Emerging Market Focus

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India: monsoons, oil prices and our forecasts

- **We expect RBI to raise its repurchase rate from 5.25% to 5.75% by Q127, with the first hike occurring in Q426. These rate hikes would move the policy rate to the upper end of neutral, giving the MPC the flexibility to move monetary policy into restrictive territory if needed. Previously, we had forecast RBI to stay on hold in 2026 and 2027.**
- **The three key factors generating this forecast change are:**
    1. **Oil prices now above USD100/bl vs RBI's forecast of USD80-85/bl.**
    2. **USD/INR trading well above RBI's assumed average of 85 for FY27.**
    3. **The monsoons coming in below the lower end of IMD's forecast, placing additional upward pressure on food prices.**
- **Despite the neutral stance in August, MPC minutes showed a clear data-dependent approach with bias towards raising rates. Deputy Governor Poonam Gupta pointed to a rate hike as a possibility in late 2026, with members increasingly concerned about supply-side inflation and potential second-round effects.**
- **Real GDP growth exceeds RBI's forecasts in H226, increasing the likelihood of second-round inflation effects. Firm service exports and government infrastructure projects are supporting the economy, suggesting that the economy can bear higher rates.**
- **The 50bp rate increase combined with ongoing capital inflows from RBI's ECB and OFCB programmes, plus record-level reserves to help the central bank lean against INR weakness, are expected to offset the drag on the INR from higher oil prices and weaker monsoons. We retain our H226 forecast for USD/INR at 96.00.**

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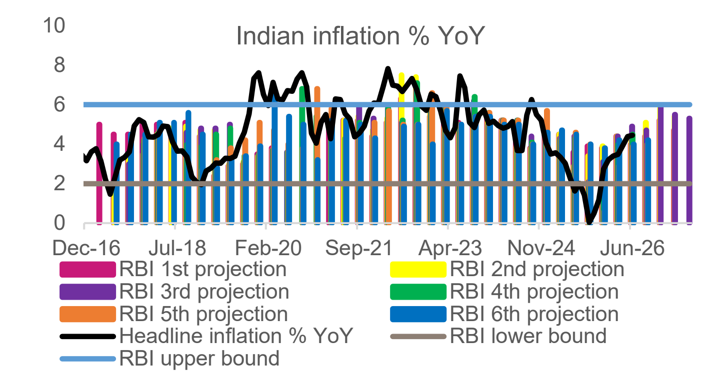
Inflation to exceed RBI forecasts

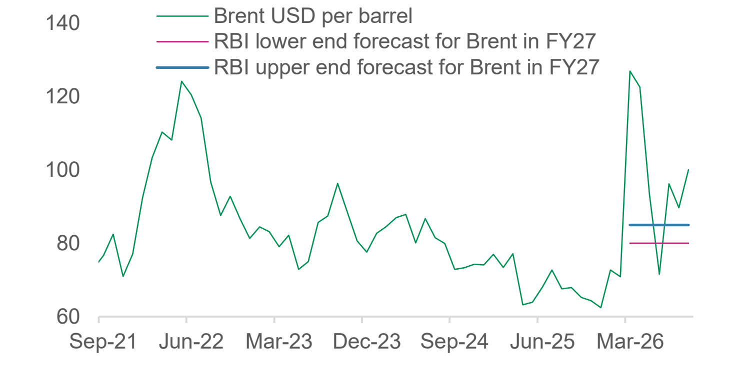
While leaving the Repurchase rate at 5.25% and sounding relatively dovish in August, RBI lowered its inflation forecast for FY27 by 10bp to 5%. The central bank saw that headline inflation would touch the top of its 2-6% tolerance band before coming back lower (Figure 1). Core inflation excluding food and energy as well as precious metals remained tame and in the bottom half of RBI's tolerance band.

Fig 1. RBI forecast inflation to touch the top of its tolerance band before coming back off



Source: CEIC, Crédit Agricole CIB

Fig 2. Oil prices are exceeding RBI's forecasts

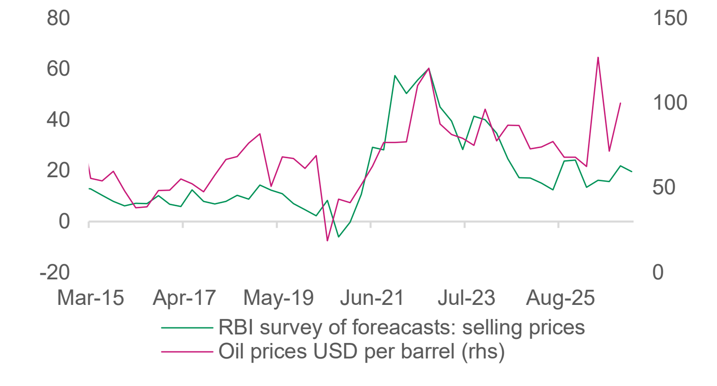


Source: Bloomberg, RBI, Crédit Agricole CIB

RBI made several assumptions in its August outlook, and they look like they are underestimates in terms of their impact on inflation. Inflation is therefore likely to top the central bank's forecast and push the central bank towards hiking rates. These assumptions included:

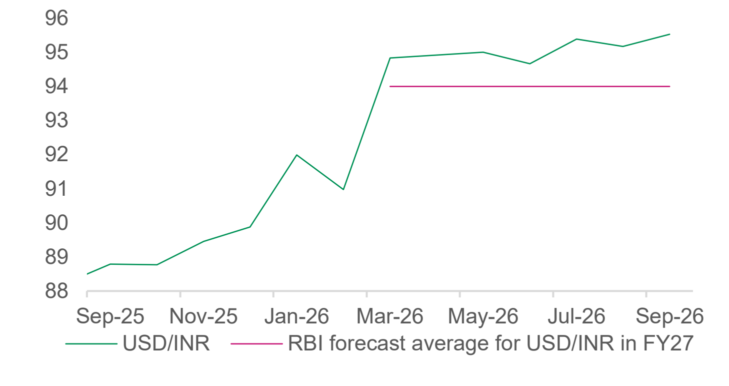
1. **Oil prices:** RBI assumed that the oil price would average USD80-85/bl for FY27. With oil prices back above USD100/bl, this assumption looks like it is easily being breached (Figure 2). RBI could rely on an end to the war soon to bring oil prices back down, but this is unlikely. And even if the US-Iran war were to end in the coming month(s), businesses are likely to revise up their price setting expectations in RBI's survey of business expectations being conducted ahead of its October monetary policy meeting (Figure 3). So, there is already an acceleration in inflation due to higher oil prices baked in.

Fig 3. Indian businesses are likely to revise up their selling price forecasts due to higher energy prices



Source: CEIC, Crédit Agricole CIB

Fig 4. USD/INR is exceeding RBI's forecasts

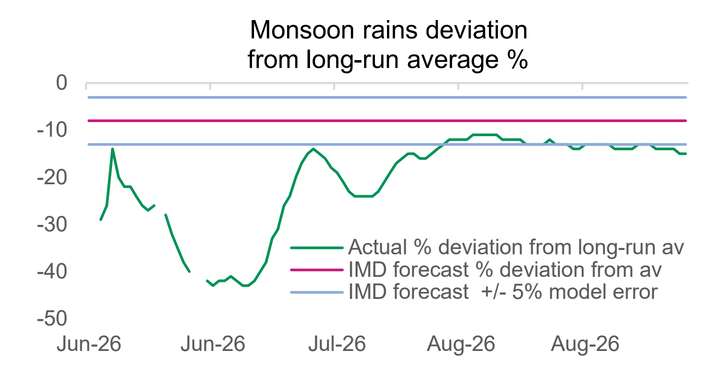


Source: CEIC, RBI, Crédit Agricole CIB

2. **USD/INR:** RBI assumed that USD/INR would average 85 during FY27, but the exchange rate looks like it well exceeds that average (Figure 4). While the central bank's FCNR deposit, OFCB and ECB schemes have succeeded in generating about USD137bn in capital inflows so far, we noted in [India: current account deficit hole plugged?] that these inflows were only enough to help offset the larger trade deficits being generated by the US-Iran war and not enough to trigger a long-lasting decline in USD/INR. Indeed, depending on how much of these inflows RBI uses to unwind its substantial outstanding forward book, the long-term fair value for USD/INR ranges between 92.50-101.50 with a central estimate of 97.00.

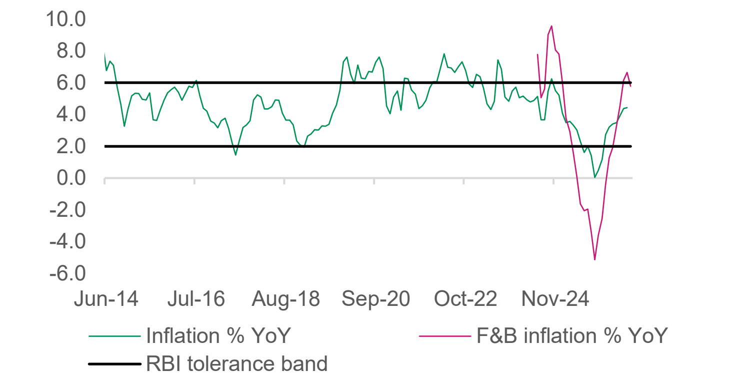
3. **Monsoons:** RBI has already factored a weak monsoon into its August forecasts. Indeed, the IMD was forecasting monsoon rains at 92% of their the long-run average with an error band of +/-5%. RBI also noted that a recovery in rains in July helped kharif sowing recover towards normal levels. The central bank also cited more efficient irrigation practises, crop diversification and significant food stockpiles as lessening the impact of below average monsoons on inflation. But the monsoons are coming out a little below even the lower end of IMD's forecast, likely placing more upward pressure on food prices and general inflation that RBI expected back in August (Figures 5 and 6).

Fig 5. Monsoon rains are below the low end of IMD's forecast range



Source: CEIC, IMD, Crédit Agricole CIB

Fig 6. Food price inflation exerting significant upward pressure on India's headline inflation

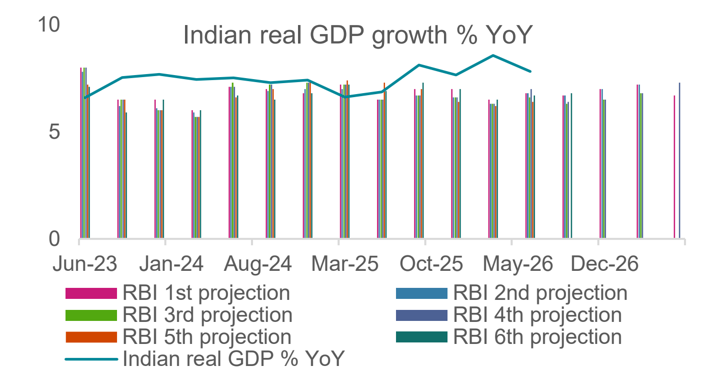


Source: Bloomberg, RBI, Crédit Agricole CIB

Minutes suggest little tolerance for upside surprises

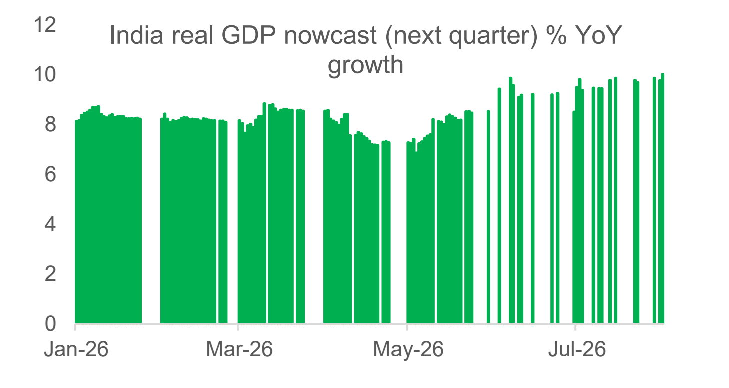
The Minutes to RBI's August meeting belied the neutral bias unanimously voted for in the meeting. They showed a clear data-dependent approach to forming policy in the coming quarters with a bias towards raising rates. Indeed, members of the MPC agreed that waiting on more clarity on the outcome of the monsoons as well as the conflict in the Middle East and oil prices meant that it was appropriate to hold policy steady for now. So the fact that the monsoons are weaker than expected and oil prices higher than forecast places pressure on the MPC to raise rates. Indeed, Deputy Governor Poonam Gupta pointed to a rate hike as a possibility in late 2026 and MPC members were becoming more concerned about supply-side inflation and its potential to lead to second-round effects. As real GDP growth looks like exceeding RBI's forecasts in H226, there is a higher likelihood of these second-round effects occurring (Figures 7 and 8).

Fig 7. India's real GDP growth exceeding RBI forecasts…



Source: CEIC, Bloomberg, Crédit Agricole CIB

Fig 8. …and likely to continue doing so



Source: CEIC, Crédit Agricole CIB

How much of an adjustment?

Firm growth also suggests that the economy can bear higher rates. Some MPC members expressed concerned about the loosening in financial conditions caused by the drop in the real Repurchase Rate. We do not think money markets being flush with liquidity due to the capital inflows from RBI's FNCR, ECB and OFCB programmes is an impetus to raise rates. Rather, RBI seems content to manage this liquidity via its money market operations.

RBI faces a delicate balancing act, however. Supply-side inflation will constrain domestic demand due to reduced purchasing power of consumers but also falling rural incomes on the back of the weaker monsoons. But the economy is being well supported by firm service exports as well as government infrastructure projects. The central bank must also assess the risk of US tariffs. So we expect RBI to raise its Repurchase rate from 5.25% to 5.75% and the upper end of its neutral range by Q127 with a first hike occurring in Q426. Previously, we expected RBI to remain on hold throughout 2026 and 2027. Moving the policy rate to the upper end of neutral will give the MPC the flexibility to move monetary policy into restrictive territory if oil prices persist above USD100/bl, the INR continues to slide and there is risk of another weak monsoon in 2027.

This 50bp increment in the Repurchase rate relative to our previous forecasts we think offsets the drag on the INR from higher-than-expected oil prices and weaker-than-expected monsoons. We also note that while less popular than the FNCR deposit programme, the OFCB and ECB schemes will continue running until year-end, bringing in some further capital inflows. RBI also now has a record level of reserves which it can use to lean against the rise in USD/INR. So, we maintain a H226 forecast for USD/INR of 96.00.

Conclusions

We expect RBI to raise its Repurchase rate from 5.25% to 5.75% by Q127, with the first hike occurring in Q426. These rate hikes would move the policy rate to the upper end of neutral, giving the MPC the flexibility to move monetary policy into restrictive territory if needed. Previously, we had forecast RBI to stay on hold in 2026 and 2027.

The three key factors generating this forecast change are:

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2. USD/INR trading well above RBI's assumed average of 85 for FY27.
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Despite the neutral stance in August, MPC minutes showed a clear data-dependent approach with a bias towards raising rates. Deputy Governor Poonam Gupta pointed to a rate hike as a possibility in late 2026, with members increasingly concerned about supply-side inflation and potential second-round effects.

Real GDP growth exceeds RBI's forecasts in H226, increasing the likelihood of second-round inflation effects. Firm service exports and government infrastructure projects are supporting the economy, suggesting that the economy can bear higher rates.

The 50bp rate increase combined with ongoing capital inflows from RBI's ECB and OFCB programmes, plus record-level reserves to help the central bank lean against INR weakness, are expected to offset the drag on the INR from higher oil prices and weaker monsoons. We retain our H226 forecast for USD/INR at 96.00.

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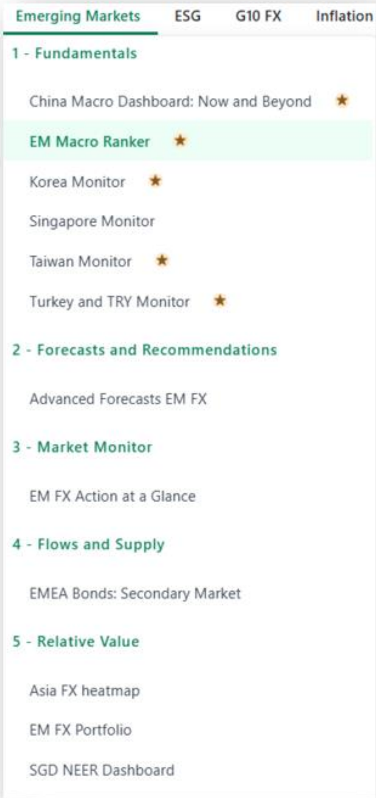

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