IN PERSPECTIVE

Repo cut or calibrated pause?

The MPC will meet next week amid rate cut speculations. Holding it at 5.5% will be a prudent response

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The data on the monthly Consumer Price Index-based, year-on-year headline inflation for August was released on September 12. Inflation in August rose to 2.07% from 1.61% in July, the first increase in nine months since November 2024, when it was 5.48%. It is below the Reserve Bank of India's (RBI) target inflation rate (4%) under the flexible inflation targeting framework. This comes with a permissible fluctuation range – a comfort zone between +2% and -2% – to take into account the uncertainties associated with natural disasters faced by the monsoon-dependent India, which is predominantly an agricultural economy.

The risks arise from drought, excessive rainfall, and floods, as well as high volatility in fluctuations in energy prices – India imports nearly 86% of its crude requirements. The monthly core inflation, which excludes domestic food and fuel prices from its scope, was also seen as rising from 4.2% in July to 4.3% in August – this is in step with the rise in retail inflation. Past increases in prices of food and energy goods have already seeped in since then, as increased costs of transportation, processed manufactured consumer goods, and wages push the monthly retail inflation.

Trends in past economic growth and inflation, monitored by international funding agencies including the IMF, and macroeconomic indicators of the two quarters of FY26, assure policymakers that the Indian economy is on the right path. The growth and inflation forecasts for FY26 are 6.2% and 4.2%, respectively. That leads us to infer that the growth-inflation differential is two percentage points. This indicates the economy is on fairly stable ground.

The above calculations do not take into account the likely impact the latest reforms announced in the general services and sales tax (GST) have on inflation and growth. With the GST rate on about 295 essential items being reduced from 12% to 5%, the inflation is likely to come down further. With a fall in the selling prices of consumer goods, domestic consumption, which is a major component (65%) of the Gross Domestic Product, is expected to see a boost during the festival seasons: Dasara in September, Deepavali in October, and Christmas in December.

Foreign exchange reserves

Although the rupee hit the lowest level at 88.47 on September 11, foreign reserves rose by the weekend of September 13 to a near record high and crossed $700 billion for the third time. The jump took them close to the high of $705 billion, which was recorded almost a year ago. India's hopes also rose on September 18, with a cut in the United States Federal Reserve's interest rate by 25 basis points, a move aimed at combatting recession.

The India-US interest rate differential has risen to 1.25% (5.5% - 4.25%), giving rise to new expectations about an increase in the inflows of capital from the US institutional investors. On the other hand, a shift in policy by the Donald Trump administration is predicted to leave a deep impact: a sharp hike in the H-1B visa fee for migrant IT workers in the US, which now stands at $100,000. This disruption has potentially wide-ranging implications in India's IT services sector and its economy.

The rupee crashed the steepest, to Rs 88.8/US$ on Tuesday, September 23. On the day, the Indian rupee was the weakest amongst major currencies in Asia. Since then, the RBI has been intervening in the markets to stabilise the rupee and is in the process of running down the reserves.

The foreign reserves data on September 26 is expected to provide fresh indications of the market conditions. The RBI, in its just-released State of the Economy report, notes that a robust pass-through of a 100 basis points cut in repo accomplished since February this year, along with the income tax simplification and GST reforms, has "revived growth impulses".

The RBI's Monetary Policy Committee (MPC) will meet from September 29 to October 1. Though the August report shows that the country's economy is on the right path, a new set of uncertainties will shape these pathways. The unfinished trade talks tell us that it is better to postpone the consideration of a rate cut to the MPC meeting in December. Considering the multiple factors in play, a status quo, with a shift in stance to accommodative from the current neutral, appears to be the right step forward. A response on these lines will be in the best traditions of the RBI's conservative, careful, and calibrated approach, which it has assiduously built through the decades.

(The writer was a senior economist with the Asian Development Bank, Manila)