



TM

India Economy

06 August 2025

RBI MPC REVIEW

RBI Acknowledges Limitations of Policy Easing

The Reserve Bank of India (RBI) has decided to keep the policy repo rate unchanged at 5.5%, maintaining its current policy stance. This decision was anticipated, especially after the central bank implemented a front-loading of rate cuts totaling 100 basis points since February 2025 and injected liquidity into the system. The effects of these measures are expected to influence growth only with a lag.

The RBI's outlook for growth remains steady, projecting an average growth rate of 6.5% for FY26, with quarterly estimates closely aligning with this figure. While the RBI's expression of optimism regarding growth is derived from factors such as a strong monsoon season, increasing capacity utilization, and supportive monetary, regulatory, and fiscal policies, the decision to ease monetary policy and provide excess liquidity is primarily influenced by the current inflation situation. Inflation is projected to average lower at 3.1% in FY26, with an upward trend anticipated at 4.4%.

Unchanged growth projections imply that the central bank does not foresee any significant impact from the front-loaded monetary accommodation on growth in the near term. Additionally, the lower near-term inflation is primarily influenced by volatile food items, and the predicted rise towards the fourth quarter, which aligns with the core inflation rate of 4.4%, suggests the RBI may consider one more rate cut in October 2025.

The cumulative liquidity infusion, estimated at INR 13.16 trillion (5.7% of bank deposits) and including upcoming Cash Reserve Ratio (CRR) cuts, is expected to maintain a substantial liquidity surplus in the coming quarters.

What Contributes to RBI's Optimistic Growth Outlook?

The RBI's growth forecast is heavily reliant on resilient demand in less productive rural areas, despite stagnant urban demand. Private investment continues to decline, with the MOSPI's survey guiding for significant cutbacks in planned private capital expenditure for FY26. The RBI's growth assessment also depends on the performance of the service sector, as it expects sustained growth in the construction and trade segments to bolster services in the upcoming months.

However, structural challenges, such as persistent weakness in real household income growth and a lack of productive employment, continue to affect consumption demand. Additionally, trade is facing increased uncertainties due to higher U.S. tariffs, complicating future demand and investment forecasts for corporates, which further restrains private capital expenditure. While the RBI acknowledges supportive fiscal policy, the central government remains committed to fiscal consolidation, implying a procyclical tightening.

The RBI has lowered its inflation projection for FY26 to 3.1% from 3.7% previously, reflecting subdued demand and ongoing deflation in food prices, particularly for volatile items like vegetables. However, the core CPI inflation continues to rise, partly driven by higher gold prices. Considering the uncertainties around volatile food inflation and the waning high base effect from the previous year, an expected increase in inflation during the fourth quarter appears reasonable.

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Monetary Transmission: Banks Adjusting to Low Lending Growth Expectations

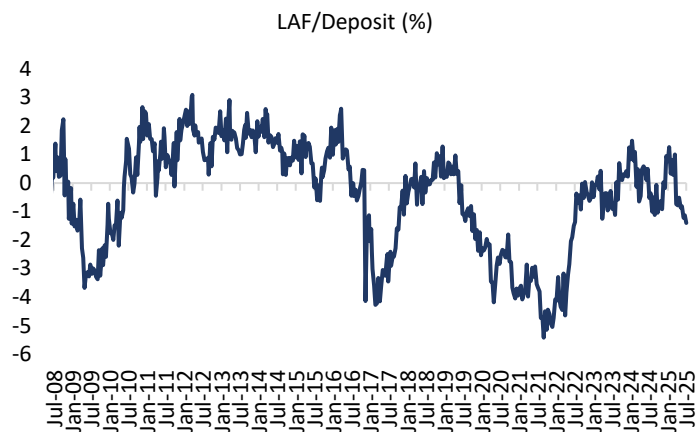
Systemic liquidity has remained in surplus, averaging INR 3 trillion/day since June 2025, and is expected to increase further in response to forthcoming CRR cuts. Due to sustained margin pressure and a lack of credit demand, fresh term deposit rates have declined by 87 basis points to an average of 5.75% since January 2025, outpacing the 71 basis point decrease in fresh lending rates to 8.62%.

This surplus liquidity situation is likely to extend the competition in bank lending, with lower money market rates, such as Commercial Papers and Corporate Bonds, intensifying margin pressure. Consequently, banks are attempting to optimize their cost of funds by significantly reducing term deposit rates and aggressively pursuing CASA deposits along with attempts to control operating costs. Bank credit growth has already slowed considerably to below 10%, down from a peak of 22% in November 2023.

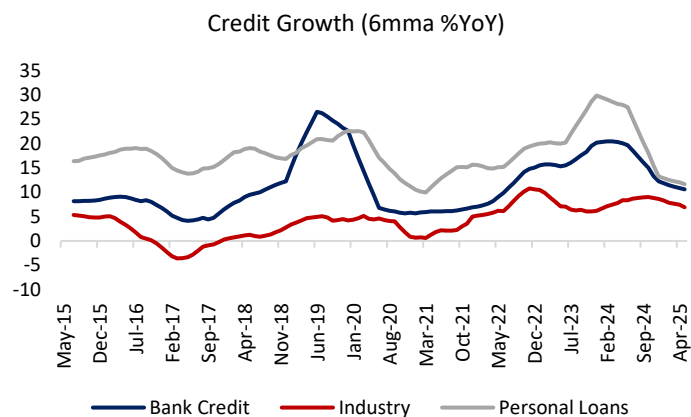
Additionally, banks are experiencing pressure to adjust lending yields due to a shift in preference from uncollateralized to collateralized lending amid rising credit cost concerns, with early signs of stress appearing in MSME lending. This combination of pro-cyclical credit tightening by lenders and slowing credit growth continues to adversely impact spreads and profitability.

In summary, while the RBI's decision to maintain the status quo is not surprising, it is noteworthy that its unchanged growth projections highlight the limitations of policy easing in revitalizing demand. The structural obstacles to growth, such as faltering private investment, stagnant household income growth, and insufficient productive employment, diminish the effectiveness of monetary accommodation. Furthermore, uncertainties in global trade, especially arising from U.S. tariffs, further impede corporate investment. Given these challenges and the potential bottoming out of inflation in the second half of the fiscal year, the scope for further rate cuts appears limited. It is likely that margin pressures for banks may persist for several more quarters, particularly due to rising credit costs.

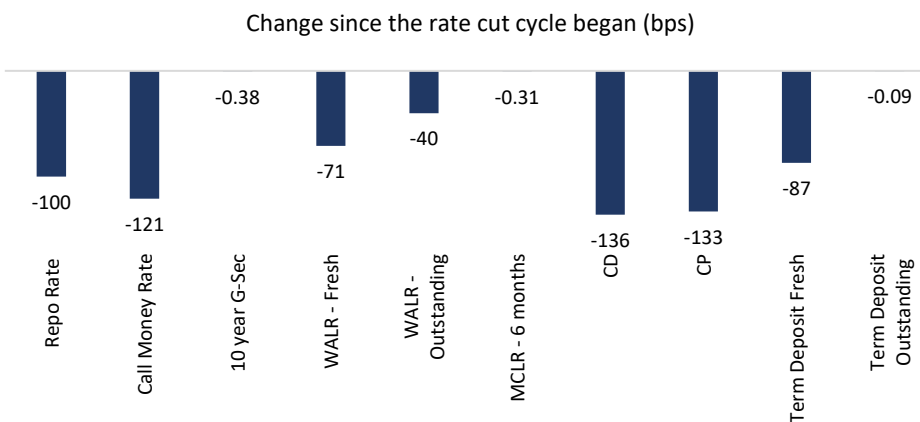
From the market standpoint, unchanged policy rate implies that additional support from the RBI is lesser, though surplus liquidity is favorable for valuations. From the banking perspective, deceleration in bank lending and decline in inflation does have an upside potential for GNPA ratio. Going with the past cycles, the NPA cycles typically last for couple of years at least. Hence, extended period of subdued credit growth and onset of the NPA cycle forebodes modest returns from banking stocks and guides us for a selective approach focused on long history of strong underwriting quality and lenders with high provisioning ratios (HDFC bank, Federal Bank, ICICI bank and Kotak Bank).

Exhibit 1: Persistence of surplus liquidity in the system

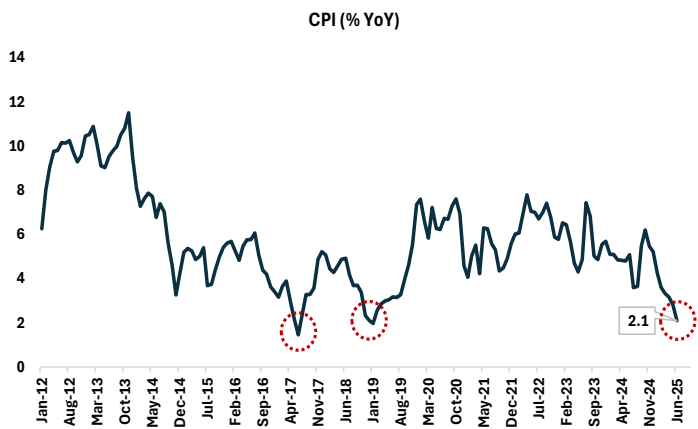
Source: CMIE, Systematix Research

Exhibit 2: Bank Credit growth has significantly moderated

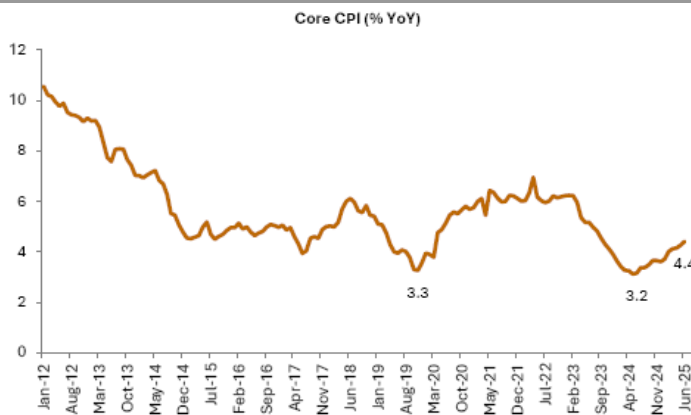
Source: CMIE, Systematix Research

Exhibit 3: Rate cut transmission remains incomplete with transmission to term deposit rate more than the lending rate

Source: CMIE, Systematix Research

Exhibit 4: Jun'25 CPI at 2.1% marks the third lowest recording after 2017 and 2019, also reflective of weak demand scenario

Source: CMIE, Systematix Research

Exhibit 5: Core inflation continues to inch upwards, 4.4% in Jun'25 vs 3.2% in Jun'24

Source: CMIE, Systematix Research

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