2 FY2025, while the AA+ bond yields of the same maturities eased by relatively shallower 10-11 bps. This dip is sharper than the 8-9 bps fall seen in the average G-sec yields of 5-year and 10-year tenures during this period. The cooling in G-sec yields, owing to the favourable demand-supply scenario for such securities amid the bond index inclusion kept corporate bond yields compressed during April-December FY2025. Going forward, while the expectations of rate cuts in Q4 FY2025 may exert some downward pressure on the corporate bond yields, this could be partly offset by tight liquidity conditions.
- **Inflows from small savings remain muted during 8M FY2025:** The cumulative inflows under savings deposit and certificates, and PPF fell by ~31% YoY in 8M FY2025, amidst unchanged interest rates for small savings schemes and an increase in the number of taxpayers opting for the new tax regime. This likely prompted the GoI to keep the small saving rates unchanged for the fourth consecutive quarter in FY2025. Given the elevated rates and spreads, and the expectations of a cut in policy rates in early-CY2025, ICRA expects a cut in small savings rates in H1 FY2026.
- **Bank deposit and lending rates unlikely to be raised in near term:** The weighted average term deposit rates on fresh and outstanding deposits of all scheduled commercial banks (SCBs) increased by 225 bps and 191 bps respectively (between May 2022 and November 2024), as compared to the 250 bps rate hikes in the monetary tightening cycle. Moreover, the weighted average lending rates on fresh loans and o/s loans rose by 154 bps and 108 bps, respectively, during May 2022-November 2024. Notwithstanding the lag in transmission, the ability of banks to hike lending rates further is anticipated to remain constrained given the expectations of a policy rate cut in that quarter.

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Thank You!