06 August 2025

RBI Maintains Status Quo on Rates; Balance of Risks Favour a Rate Cut in Future

- As expected, the RBI kept the policy repo rate unchanged at 5.5% and retained a neutral policy stance, with a unanimous vote. The decision follows the front-loaded rate cut delivered in June.
- The RBI noted that the recent fall in headline CPI inflation was largely due to volatile food prices, while core inflation remains stable near 4%. Economic growth momentum has also held up and is expected to improve modestly, supporting a cautious policy approach.
- The Governor noted a meeting-to-meeting policy approach, reflecting high macro uncertainty. This suggests the door remains open for a future rate cut, especially if growth falters and inflation remains contained.
- The RBI revised FY26 inflation projection down to 3.1% from 3.7%, amid benign food prices and contained input cost pressures. However, Q4 FY26 and Q1 FY27 inflation is projected to exceed 4%, primarily due to base effects rather than demand-side pressures.
- The RBI retained its FY26 real GDP growth forecast at 6.5%, supported by rural demand, public capex, policy support, and low inflation. However, high-frequency indicators suggest Q1 growth may undershoot the RBI's forecast, and FY26 projection also faces downside risks especially from the external environment.
- The recent announcement of 25% US tariffs on Indian exports, effective August 7, could delay trade negotiations and weigh on external demand. While the estimated direct GDP impact of the announced US tariffs is moderate (~30-bps), specific sectors such as electronics, pharma, gems, and textiles could face relatively more pressure.
- These tariffs (if sustained) and the risk of additional tariffs tied to Russia-linked trade could dampen manufacturing, exports, and investment sentiment. Combined with the already constrained fiscal space, this strengthens the case for additional monetary policy support.
- Considering downside risks to growth, we believe there is scope for a 25-bps rate cut as inflation is expected to remain contained. We see possibility of a rate cut in Q3 FY26, given the RBI will have more information on the monsoon progress, the trajectory of US–India trade relations, the US Federal Reserve's policy stance, India's Q1 GDP data, and signs of further policy transmission.

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RBI Maintains Status Quo on the Policy Rate; Balance of Risks Favour Additional Rate Cut

Post front-loading of the policy rate cut in the June policy meeting, the RBI's Monetary Policy Committee (MPC) kept the policy repo rate unchanged at 5.5% in its August meeting. Accordingly, the Standing Deposit Facility (SDF) Rate remains unchanged at 5.25% and the Marginal Standing Facility (MSF) Rate and Bank Rate remain unchanged at 5.75%. Moreover, the RBI maintained the policy stance at neutral. The decision on policy rate and policy stance was unanimous.

In our view, the policy statement seems slightly hawkish as the RBI kept its optimistic economic growth forecast unchanged and also projected inflation rising to 4.9% in Q1-FY27 (discussed in detail in a subsequent section). As a result, the 10-year G-sec benchmark yields rose by ~ 8-bps to close at 6.42% today. The RBI maintained status quo on rates, noting that the latest moderation in the headline CPI inflation was primarily driven by fluctuating food prices, while core inflation remains steady in the vicinity of 4%. On the other hand, the economic growth as per the RBI assessment has likely held up the momentum and is expected to pick-up slightly ahead. However, the RBI Governor indicated that the MPC would assess the need for policy action on a meeting-to-meeting basis, especially given the prevailing high uncertainty. This indicates that the door for a rate cut is not closed, and the central bank could consider a rate cut in future meetings if economic growth underperforms and inflation remains contained.

We retain our view that there is a room for one more rate cut of 25-bps (likely in Q3) in the current easing cycle due to the following. ***Firstly, we believe that the projected uptick in inflation in late FY26 and early FY27 is primarily a result of an adverse base effect and not due to any significant underlying demand-side drivers***. The outlook for inflation in fact is more benign in our view, due to several reasons including absence of input price pressures, global crude oil prices being capped by slower global growth and higher OPEC supply, and favourable domestic food inflation outlook due to a strong rainfall, kharif sowing, and reservoir levels. Using the RBI's revised inflation projection for FY26 of 3.1% and the current policy repo rate of 5.5%, the real rate is estimated at 2.4%, significantly higher than the neutral range of 1.4%-1.9% - providing space for a policy cut. However, if the RBI is considering its one-year ahead forecast of 4.9% (in Q1-FY27), the estimate real rate would decline to about 0.6% (given the current repo rate at 5.5%), which is much lower than neutral range. We believe that the disinflation process is likely to continue, and the RBI's Q4-FY26-Q1-FY27 inflation projections are likely to be revised lower in future meetings, opening the scope for a rate cut from a real rate estimate perspective as well.

Secondly, based on our estimates, the FY26 real GDP growth forecast is expected to undershoot the RBI's forecast of 6.5%, which will likely warrant additional monetary policy support, especially given that the fiscal policy is constrained due to the already announced tax cuts in the FY26 Budget. In our view, economic growth is likely to be around 6.2% in FY26 and faces downside risks from the imposition of a 25% tariff by the US on India's exports (as discussed in detail in a subsequent section). There is risk of trade negotiations continuing past the previously anticipated timeline of September–October, which would weigh on exports and investment sentiment.

Surplus Liquidity Supporting the Monetary Policy Transmission; RBI to Remain Nimble and Flexible in its Liquidity Management

System liquidity has remained comfortably in surplus, averaging around Rs 3.1 lakh crores in July rising from an average of Rs 2.8 lakh crores in June and Rs 1.7 lakh crores in May. With that the Weighted Average Call Rate (WACR) averaged at around 5.33% in July down from 5.37% in June and is tracking around 5.36% based on 5th August data. However, the WACR was volatile in the past few weeks as it hovered in the vicinity of both ends of the Liquidity Adjustment Facility corridor—dipping below the Standing Deposit Facility Rate (5.25%) and tracking close to the Marginal Standing Facility Rate (5.75%). Accordingly, the RBI actively managed liquidity through two-way variable rate repo (VRR) operations to bring WACR back closer to the policy repo rate.

Going ahead, we expect surplus liquidity to prevail supported by the phased implementation of the 100-bps CRR cut (from September through November) and likely rising government spending as it utilizes the bumper dividend transfer by the RBI.

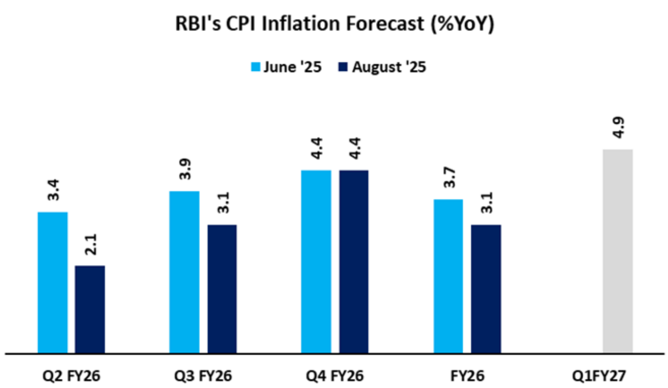
The RBI will continue to be nimble and flexible in its liquidity management to aid the transmission process. In response to the total of 100-bps policy repo rate cuts so far, weighted average lending rates of banks' outstanding loans have fallen by 39-bps and on fresh loans by 71-bps by the end of June, and MCLR has declined by 25-bps as of July-end. This should in turn support a pick-up in credit growth going ahead.

The Governor also noted that the internal Working Group's review of the Liquidity Management Framework recommended continuing with WACR as the operating target and retaining the variable rate auction mechanism for repo and reverse repo operations. The report has been released for public comments. He also announced three consumer-focused initiatives: (1) Doorstep banking camps for Jan Dhan re-KYC and financial inclusion, (2) Standardised procedures for claim settlement in case of banks' deceased customers, and (3) Introduction of SIP functionality (auto-bidding) in the RBI Retail Direct platform for investing in treasury bills.

RBI Significantly Lowers FY26 Inflation Projection, Though Projects Above 4% Inflation in Q4-FY26 - Q1-FY27

The RBI revised inflation projection for FY26 downwards as moderation in the headline CPI inflation has materialized at a much quicker pace than previously anticipated due to lower food prices. Indeed, CPI inflation in Q1 FY26 undershot the RBI's projection by 20-bps to 2.7%. It is also expected to moderate ahead due to a benign food inflation outlook. Further, we believe there are no major signs of pick up in input prices pressures, which should support inflation outlook. Accordingly, the RBI's Q2 and Q3 inflation projections have been revised significantly downwards to 2.1% and 3.1% respectively from the earlier estimates of 3.4% and 3.9%. However, with the base effect turning unfavourable, the RBI retained the Q4 inflation projection at 4.4% and now the estimated Q1 FY27 inflation is at 4.9%.

Inflation Estimates Revised Downwards to 3.1% for FY26



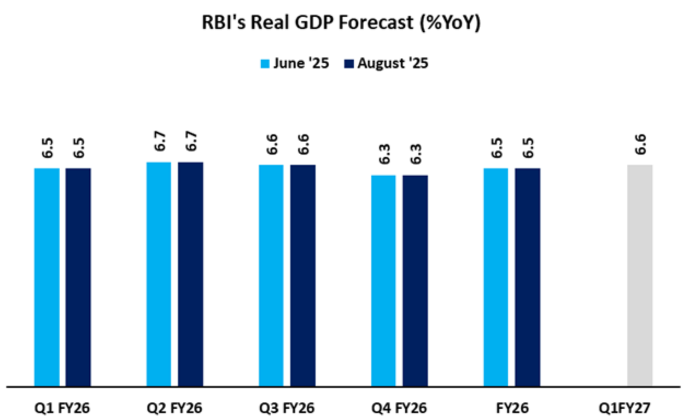
Source: RBI; Note: June '25 and August '25 refer to projections given by the RBI in its June 2025 and August 2025 MPC updates, respectively.

While we do acknowledge the unfavourable base effect later in FY26 and into FY27, these RBI's projections seem to be on the higher-end given the positive supply-side factors and a lack of underlying demand drivers as consumption is expected to see only a moderate recovery. Overall, the RBI estimates FY26 inflation at 3.1%, down from 3.7% earlier, with weather-related disruption cited as a risk. Meanwhile, core inflation is likely to remain moderately above 4%.

RBI Maintains its Optimistic FY26 Economic Projection

The RBI's assessment of growth remains positive as it retained the FY26 real GDP growth projection at 6.5% (no changes in the quarterly profile compared to the forecast given in the June meeting), with downside risks emanating from prolonged geopolitical tensions and global uncertainty. It also projected Q1 FY27 real GDP growth at 6.6%. The RBI expects consumption demand to be supported by an above normal southwest monsoon, lower inflation, and supportive monetary and fiscal policies. Further, the government's robust capital expenditure and rising capacity utilisation for private sector supports investment outlook. Lastly, as per the RBI the external sector demand faces uncertainty due to ongoing tariff announcements and trade negotiations.

RBI's FY26 Economic Growth Forecast Remains at 6.5%



Source: RBI; Note: June '25 and August '25 refer to projections given by the RBI in its June 2025 and August 2025 MPC updates, respectively.

Our FY26 real GDP growth projection stands at 6.2% (with downside risks), factoring in moderate urban demand recovery while global uncertainties and risk of delays in recovery in broader consumption will keep private investment subdued. Incoming high-frequency data suggests Q1 FY26 real GDP growth may slow to around 6.0% (vs 6.5% as per the RBI) - based on our initial estimates. The recently announced 25% US tariffs (with risk of additional tariffs) on Indian exports could further weigh on trade and manufacturing activity.

Deterioration in External Environment Poses Downside Risks to Economic Growth

On July 31, US President Donald Trump announced a 25% reciprocal tariff on India's exports to the US, effective August 7, 2025. This marks a sharp escalation from the existing 10% baseline tariff, though it is marginally lower than the 26% rate proposed (but not implemented) in April. The announcement also included references to additional, though unspecified, penalties related to India's ongoing purchases of Russian military equipment and energy.

These new measures risk complicating the ongoing trade negotiations between India and the US, which have been progressing steadily in recent months. Both countries have been working toward a comprehensive bilateral trade agreement (BTA), aimed at addressing issues related to tariffs, market access, investment norms, and broader trade barriers. However, the possibility of penalties tied to India's Russia-linked trade adds a new layer of complexity to the discussions. There is a risk of the latest developments delaying the potential trade deal beyond the previously anticipated timeline of September–October.

Estimated Direct Impact on India Likely to be Moderate, though Select Sectors at Risk

In FY25, India exported $86.5 billion worth of goods to the US, accounting for ~19.8% of its total merchandise exports, but just around 2.2% of GDP. This relatively low share of GDP suggests that if the 25% tariff remains in place, the estimated direct impact on India's GDP would be moderate, around 30 basis points in FY26. That said, the final impact will depend on the duration of the higher tariff, any additional penalties, the specific tariff rates ultimately applied to India and its peers, and the extent of any exemptions. While there are some reports of exemptions for some sectors such a Pharma and Semiconductor, we have assumed no exemption for our analysis as media reports suggest that sectoral exemptions are likely to be removed in the coming weeks.

US Revises Tariff Structure Under Reciprocal Trade Framework

	Tariff Rate (%) (April 2)	Tariff Rate(%) (July 31)	Share of US in total exports (%), 2024
China	34	30	13
Mexico	25	25	83
Canada	25	25	74
India*	26	25	21
Malaysia	24	19	16
Vietnam	46	20	35
Bangladesh	37	20	19
Thailand	36	19	22
Phillippines	17	19	20
Indonesia	32	19	11
South Korea	25	15	20
Japan	24	15	22
EU	20	15	9

Source: White house documents, BEA and WTO Note: China's tariff rate before the agreement was also increased to 145%. Note: * India's share in this table is computed based on calendar year 2024 for consistency.

According to the White House announcement on July 31, India's tariff treatment has been broadly aligned with countries such as Mexico and Canada – which have a relatively high share of exports to the US. However, Indian exports now face higher tariffs relative to peers like Vietnam, the Philippines, Indonesia, and Japan—many of whom have concluded recent trade deals with the US. This divergence could exert pressure on India's sectoral exports. In FY25, the top five sectors exporting to the US were electronics, gems & jewellery, pharmaceuticals, textiles, and machinery & parts—together accounting for around 60% of India's total goods exports to the US. These sectors are likely to be most vulnerable if elevated tariffs persist.

High US Exposure Makes Select Indian Sectors More Susceptible to Tariffs

Goods Category	Exports to US in FY25 (US$ Bn)	Share in India's exports to US %
Electronics	15.9	18.4
Gems & Jewellery	10.0	11.5
Pharmaceuticals	9.8	11.3
Textiles*	9.5	11.0
Machinery, Parts etc.	6.7	7.7
Agricultural & Allied Products*	5.6	6.5
Refined Petroleum Products	4.2	4.9
Iron & Steel and Articles thereby*	3.7	4.3
Organic Chemicals	2.7	3.1
Auto Components	2.6	3.0
Plastic Articles	1.7	1.9
Miscellaneous Chemicals	1.2	1.4
Furniture & Accessories	1.1	1.3
Articles of Stone, Cement etc.	1.0	1.1
Optical Parts	0.9	1.1

Source: Ministry of Commerce, CMIE. *Note: Data for textiles, agriculture & iron & steel have been clubbed with their related industries.

In addition to tariff-related measures, the US has announced unspecified penalties targeting India's energy and defence ties with Russia. On the defence front, Russia accounted for 36% of India's arms imports during 2020–2024, down from 55% in 2015–2019 and 72% in 2010–2014, as per SIPRI (Stockholm International Peace Research Institute). India has been diversifying its arms procurement sources, with increasing reliance on western suppliers such as France, Israel, and the United States.

Meanwhile, Russia accounted for ~36% of India's crude oil imports in FY25. In April-May of FY26, India purchased Russian crude oil at an average imputed price of US$70.9 per barrel—close to the global benchmark of US$73.6 and significantly narrower than the ~US$9.5 per barrel discount seen in FY23. As the pricing gap narrows, India's economic incentive to continue sourcing from Russia weakens, and diversifying away from Russian crude is unlikely to materially impact the import bill. However, if broader sanctions on Russia escalate and result in higher global oil prices, India could face pressures on external accounts, economic growth, and inflation.

Overall, we believe that there is a scope for another rate cut given that inflation and real GDP growth are likely to undershoot the RBI's FY26 projections. Downside risks from the US tariff also add to the case for additional policy support. From a timing perspective, Q3 FY26 seems to be relatively plausible for one more rate cut given the RBI will have more information on the monsoon progress, the trajectory of US–India trade relations, the US Federal Reserve's policy stance, India's Q1 GDP data, and signs of further policy transmission.

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