1 Aug 2026

Bank of Baroda

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RBI in wait and watch mode

Globally, tensions between US and Iran have resurfaced which have once again engulfed countries in the Middle East and threat has also expanded from the Strait of Hormuz to the Red Sea. This has led to 11% increase in oil prices since the last US-Iran peace deal (17 Jun) and 21% increase in Jul'26 alone (MoM basis). Even though news reports are indicative of back-channelling of peace talks between US and Iran, fresh military strikes by both signals otherwise. On the domestic front, high frequency indicators are pointing towards slight moderation in service sector activity, while corporate performance remains steady despite surge in price pressures. Given that RBI estimates for Q1 growth had already factored in the impact of US-Iran war on Indian economy, we expect growth to come in line with these estimates (6.6-6.8%) and gives no reason for the central bank to alter its forecasts at this stage. In case of inflation, upside risks remain with elevated global oil prices, weak monsoon at home and lower water reservoir levels. IMD also expects El Nino to move to 'very strong' category in Oct-Dec'26 period. We expect MPC members will remain watchful of the progress of the monsoon and its impact on food inflation. Given this backdrop we expect RBI to remain on hold for now and also keep the stance unchanged. However, this is also the right opportunity for the central bank to signal the markets that RBI may hike rates in future, by taking a cautious tone. We expect at least one rate hike in H2FY27 depending on the inflation trajectory.

What has changed since the last policy?: In Jun'26 it appeared that the war between US and Iran had come to an and there was even a draft peace deal agreed upon between the two on 17 Jun 2026. Both countries signed a 14-point MoU and announced a 60-day ceasefire for the final talks to materialise. However, early in July 2026, before the ceasefire deadline ended, US and Iran were again engaged in hostile military strikes. This pushed oil prices higher once again, leading to revival of upside risks to global inflation. Domestically, there is slightly more clarity on the progress of the monsoon. Overall, the country has still received 13% less rain than LPA (cumulatively between June and till 31st July).

Table 1. Performance of major market and macro variables

Variables	Start of the war (27 Feb 2026)	Last policy (5 Jun 2026)	Current* (31 Jul 2026)
Brent (US$/bbl)	72.48	93.09	88.0
DXY index	97.6	100.1	100.2
US 10Y yield, %	3.37	4.53	4.65
India 10Y yield, %	6.66	6.97	6.81
INR/USD	90.98	94.94	95.34
CPI	3.21	3.48	4.38
WPI	2.18	8.36	9.87

Source: Bloomberg, CEIC, Bank of Baroda Research| Note: * Current CPI and WPI data as of Jun'26 and data as per new base year

Expectations from MPC: We expect the RBI to keep the repo rate steady at 5.25% in its Jun'26 policy. The stance is also expected to be maintained at neutral as the central bank is likely to remain vigilant about the evolving situation. However, the central bank could also take a cautious approach in the articulation to prepare the markets for future rate hikes. We expect 1at least one rate hike in H2FY27.

Rationale for this decision:

1. **Global developments:** With the ongoing crisis in the West Asia region, throughout last month global markets have registered significant volatility, and its impact has also been felt by Indian markets. After the announcement of temporary peace deal between US and Iran (17 Jun), markets rebounded. However, since the war has started again, uncertainty has clouded the economic outlook once more. Between 17 Jun (when peace deal was signed) and now:
    - Oil prices have risen by ~11% to US$ 88/bbl as of 31 Jul 2026.
    - US 10Y treasury yield has risen by 16bps.
    - India's 10Y G-Sec yield has fallen by ~8bps and currently hovering around 6.81%.
    - Equity markets have registered tepid growth with Sensex and Nifty up by 1.1%, Dow Jones by 1.4%, and S&P 500 by 0.2%
    - INR has depreciated by 0.8% in this period and currently trading at ~ 95.34/$.
    - The impact on currency and equity markets can be explained by foreign fund outflows, which exacerbate during times of stress.
    - NSDL data shows between June- July, net FPI outflows in equity segment stood at US$ 3.03bn and debt segment has registered net inflows to the tune of US$ 7.80bn (debt inflows slowed in Jul'26). Overall total FPI inflows in last two months was at US$ 4.73bn.
    - As per the current situation, hostilities between US and Iran are ongoing, despite news reports indicating possibilities of peace of talks between the two. While the Strait of Hormuz remains open for commercial cargo ships, there remains significant risk of military strikes. To further add to the supply-chain problem, shipping through Red Sea has also come under threat. This is expected to keep insurance costs of shipping elevated, which will ultimately lead to higher commodity prices, even if oil prices come down.
    - IMF in July 2026 update of the WEO, has lowered global GDP growth projection for CY26 to 3% (3.1% in Apr'26) with estimates for UK, Euro Area, Canada, and India all revised downward.
    - Global CPI is expected to come in higher at 4.7%, up from 4.4% projected in Apr'26.

2. **Domestic growth scenario:** After registering growth of 7.7% in FY26 and 7.8% in Q4FY26, real GDP growth in Q1FY27 and FY27 overall, is expected to slow down, given external geopolitical tensions. RBI has estimated growth in FY27, and Q1, at 6.6%. We believe RBI will keep growth estimates unchanged for now. Growth in Q1 may come in line with expectations as it factors in the moderation in activity due to US-Iran war related conditions. High frequency data for quarter ending Jun'26 indicates that airline passenger traffic (including domestic travel), rail freight traffic, diesel consumption, GST e-way bill generation growth, all slowed compared with Jun'25. On the other hand, port cargo traffic, telecom subscribers, vehicle registrations and GST collections have maintained upward momentum in Q1FY27. Corporate earnings are also showing a broad-based growth, despite surge in costs. We expect Q1FY27 GDP growth between 6.8-7%.

3. **Domestic inflation:** CPI inched up in Jun'26, crossing the 4% mark, bearing the impact of higher food and fuel inflation. Other than these major components of core inflation remained sticky. The upward momentum of restaurant and accommodation services was a pass through of earlier price hike of commercial cylinder. Consumer food price index rose by 5.3% in Jun'26,

around 50bps higher compared to May’26. As per IMD, El Nino conditions were weak in Jun’26 but intensified to moderate category by Jul’26. The phenomenon is further expected to intensify to very strong category during Oct-Dec 2026 period. As a result, upside pressure on inflation will remain in the near-term, even if international oil prices moderate. In the upcoming policy, we do not expect any change in RBI’s inflation forecasts. The central bank will await more clarity on progress of the monsoon. As of 31 Jul, rainfall is 13% below LPA and 41% of sub-divisional % area of the country remains in the deficient category. Water reservoir data indicates that storage (% of live capacity at FRL) was at 44.4% as of 30 Jul 2026 compared with 67.9% last year during the same period. Storage levels have an impact on Rabi sowing.

4. **Banking sector growth:** Bank credit has seen pickup in momentum as it has risen by 17.7% in FYTD27 so far (15 Jul’26) versus 9.9% growth last year during the same period (till 11 Jul’26). Even deposit growth has improved, registering 12.7% this year versus 10.1% last year. Part of the reason for improvement in deposits can be explained by FCNR (B) deposits. RBI data shows that India has received US$ 40.1 bn as foreign capital inflows till 31 Jul 2026, largely on account of as FCNR (B) deposits (US$ 36.7bn). RBI Governor in his latest interview informed that elevated credit growth is not a concern and will not cause overheating as it helps generate deposits. He further added that the primary constraints for lending are “capital adequacy, liquidity coverage and stable funding ratios”, and Indian banks are doing well on all these parameters.

5. **System liquidity:** On an average, liquidity has remained in surplus since the last policy (5 Jun-30 Jul) at Rs 87,000 crore. In Jun’26 average liquidity was lower at Rs 69,000 crore and even witnessed a deficit of Rs 28,000 crore between 22-29 Jun. However, supported by RBI’s VRR auctions, liquidity surplus increased to Rs 1 lakh crore by Jul’26. RBI injected liquidity to the tune of Rs 5.98 lakh crore in Jun’26 and Rs 4.13 lakh crore in Jul’26, using overnight, 1-day and 3-day VRRs. Foreign fund inflows are eventually going to have an impact on system liquidity, which should note significant rise in surplus in Aug-Sep’26. We do not expect any specific announcement on VRR calendar.

6. **Transmission of rates:** In measuring how transmission of interest rates as of Jun’26 across different spectrum have fared, the change is taken from Jan’25 just before RBI embarked on the journey of rate cuts.

   In case of PSBs, the transmission on fresh term deposits has seen a decrease of 66bps, while on the lending side, WALR has fallen by 56bps. For PVBs the decrease on fresh deposits is lower at 49bps, while that on loans is higher at 108bps.

Table 2. Fresh term deposit and lending rates

Transmission of rates	Jan’25	Mar’26	Apr’26	May’26	Jun’26
WADTDR: PSBs	7.06	6.45	6.18	6.33	6.40
WADTDR: PVBs	6.70	6.26	6.01	5.94	6.21
WALR: PSBs	8.59	7.84	7.87	7.93	8.03
WALR: PVBs	10.20	9.12	9.19	9.12	9.12

Source: RBI, Bank of Baroda Research

7. **Sovereign yields range-bound:** Since the last policy, yields on 10Y G-sec has fallen by ~19bps to 6.80%, compared with 6.99% before the Jun'26 policy. This has been primarily supported by sharp uptick in foreign fund inflows in the debt segment. In early Jun'26 RBI and Government of India announced measures to attract foreign capital in India's G-sec. Following this, significant inflows were recorded in Jun'26 (US$ 5.85bn). However, in Jul'26, following revival in geopolitical tensions and rise in oil prices, inflows have slowed to US$ 1.95bn and bond yield has also risen by 5bps (between end-Jun and end-Jul). Similar trend has been observed in short-term rates, with 364-day T-bill rate rising by 22bps, 182-day up by 29bps and 91-day up by 8bps. Furthermore, delay in inclusion of India to Bloomberg's global bond index will also have an impact on yields in the short-term. Continued volatility in oil prices, lack of clarity on peace deal between US and Iran, increased possibility of Fed hiking rates in Sep'26 and weak monsoon at home, all pose upside risks to India's 10Y bond yield.

8. **Currency:** Since 5 Jun 2026, INR has depreciated by 0.8% till 31 Jul 2026. INR's performance can be analysed in 2 parts. Between 5 Jun and end-Jun'26, rupee appreciated by 0.3% against the US$. This was largely due to significant foreign fund inflows received at time, on account of FPIs in debt segments and FCNR (B) deposits. Benefiting from this, news reports indicate that RBI also tapered its net forward book (short) to US$ (-) 103.3bn from (-) 106.7bn in May'26. In Jul'26, the story changed. With re-intensification of tensions between US and Iran and jump in oil prices (~21% MoM in Jul'26), INR depreciated by 0.7% (MoM). This was despite FCNR (B) deposits picking pace and DXY index falling by 1% (MoM). News reports indicate that RBI further pared its forward book in Jul'26. In the near-term, RBI is expected to defend the rupee, given robust foreign fund inflows. We thus expect rupee to trade in the range of 95.25-95.75/S$ in the near term.

To sum up: We expect RBI to hold policy repo rate unchanged at 5.25% and keep the stance as neutral. However, we believe that could be the right opportunity for the central bank to prepare markets for a future hike. Growth and inflation forecasts will also be left unchanged by RBI. High frequency indicators along with corporate results are pointing towards India's GDP growth in Q1 to range between 6.8-7%. Actual numbers will be available before the Oct'26 policy, which is when we expect revision in numbers. Members will also remain watchful regarding inflation, given volatility in international oil prices and weak monsoon. A clear picture on sowing will also be available by Sep'26. We estimate upside risks to inflation to prevail, even if the international oil prices come down, in the form of higher insurance cost for shipping through the Strait of Hormuz and Red Sea, and domestic food prices. Therefore, we are pricing in at least one rate hike in H2FY27.

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