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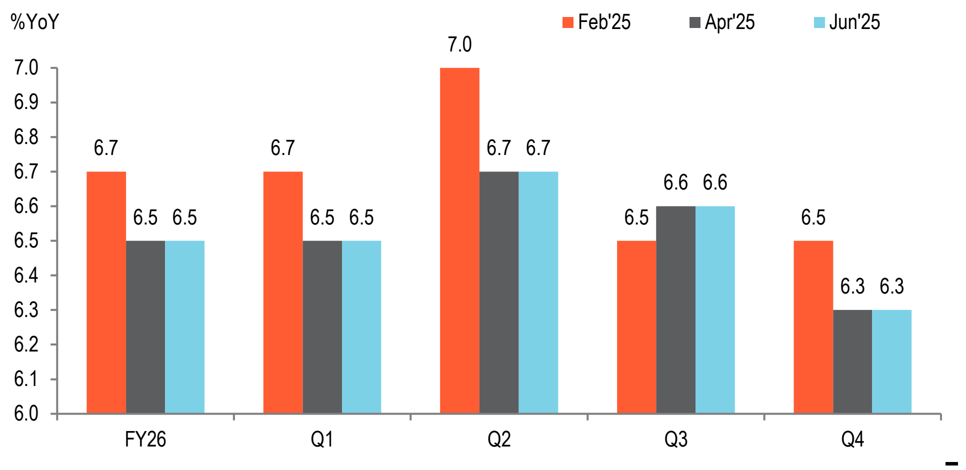
RBI delivers a bumper cut

The MPC with a 5-1 vote lowered the repo rate by 50bps from 6% to 5.5%, as RBI announced frontloading of rate cuts. Stance was changed to 'neutral' from 'accommodative', signalling that there remains limited room for future rate cuts. The Governor noted that "price stability is a necessary condition, it is not sufficient to ensure growth. A supportive policy environment is vital". This provides a rationale for today's bumper rate reduction and also gives a hint that if growth falls substantially below RBI's projection then the central bank may lower rates further. In addition, to this, 100bps CRR cut announced will help speed up the transmission, which in turn will support credit growth and GDP. RBI also lowered its inflation projection for FY26 downward to 3.7% from 4% estimated in Apr'25. This is on account of significant moderation in food prices. This also augurs well domestic consumption. Going forward, we expect a pause from RBI in its next 2 meetings at least, as it evaluates the impact of monetary policy loosening done so far. More data on monsoon, and growth will also be awaited. For now we maintain that terminal repo rate will be held at 5.5%, also keeping in mind the impact on real rates, FPI inflows, and currency.

Hat-trick by RBI: The monetary policy committee decided to cut repo rate by 50bps (BoB est.: 25bps cut) to 5.5% from 6% in a 5-1 vote. Only Shri Saugata Bhattacharya voted for a 25bps cut. Consequently, the SDF rate now stands at 5.25% and MSF at 5.75%. This is the third rate cut announced by the central bank this year, taking the cumulative reduction to 100bps so far. Stance of the monetary policy was also changed to 'neutral' from 'accommodative'. To support permanent liquidity in the system, RBI in a surprise move, also lowered the CRR by 100bps to 3% from 4% earlier. This will be done in a staggered manner, in tranches of 25bps each, starting from fortnights beginning 6 Sep, 4 Oct, 1 Nov and 29 Nov 2025.

GDP growth unchanged: Mospi's data confirms that India's GDP in FY25 rose by 6.5%. For the current financial year (FY26), RBI expects economy to grow at a similar pace, as it left its growth forecast unchanged at 6.5%, as also estimated in its Apr'25 policy. The quarterly forecast were also maintained with growth in Q1 at: 6.5%; Q2: 6.7; Q3: 6.6%; and Q4: 6.3%. The central bank noted that gradual rise in discretionary spending (measured through production of consumer durables), healthy rural demand, improvement in urban demand, revival in investment activity, strong export growth and forecast of above normal monsoon bodes well for growth. Services activity is also maintaining momentum. However, downside risks to growth remain on account of continued geo-political tensions and weather related uncertainties. We also maintain our forecast of 6.4-6.6% for real GDP growth in FY26.

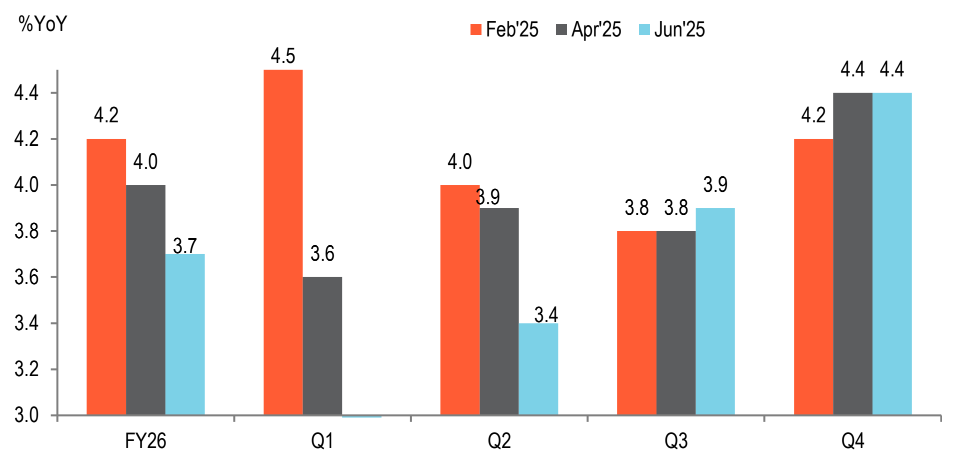
Figure 1: RBI expects 6.5% growth in FY26



Source: RBI, Bank of Baroda Research

Inflation projections lowered: In line with expectations, RBI lowered its inflation projections for FY26 to 3.7% from 4% earlier. This was on account of sharp downward revisions made to Q1 and Q2 inflation forecasts, which have been brought down to 3.6% from 4.5% (Apr'25) and to 3.9% from 4%, respectively. On the other hand, estimate for Q3 has been revised upward to 3.9% from 3.8% earlier, while Q4 projection has been retained at 4.4%. This trend also shows that RBI has taken into account of the reversal of low base effect from Q3 onwards. In H1FY26, inflation is expected to be lower than previously expected on account of low base and significant moderation seen in food prices. This trend will be further supported by expectation of above normal monsoon and early onset of rains. The central bank notes that core inflation also remains contained, despite recent price rise seen in gold. Upside risks to these forecasts may emerge uncertainties related to tariffs, and global commodity prices. We expect inflation to be slightly higher in FY26 at 3.8-3.9%, as we await more information on spatial distribution of rainfall and remain cautious regarding the core inflation.

Figure 2: Headline CPI forecasts for FY26 lowered to 3.7%



Source: RBI, Bank of Baroda Research

Way forward: RBI Governor, while delivering aggressive rate cut of 50bps, also cautioned that there now remains 'limited room' for monetary policy to support growth. In addition, the change in stance from 'accommodative' to 'neutral' also implies that the central bank is looking at maintaining status quo in its next 2 meetings at least. RBI is likely to assess the impact of 100bps cuts announced so far, and speed of transmission, which will also be supported by 100bps reduction in CRR, before taking a call on its rate trajectory. We believe that the terminal rate will remain at 5.5% for some time in the near-term as RBI is also cognizant of movement in real rates. Given that inflation is low currently, real rates are at ~2%. As we approach Q4, and inflation edges up to 4.4%, real rates will come down to ~1%. We expect RBI to maintain this level of real rate. Any future rate reduction will be expected if there is significant downside seen to RBI's growth projections.

Summary of Impact

- The full frontloading of action is reflective of the new approach of the RBI where the message is that there will be more certainty in the market by announcing all measures at one point of time. The CRR cut could have been announced later too, but the fact that this has been done in this policy buttresses this approach. If both the repo rate and CRR cut are combined, the effect is quite comprehensive.
- With the stance being changed to neutral, the implication is that there will possibly be no further cuts as space is limited. It can be said that unless the two forecasts on inflation and GDP change significantly, only then can there be a further look on stance or rates. Therefore, future action will be data dependent.
- Inflation in Q3 and Q4 would be 3.9% and 4.4% respectively. For the year it will be 3.7%. Hence, the real repo rate for the year would be 1.8% while it will be 1.6% and 1.1% for Q3 and Q4.
- Bond yields should moderate to some extent though this has not been the immediate reaction of the market. The liquidity injection through CRR cuts which starts in September should definitely work in lowering yields.
- The transmission of the rate cuts invoked so far will work directly where the EBLR is concerned. For MCLRs banks will be evaluating their deposit rate structure. The impact of CRR cut will be seen in the second half of the year.
- Banks will have to relook at the deposit rates in response to the rate cut and accordingly calibrate them.
- Growth receives a positive thrust on account of this rate cut and will also support the measures announced in the budget on income tax.

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