

Between government and RBI, getting back the investor



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THE MONETARY Policy Committee's second bi-monthly meeting for the year unfolded in line with our expectations, with a unanimous status quo on the policy rates and stance. The tone of the policy document was expectedly hawkish, amid uncertainty owing to the West Asia conflict, the potential El Niño development and sub-par monsoons.

While the committee pared its real GDP growth projection for FY2027 by 30 bps to 6.6 per cent from 6.9 per cent in the April policy, the commentary around growth outcomes was fairly benign. This stems from expectations of a continued momentum in urban consumption, investment activity, and services exports, and the impact of the government's programmes to mitigate the effect of the sub-par monsoon on rural demand and agricultural activity.

The quarterly growth trajectory for FY2027 has been lowered, although unevenly, with a 20-40 basis points cut in the projections for the first and second quarter, and a 40-50 basis points cut in those for the third and fourth quarters. The MPC expects GDP growth to lie in a narrow range between 6.3 and 6.8 per cent.

We are somewhat less sanguine, particularly for the first half of this year. Elevated energy prices and heightened uncertainty around the duration of the conflict could compress corporate profitability and investment demand. This, along with higher inflation, could also dampen consumer sentiments. Besides, the weak monsoon forecast for 2026 has dulled the agricultural outlook and rural demand prospects, although the distribution of rainfall remains key. Moreover, a modest fiscal slippage following the West Asia conflict could pare the govern-

ment's discretionary spending, including that on capex.

Assuming an average crude oil price of \$95 per barrel in FY2027, ICRA projects the GDP growth at 6.2 per cent. We expect the GDP growth to slump to sub-6 per cent in the first half, before recovering in the second half of the year, to around the levels projected by the MPC in the fourth quarter.

Simultaneously, the MPC has raised its CPI inflation projection for FY2027 by 50 bps to 5.1 per cent from 4.6 per cent earlier, amidst a sharp 70 bps hike in the forecasts for the second, third and fourth quarters. The core inflation forecast has been raised by a milder 30 bps to 4.7 per cent. It has stressed that inflation risks remain tilted to the upside owing to the sub-par monsoon and global supply-chain risks.

The committee's CPI inflation projections are largely in line with our estimates. We concur with the upside risks and remain particularly concerned around the generalisation of food and fuel price pressures to the rest of the CPI basket.

Interestingly, unlike the usual trend of balanced risks around its projections in the past, the MPC placed upside risks to inflation and downside risks to growth for the second consecutive policy review, with the outlook being mired by unpredictable nature of the conflict, the sustained global commodity price shock and supply disruptions as well as deficient rainfall in the southwest monsoon season.

Unlike us, some market participants had argued for an early rate hike on account of two factors. First, the upward revision in the CPI inflation trajectory has compressed the real policy rate, fanning argu-

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ments around the need for immediate rate hikes. However, the paring of growth projections justifies a lower real policy rate, at least in the immediate term, as inflation projections remain below the upper bound of the MPC's target range of 2-6 per cent. In our view, any premature policy tightening would have only exacerbated the weakness in growth outcomes.

Nevertheless, the next move on rates is likely to be a hike, although its timing will depend on how geopolitical and macro developments, including the severity of El Niño, transmit to a generalisation of inflationary pressures. We believe that the October and December 2026 policy meetings will be live for potential rate hike(s), after there is some clarity on the monsoon impact.

In addition to the compression in the real policy rate, the weakness in the rupee was cited as a reason for bringing forward rate hikes. The surge in energy prices in the aftermath of the West Asia crisis will undoubtedly enlarge India's current account deficit (CAD) materially. We project it to more than double to around 2 per cent of GDP in FY2027. While this does not seem large, financing deficits of sub-1 per cent of GDP in the past two years posed a challenge, amid a drying up of capital flows, which has brought the USD/INR pair under pressure.

As anticipated, the MPC acted within its mandate, and appropriately kept the repo rate unchanged, despite the weakness in the rupee. But, alongside, the RBI governor made several announcements to attract capital flows, in line with our expectations that the RBI and not the MPC would address the issues surrounding the currency.

The announcements made by the RBI are aimed at incentivising more foreign capital inflows, especially in government securities (G-secs). With the GoI exempting foreign portfolio investors (FPIs) from capital gain tax on investments made in G-secs, the RBI also made a coordinated move, expanding the list of specified securities under the fully accessible route (FAR). It also removed various limits for FPIs under the general route. These moves are likely to boost demand for G-secs, auguring favourably for bond yields, given the risks from an expected fiscal slippage. Besides, this could potentially facilitate the inclusion of Indian G-secs in the Bloomberg Bond index, in the next round of the review due later this year.

Further, in order to support equity inflows, the RBI proposed to increase limits for investments by non-resident Indians and Overseas Citizens of India in equity instruments traded on the stock market without SEBI registration, while extending the same facility to persons resident outside India as well. The central bank has also introduced a concessional forex swap facility and a similar facility for bearing full hedging cost to authorised dealer banks for raising fresh three- to five-year foreign currency non-resident bank (FCNR (B)) deposits, along with restoring the time for realisation of export proceeds to nine months.

Subsidised hedging cost of foreign borrowings and deposits will also help in increasing inflows. This will help reverse the exodus of capital and crucially support India's balance of payments position, amid expectations of a doubling in the current account deficit.

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