5 August 2026

RBI Maintains Status Quo on Rates; Wait-and-Watch Extends, Expected Policy Tightening Now More Back-Ended

- As expected, the RBI's Monetary Policy Committee (MPC) unanimously kept the policy repo rate unchanged at 5.25% and retained its neutral policy stance.
- The policy statement was more cautious and balanced than expected, signalling a continuation of the wait-and-watch approach while the MPC awaits greater clarity, especially regarding inflation's path and composition, before taking any policy action.
- The RBI kept the door open to future policy action, noting that any policy move would have to "consider the need for recalibration of policy rates in line with the evolving growth-inflation dynamics, especially the normalisation of the underlying inflation from its benign levels seen hitherto".
- At the same time, limited forward guidance on future policy rate hikes raises the risk that policy tightening could be delayed beyond what would be optimal. In that event, a sharper policy tightening may be required if inflation pressures broaden or upside risks to inflation materialise.
- We continue to expect cumulative policy repo rate hikes of 50–75 basis points (bps) but now see the rate-hike cycle beginning in December 2026 or February 2027, later than our previous expectations of October or December 2026. The revision reflects the balanced tone of the policy statement and the RBI's lower inflation forecast.
- The RBI raised its FY27 real GDP growth projection by 10 bps to 6.7%, bringing it in line with our forecast, and projected Q1 FY28 growth at 7.3%. Economic activity was stronger than expected in Q1 FY27, supported by resilient manufacturing and buoyant services, even as the agriculture sector continues to face headwinds.
- The RBI lowered its FY27 CPI inflation projection by 10 bps to 5.0%, marginally below our 5.1% forecast, and cut its core CPI inflation projection by 40 bps to 4.3%. However, it expects core CPI inflation excluding precious metals to converge towards overall core inflation by financial year-end, indicating a broadening of underlying price pressures.
- Based on the RBI's forecasts, headline CPI inflation is projected to be above 5% for three consecutive quarters, from Q3 FY27 to Q1 FY28, peaking at 5.9% in Q3. The estimated real policy rate therefore turns negative during this period, an uncomfortable trajectory for an inflation-targeting central bank.
- In our view, resilient economic growth, a negative estimated real policy rate going ahead, and persistent upside risks to inflation warrant policy tightening. Key risks include supply chain disruptions, uneven monsoon rainfall amid El Niño conditions, and the pass-through of elevated wholesale prices into retail inflation.
- External account buffers remain comfortable, supported by foreign capital inflows aided by measures announced in June, and sizeable foreign-exchange reserves. However, a sustained increase in crude oil prices could place renewed pressure on the current account and the rupee.

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RBI Holds at 5.25%; a Balanced Policy Tone Pushes Our Expected Policy Tightening Further Out

As expected, the RBI's Monetary Policy Committee (MPC) kept the policy repo rate unchanged at 5.25% in a unanimous decision, with the standing deposit facility rate remaining at 5.00% and the marginal standing facility rate and Bank Rate at 5.50%**. The neutral policy stance was retained,** preserving the RBI's flexibility to respond to evolving macroeconomic conditions.

The accompanying policy statement read more cautious and balanced than we had anticipated. There are hints that policy action lies on the horizon, but the absence of firmer language on inflation risks, coupled with a lower inflation projection, leaves the overall message balanced. At the same time, limited forward guidance on future policy rate hikes raises the risk that policy tightening could come later than would be optimal. In that event, a sharper policy tightening may be required if inflation pressures broaden or upside risks to inflation materialise. An extended wait-and-watch posture may also prove harder to sustain as major central banks have either begun raising policy rates or are expected to do so in the coming months, potentially keeping the rupee and capital flows under intermittent pressure and narrowing the RBI's room for policy divergence.

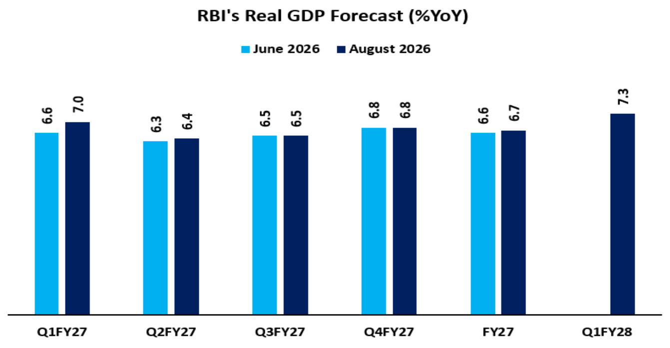
Factoring inflation risks, we continue to expect cumulative policy repo rate hikes of 50–75 bps, but now see these as more back-ended, commencing at the December 2026 or February 2027 meeting rather than in October or December 2026.

RBI Revises FY27 Economic Growth Projection Modestly Upward and Inflation Slightly Downward

Despite external shocks and elevated uncertainty, domestic activity held up well through Q1 FY27, performing better than previously expected. Manufacturing drew support from healthy early corporate results and an expansionary PMI, while services retained momentum on strong domestic demand. In Q1 FY27, private consumption was led by buoyant discretionary spending; investment remained steady on robust government infrastructure and construction outlays; and merchandise exports grew in double digits while services exports sustained their momentum. The RBI noted that supply-side pressures from the Middle East conflict had eased somewhat since June, allowing the government to withdraw its temporary fuel and LPG measures, though the resumption of the Middle East conflict in July has renewed energy price volatility and supply chain uncertainty.

Looking ahead, the economic outlook continues to face headwinds from the evolving monsoon conditions and geopolitical situation. The agricultural outlook is clouded by deficient and uneven south-west monsoon rainfall amid El Niño conditions, partly cushioned by near-normal reservoir levels and crop diversification efforts. The manufacturing sector may face cost pressures, but supply-chain diversification should mitigate the impact, while the services sector is expected to stay buoyant.

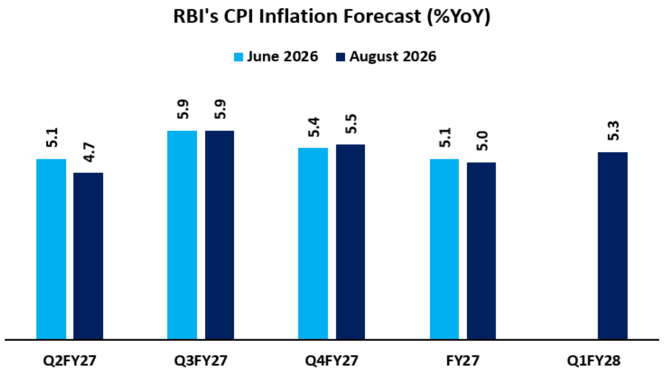
RBI Revised FY27 Growth Projection Higher to 6.7%



Source: RBI; Note: June 2026 and August 2026 refer to projections given by the RBI in its June 2026 and August 2026 MPC updates, respectively

Weighing these factors, the RBI raised its FY27 real GDP growth projection by 10 bps to 6.7%, in line with our FY27 projection, with risks evenly balanced. It revised the Q1 and Q2 projections upward while leaving the Q3–Q4 forecasts unchanged. It set the Q1 FY28 growth projection at 7.3%. Growth, though resilient, is expected to be lower in FY27 than last year, with the outlook clouded by the south-west monsoon, El Niño, geopolitics, and global trade policy.

Inflation Projected to Stay Above 5% for Three Consecutive Quarters



Source: RBI; Note: June 2026 and August 2026 refer to projections given by the RBI in its June 2026 and August 2026 MPC updates, respectively

The RBI noted that headline CPI inflation rose to 4.4% in June 2026, crossing the 4% target for the first time since January 2025, driven mainly by food, fuel, and fuel-induced pressures in select categories, such as restaurant services. Core inflation (CPI excluding food and fuel) held at 3.9% across May and June, while core excluding precious metals was even lower at 2.3–2.5%, despite higher input costs. Realised headline inflation in Q1 FY27 came in 30 bps below the RBI's June projection, at 3.9% against 4.2% projected.

The RBI lowered its FY27 headline CPI inflation projection by 10 bps to 5.0%, marginally below our forecast of 5.1%, largely reflecting a softer Q1 outturn and a 40-bps downward revision to the Q2 projection, bringing it to 4.7%. It left Q3 forecast unchanged at 5.9%, raised Q4 by 10 bps to 5.5%, and set Q1 FY28 at 5.3%. The FY27 core inflation projection was cut by 40 bps to 4.3%.

Overall, headline inflation is expected to rise in the near term, peak in Q3 FY27, driven by food and fuel, and then ease. More notably, the RBI expects underlying inflation, proxied by core CPI excluding precious metals, which has been benign for some time, to align with core inflation towards the close of the financial year, an acknowledgement that price pressures may start to generalise beyond food, fuel, and precious metals. The RBI flagged the impact of El Niño on the timing and spatial spread of rainfall as a major risk, tempered by proactive supply management and comfortable foodgrain stocks, and it retained geopolitics and energy prices as the key external watch-points. It judged that while generalised price pressures remain modest for now, the risk of second-round effects from higher food, fuel, and input costs persists.

Cumulative 50-75 bps Policy Rate Hike Expected

According to the RBI's own numbers, headline inflation remains above 5% for three consecutive quarters, from Q3 FY27 to Q1 FY28. That is an uncomfortable path for an inflation-targeting central bank to look through, even when the pressure originates in evolving El Niño conditions and an external energy-supply shock. At the FY27 average CPI inflation projection of 5.0%, the real policy rate is only marginally positive; from Q3 FY27 to Q1 FY28, it slips into negative territory.

In our view, the combination of resilient economic growth, a real rate turning negative from Q3 FY27, and persistent upside risks to inflation continues to warrant policy tightening. Those risks are familiar: ongoing supply-chain disruptions, uneven monsoon rainfall, and the potential pass-through of elevated wholesale prices to retail prices, signalled by the still-wide WPI–CPI gap.

The RBI kept the door open to future policy action, noting that any policy move would have to "consider the need for recalibration of policy rates in line with the evolving growth-inflation dynamics, especially the normalisation of the underlying inflation from its benign levels seen hitherto". The RBI described itself as "resolute in its commitment to align inflation with the target" and framed its patience as a wait for greater clarity on the path and composition of inflation before moving.

Liquidity and Financial Market Conditions

The RBI stated that it will proactively ensure sufficient liquidity in the banking system. System liquidity remained in surplus, with the average daily net position under the liquidity adjustment facility (LAF) at around Rs 1.0 lakh crore since the June meeting. The weighted average call rate (WACR) traded within the corridor, averaging 5.31% during the same period. Meanwhile, short-term money-market rates eased in July, and G-Sec yields softened across maturities on the government's and the RBI's measures to attract foreign capital into the debt market. Credit growth stayed robust and broad-based, even as transmission to lending rates moderated during May–June. The RBI expects the seasonal return of currency, drawdown of government cash balances, and its capital-inflow measures to support liquidity in the near term, with surplus liquidity likely to peak in September. It reiterated that it would conduct two-way operations as needed to keep the WACR aligned with the policy repo rate.

External Sector: Energy Prices Continue to Pose Risks

The external position appears to have offered the RBI more comfort than the domestic inflation path. The current account recorded a surplus of US$ 2.8 billion in April–May FY27, driven by a robust services surplus and strong remittances, though it is likely to return to a deficit in the coming months. Moderation in global trade growth, a surge in energy prices, and persistent trade-policy uncertainties continue to pose upside risks to the current account deficit in FY27.

On a positive note, gross foreign direct investment (FDI) inflows rose to US$ 30.7 billion in April–June. Foreign portfolio investment (FPI) turned around to net inflows of US$ 7.1 billion in June–July, supported by the foreign capital-flow measures announced in June. On this basis, the RBI expects a healthy balance-of-payments surplus for the year. FX reserves stood at US$ 692.9 billion by end-July, providing over ten months of import cover and covering 90.8% of external debt. We read the external buffer as comfortable but energy price-contingent: a surge in crude oil prices, alongside moderating global trade and lingering tariff uncertainty, remains the most direct channel through which the current account and the rupee could come under pressure again.

The RBI Also Announced the Following Developmental and Regulatory Policy Measures:

1. **Review of Guidelines on Interest Rates on Advances:** The RBI proposed to harmonise and standardise the regulatory framework on interest rates on advances for all regulated entities (REs) on a principle-based basis. The proposed rationalisation aims to: (i) harmonise the guidelines across REs while maintaining proportionality; (ii) address certain

operational aspects of the current framework on MCLR and EBLR; and (iii) standardise certain divergent market practices concerning interest charging, including day count convention and benchmark reset dates. These measures seek to ensure uniformity, enhance transparency in loan pricing, strengthen monetary transmission, and bolster consumer protection. Draft directions will be issued for public comments.

2. **Draft guidelines for the licensing of Urban Co-operative Banks (UCBs)**

   The RBI has decided to resume issuing fresh licenses for UCBs on an "on tap" basis after a two-decade pause. Draft guidelines will be released for stakeholder consultation.

3. **Review of Guidelines on Concentration Risk Management - Rural Co-operative Banks (RCBs)**

   The RBI has decided to review its prudential norms for RCBs to address risks associated with concentrated lending. Currently, these norms are governed by the Credit Monitoring Arrangement (CMA) instructions issued in 2008. Given the significant expansion and changes in the banking and co-operative banking sectors since then, the RBI intends to address prudential concerns with a view to developing a vibrant co-operative sector. Draft Amendment Directions will be issued for wider stakeholder consultations.

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