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RBI to go in for a hat-trick

Given that RBI's mandate is to keep inflation within the targeted range, and since CPI has remained on the lower to middle end of RBI's band since Jan'25, we expect another back-to-back rate cut by the central bank in its upcoming policy. Since the start of CY25, RBI has announced 2 rate cuts of 25bps each so far (Feb'25 and Apr'25), bringing down the policy repo rate to 6%. We even expect the central bank to revise its inflation projection for FY26 down by ~10bps, as its Q1 forecast will undershoot by 30-40bps, given the continued moderation in food prices. Further, assuming normal monsoon and subdued oil and other global commodity prices, we expect this trend of softening will continue. We maintain our inflation forecast at ~3.8-3.9% for FY26. Growth forecasts on the other hand will likely remain unchanged as the central bank takes note of rising global trade uncertainties and its impact on growth. Our GDP forecast for FY26 at 6.4-6.6% also remains unchanged so far. RBI will continue with its "accommodative" stance as it aims to keep liquidity at comfortable levels to support credit growth. Cumulatively we expect 100 bps cut in the current cycle.

What has changed since the last policy?: Since the last policy, RBI will be evaluating performance of economic activity, trend in inflation, arrival of monsoon, movement of domestic high frequency indicators, and developments regarding global growth scenario.

Domestic growth scenario: Latest data release by Mospi shows that economic activity moderated in FY25, partly due to base effect, as GDP rose by 6.5% compared with 9.2% in FY24. This was unchanged from the second advanced estimates released in Feb'25. On a quarterly basis, Q4FY25 growth came in at 7.4% which was highest in past four quarters. Both annually and in Q4, agriculture growth was a major support compared with last year, while manufacturing and mining sector growth softened. The last quarter of FY25 also got support from improvement in construction and services activities, driven by seasonal factors (marriage season, Mahakumbh).

High-frequency indicators: In Q1FY26 so far (Apr/May'25), economic activity is signalling mixed trends. Indicators which are showing an improvement or are holding ground so far include: domestic air passenger traffic growth (4.8% versus 4.9% during the same period last year), GST collections (Rs 4.4 lakh crore versus Rs 3.8 lakh crore), diesel consumption (3.2% versus 1.9%), vehicle registrations (45.3 lakh units versus 43.4 lakh units), and toll collections (18.3% versus 5.6%). On the other hand, manufacturing (57.9 versus 58.2) and services (60.0 versus 60.5) PMIs are showing some signs of moderation in activity, possibly reflecting the impact of global trade tensions. As economic activity remains broadly resilient, but external risks to growth persist, RBI may keep GDP forecasts unchanged for now in the upcoming policy meet.

Domestic inflation well within comfort zone: CPI in Apr'25 softened for the sixth consecutive month, and came in at 3.2%, down from 3.3% in Mar'25. Since the beginning of CY25, inflation has hovered within RBI's lower to middle target range, making a case for 2 back-to-back rate cuts this year so far. Given that inflation in May'25 and Jun'25 is likely to come in this same range, it is likely to undershoot RBI's Q1 forecast by 30-40bps. Also given the advance onset of monsoon and IMD's prediction of normal monsoon this year, it can be expected that food inflation will largely remain contained. Global commodity prices also remain subdued as risks to global growth loom at large given the ongoing tariff war situation. As a result, a downward revision to inflation forecast can be expected. However, upside risks from imported inflation and impact of tariffs will also be carefully evaluated by the central bank.

Banking sector growth: Bank credit has seen some significant easing it has risen by only 10.2% in Apr-May'25 so far (till 16 May), down from a high base of 19.5% registered last year during the same period. At the start of Q1FY26 (Apr'25), slowdown has been noted across sub-sectors, primarily in the personal loan (11.9% versus 26.7%) and services (10.5% versus 22%) segment. Credit to industries has moderated marginally (6.6% versus 7.4%). On the other hand, deposit growth has witnessed less sharp movement as it rose by 10% in Apr-May'25 period, compared with 13.5% increase noted during the same period last year. Going forward, as we embark upon low rate regime scenario, sustaining deposit growth would become a challenge for banks.

Transmission of rates: In measuring how transmission of interest rates as of Apr'25 across different spectrum have fared, the change is taken from Jan'25 just before RBI embarked on the journey of rate cuts. The transmission of interest rates is better for PSBs relative to PVBs.

In case of PSBs, the transmission on fresh term deposits has seen a decrease of 33bps, while on the lending side, WALR has fallen by 13bps. For PVBs the decrease on fresh deposits is lower at 8bps and that on loans is at 12bps. In FY25, fresh term deposit rates rose by 4bps in case of PSBs and by 8bps in case of PVBs. In FY25, weighted average lending rates fell by 2bps in case of PSBs and rose by 3bps in case of PVBs.

Table 1. Fresh term deposit and lending rates

Transmission of rates	Jan'25	Feb'25	Mar'25	Apr'25
WADTDR: PSBs	7.06	7.00	7.01	6.73
WADTDR: PVBs	6.49	6.51	6.69	6.41
WALR: PSBs	8.59	8.68	8.66	8.46
WALR: PVBs	10.20	10.24	10.32	10.08

Source: RBI, Bank of Baroda Research

System liquidity: On an average, liquidity has remained in surplus in the month of May'25 at Rs 1.71 lakh crore, compared with a surplus of Rs 1.40 lakh crore in Apr'25. The surplus in the system has remained since the beginning of the new financial year supported by RBI measures. Daily VRR along with liquidity infusion through OMOs has helped. We expect RBI to maintain comfortable liquidity in the coming months as well. Thus we expect RBI to keep its stance—"accommodative"—unchanged in the Jun'25 policy.

Softening sovereign yields: Since the last policy, yields on 10Y G-sec have fallen by ~18bps and are currently trading at around the 6.26% mark, compared with 6.48% before the Apr'25 policy. Limited central government borrowing, buyback of securities, RBI's liquidity support measures, prospects of inflation remaining under control given the normal monsoon outlook, and subdued global cues (weakening growth in the US and China), will give yields a downward bias going forward.

Global developments: Since the start of the year, global trade tensions have remained heightened led by US government's aggressive stance on tariffs. So far, US has announced 10% baseline tariffs on its imports from all countries. In addition, imports of automobiles and parts attract 25% tariff, while that on steel and aluminium imports has been raised from 25% earlier to 50% now. Currently, country-wise tariffs have been put on hold by the Trump administration, but are set to kick in from 9 Jul 2025. Most importantly, a temporary truce between US and China had also been achieved, however, it has come under threat once again as both nations accused each other of violating the trade agreement. This has reignited fears that tariffs on US imports from China could kick in sooner, leading to a scenario of stagflation in the country. US Fed has cautioned that tariffs will have an upside impact on inflation and may hamper growth. For now US inflation appears to be cooling, raising hopes for 2-3 rate cuts by Fed in CY25, beginning from Sep'25.

Where do our forecasts stand?: Looking at the factors mentioned above, we believe that domestic growth fundamentals still remain strong. Key uncertainty remains around the escalating tariff war situation and its impact on global growth. Spatial distribution of rainfall during the monsoon season is also yet to be seen. Rise in dollar strength due to safe haven demand, and its impact on INR may also increase the risk of imported inflation.

1. We expect GDP growth to stabilise at ~6.4-6.6% in FY26. This is broadly in line with RBI's current estimates. This is based on the assumption of normal monsoon and escalated global trade tensions. However, if trade tensions ease, and given that growth in FY26 will be coming over a low base, there remain some upside risks to our forecast.

2. We expect headline CPI to settle at ~3.8-3.9% in FY26, with risks evenly balanced. Continued moderation in food prices, prediction of normal monsoon, subdued global commodity prices, lower international oil prices, will help sustain the downward momentum in CPI. Key upside risks emerge from imported inflation—if INR weakens owing to strengthening US$, and spatial distribution of rainfall in this monsoon season. We expect RBI to lower its inflation projection by ~10bps in the upcoming policy.

3. On the external sector side, INR has appreciated by 1.3% since the last policy, as US$ weakened by 3.9% during the same period. INR is currently hovering around 85.59/$ mark. However, in May'25, INR reversed the gains made in Apr'25 as it depreciated by 1.3%. DXY index declined only marginally by 0.1% in May'25 following 4.6% decline in Apr'25. While on one hand, fears of stagflation exerts downward pressure on US$, on the other hand, safe haven demand in the wake rising global trade tensions, provides support to the currency. Interplay of these factors will determine how the US$ will perform. This will impact INR's movement and also trend in FPI flows. Overall we expect INR to trade with a depreciating bias in the near-term in the range of 85-86/$.

Under these conditions, we expect RBI to lower rates by 25bps in its upcoming policy and keep the stance unchanged. We do expect central bank to announce measures to keep liquidity at comfortable levels, to support credit growth.

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