

The RBI Pivot: Policy Normalisation Begins

Policy Action

- The Monetary Policy Committee (MPC) unanimously voted to raise the policy repo rate by 25 bps to 5.50% from 5.25%.
- Consequently, the Standing Deposit Facility (SDF) rate increased to 5.25%, while the Marginal Standing Facility (MSF) rate increased to 5.75%.
- The MPC also changed its stance from 'Neutral' to 'Calibrated Tightening'. Two MPC members argued for retaining the 'Neutral' stance.

Assessment of Policy Action

As economic growth remains resilient and the inflation outlook is no longer 'benign', there was a need to recalibrate the monetary policy, which was arguably too easy for the prevailing macro backdrop.

In this regard, the RBI's decision to hike the key policy rate by 25 basis points seems justified and is largely in line with market expectations.

The stance change to 'Calibrated Tightening' will further strengthen the RBI's inflation-fighting credibility and should help anchor inflation expectations in an otherwise inflationary world. The RBI underscored that, given the current conditions, the stance implies that rate cuts are off the table in the near term. It added that policy action ahead can only be a rate hike or a pause, depending on evolving conditions and the outlook. The duration and extent of the rate hike cycle would be contingent on the actual growth-inflation developments and the outlook.

The RBI reiterated that monetary policy works mainly by preventing second-round inflation effects, which tend to emerge with a lag and are difficult to isolate from ongoing supply-side pressures. It noted that, though there is some evidence of elevated inflation expectations and a generalisation of inflation, there are limited signs of supply-side pressures getting embedded in pricing behaviour at this point.

The RBI Governor noted the growing uncertainties in the global economic outlook due to geopolitical conflicts, elevated and volatile energy prices and tightening monetary policy. He also pointed to uncertainty about the fair valuation of AI stocks as a downside risk to global economic outlook.

On domestic growth, the RBI's tone was relatively sanguine, though it also acknowledged the risks from global economic uncertainties, supply chain disruptions and the weak Monsoon season.

Below are the RBI's key estimates for the growth and inflation trajectory over the next year, compared to its previous forecasts:

	CPI Inflation (%)			GDP (%)		
	5-Jun-26	5-Aug-26	7-Oct-26	5-Jun-26	5-Aug-26	7-Oct-26
FY26	2.1			7.6		
Q1FY2027	4.2	3.9		6.6	7.0	
Q2FY2027	5.1	4.7	4.9	6.3	6.4	7.2
Q3FY2027	5.9	5.9	6.0	6.5	6.5	6.9
Q4FY2027	5.4	5.5	5.7	6.8	6.8	6.8
FY27	5.1	5.0	5.2	6.6	6.7	7.1
Q1FY28		5.3	5.6		7.3	7.1

Source: RBI

Assessment of Inflation

The RBI raised its average inflation forecast for FY27 to 5.2% from 5.0%, and for Q1FY28 to 5.6% from 5.3%. The upward revision in the inflation forecast reflects the broadening of price pressures, particularly in food items.

Inflationary pressures have firmed up, with August 2026 headline CPI inflation rising to 4.8% and Core CPI inflation to 4.2%. The uptick in inflation was largely supply driven, led by an increase in food and fuel prices, while Core inflation, excluding precious metals, remains benign at 2.9% in August. Having said that, there are some signs of price pressures broadening, which could put further upward pressure on underlying inflation.

The CPI inflation is expected to rise further in the coming months, due to an unfavourable base effect from last year and continued supply-side pressures on account of the deficient Southwest Monsoon, El Niño conditions and high volatility in international oil prices. In addition, the RBI pointed to early signs of inflation becoming more generalised, as inflation picked up across a larger segment of the CPI basket.

Assessment of Growth

The RBI revised its FY27 growth forecast to 7.1%, from its earlier projection of 6.7%, reflecting higher-than-expected growth in the first half of FY27. However, the GDP growth forecast for Q1FY28 is revised lower, from 7.3% to 7.1%.

The RBI noted the prevailing strength in economic activity despite geopolitical uncertainties and expects the resilience in economic momentum to continue. It took comfort from robust domestic demand, sustained momentum in services, a rebound in private capex and sustained credit flow.

The RBI also highlighted risks to the growth outlook from protracted geopolitical tensions, elevated commodity prices, additional frictions in global trade and tightening of global financial conditions.

Liquidity Management

The banking system liquidity had increased substantially in August and September due to FCNR deposit inflows, raising net banking system liquidity to over Rs. 11 trillion by September 10. The surplus subsequently moderated to around Rs. 5 trillion in the second half of September due to tax outflows and the RBI's liquidity absorption measures, such as variable rate reverse repo operations (VRRR), OMO sales and Sell/Buy FX swaps.

Going into this policy, a segment of the market expected the RBI to announce some liquidity absorption measures such as a CRR hike or further OMO sales. The fact that it did not announce any immediate liquidity absorption measures was marginally positive for the bond market.

Going forward, the RBI reiterated that it will deploy an appropriate mix of liquidity management tools to ensure that the Weighted Average Call Rate (WACR) remains closely aligned with the policy repo rate. Importantly, with a seasonal increase in currency in circulation and upcoming maturities of the RBI's short FX forward positions, surplus banking system liquidity is expected to decline meaningfully over the coming months. As a result, the need for durable liquidity absorption measures appears limited.

In this environment, we expect the RBI to rely predominantly on VRRR operations and short-tenor FX Sell/Buy swaps to manage surplus liquidity, while the likelihood of further OMO sales has diminished considerably.

This stance is likely to keep overnight funding rates well anchored, limit volatility in money markets and provide a supportive backdrop for short-duration fixed-income assets.

Market Outlook

Barring a major inflationary shock, we expect the RBI to continue policy normalisation and deliver an incremental 50-75 bps of hikes in this cycle.

Importantly, a significant part of this anticipated tightening appears to be already reflected in market pricing, particularly at the front end of the yield curve. Thus, we maintain our constructive outlook on the high-quality corporate bonds at the front end of the yield curve.

We continue to favour high-quality, accrual-oriented strategies in the 1–3-year duration segment, with some flexibility to capitalise on valuation opportunities and yield curve dislocations that may emerge at longer maturities.

Suggested asset allocation framework by time horizon

- **3–12 months:** Investors may consider Money Market Funds or Ultra Short to Short Term Funds, which are suitable for managing short-term surplus while maintaining liquidity.
- **12-24 months:** Investors may consider Short Term Funds and Corporate Bond Funds, which are well-positioned to benefit from a benign macro backdrop and a liquidity-rich environment.
- **More than 24 months:** Investors may consider Income Plus Arbitrage strategies for tax-efficient return generation.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.