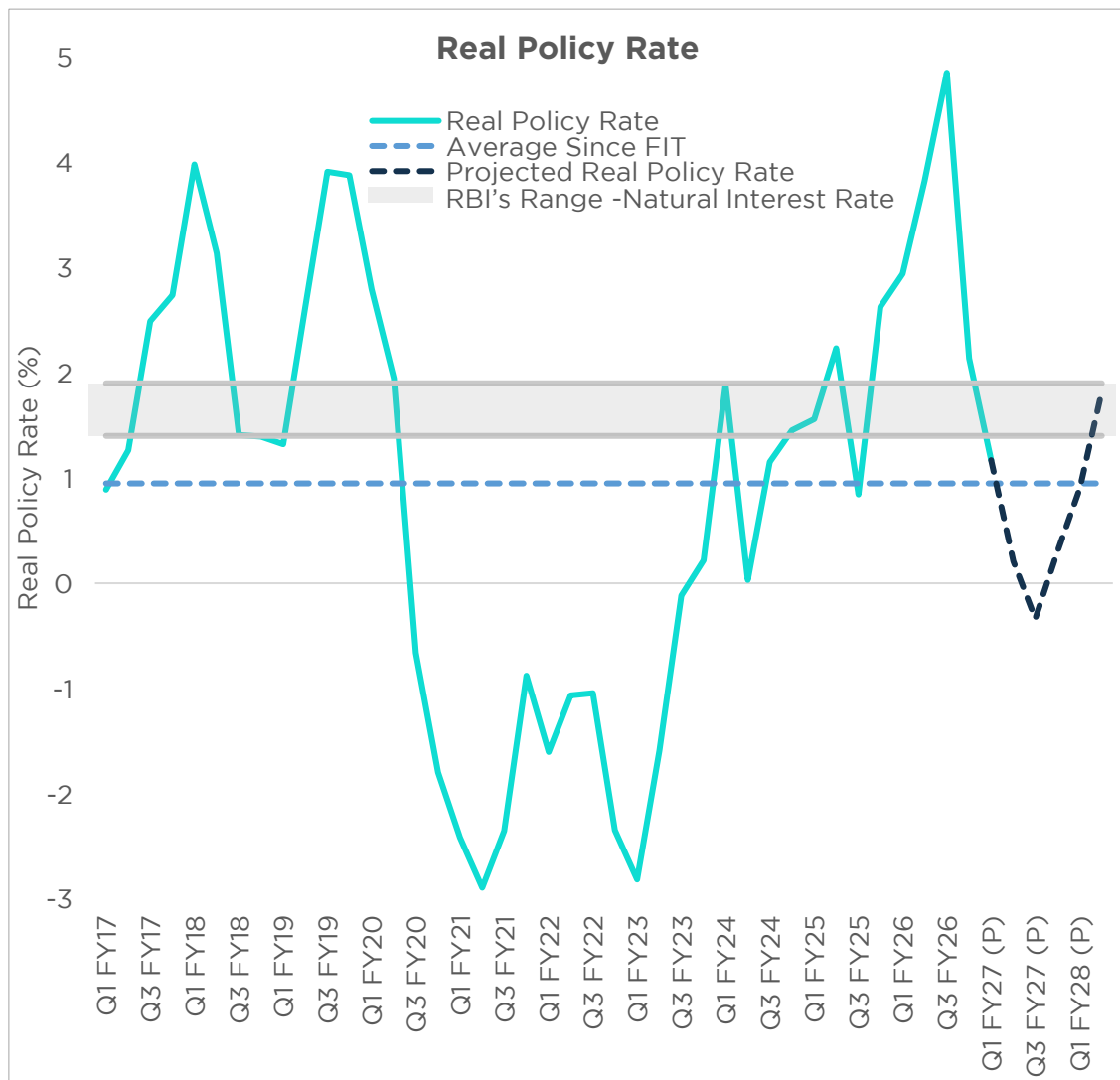


Backdrop: MPC Policy Meeting Comes Amidst Volatile Environment

- Conflict in West Asia entered its third month without any meaningful resolution, extending beyond initial expectations.
- Global crude oil prices have risen by 30% since the beginning of crisis.
- Inflationary concerns have intensified as retail fuel price increases by cumulative of about Rs 7.5/lit in last one month
- Sharp rise in WPI inflation in April to 8.3% also raises the risk of a faster second-round pass-through to consumer prices.
- Domestic growth outlook has weakened considerably as the economic impact of the prolonged conflict transmits through multiple channels.
- Both global and domestic bond yields rose sharply amid a persistently inflationary environment and increasing fiscal concerns.
- USD/INR has weakened by 4.9% since the onset of the conflict, due to subdued investment inflows and a widening of current account deficit.
- **Against this backdrop, we expect the RBI's Monetary Policy Committee (MPC) to remain in a wait-and-watch mode, maintaining a status quo on both policy rates and stance while closely monitoring evolving geopolitical developments.**
- **Tone of the policy statement will be crucial, as the possibility of policy rate hikes towards the end of the year cannot be ruled out if the inflationary pressure prolongs.**
- **Measures aimed at supporting the rupee — including measures to attract capital flows and special dollar liquidity facilities for oil marketing companies (OMCs) — may also be considered.**

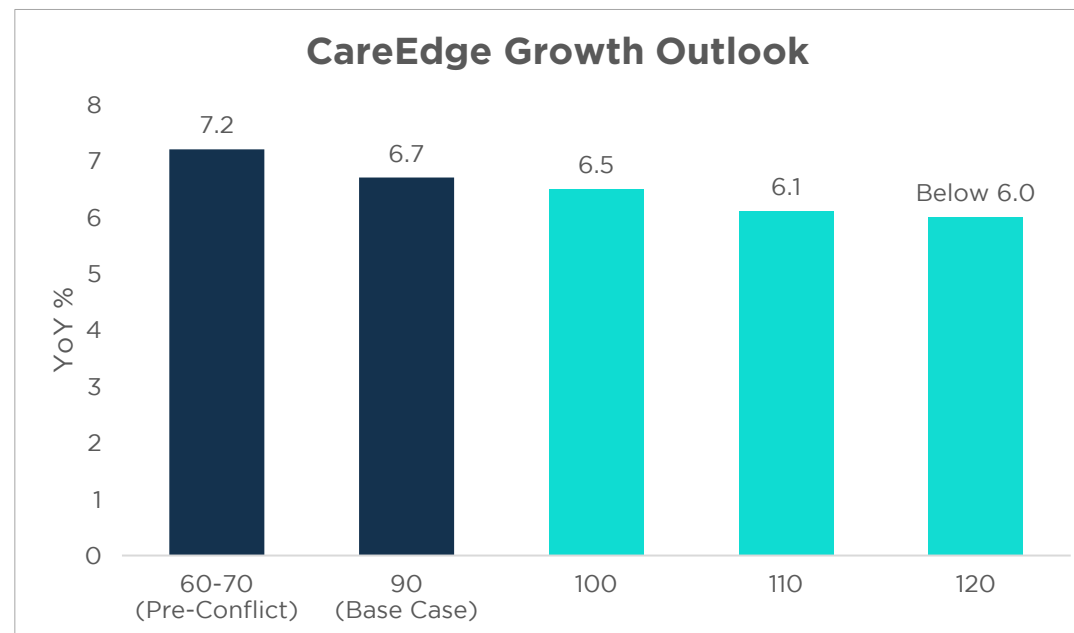
The MPC Awaits Signal: Transient or Persistent Price Pressures?



Source: CareEdge. FIT denotes the Flexible Inflation Targeting regime adopted in FY17. Shaded area indicates RBI's estimated natural rate of interest (1.4-1.9%) in the post-pandemic period.

- We expect the MPC to adopt a wait-and-watch approach amid external volatility, assessing whether current price pressures are transient or persistent based on external developments. The current uptick in inflation is a supply shock and not demand driven.
- If external conditions stabilize fast, the recent uptick in inflation can be seen as transient.
- In this scenario, the real policy rate is expected to remain below its long-term average (0.95%) for three quarters (Q2 FY27-Q4 FY27), before converging to this average by Q1 FY28, and move into the RBI's estimated natural rate band (1.4-1.9%) by Q2 FY28.
- Future trajectory of the policy rate will depend on the MPC's assessment of evolving inflation dynamics, which are significantly influenced by external factors.
- If the MPC considers inflationary pressures to be transient it may look through the near-term spike. However, if conflict persists and inflation risks become entrenched in household expectations, rate hikes could be considered toward the end of the year.
- MPC will also remain attentive to growth risks. We project FY27 GDP growth at 6.7% assuming crude oil averaging USD 90/bbl. However, prolonged conflict and oil prices around USD 110/bbl could lower growth closer to 6%.
- Growth in FY27 is likely to remain below potential growth rate of 7% as estimated by Economic Survey.
- This further reinforces our expectation that the RBI should be comfortable with a few quarters of low real policy rate, unless there is clear evidence of sustained pass-through into household inflation expectations.
- Some central banks, such as Bank Indonesia, have implemented larger-than-expected rate hikes, it is important to note that BI's primary mandate focuses on Rupiah stability, unlike the RBI.
- The RBI has additional tools and a comfortable foreign exchange reserves to manage exchange rate volatility beyond policy rate adjustments.

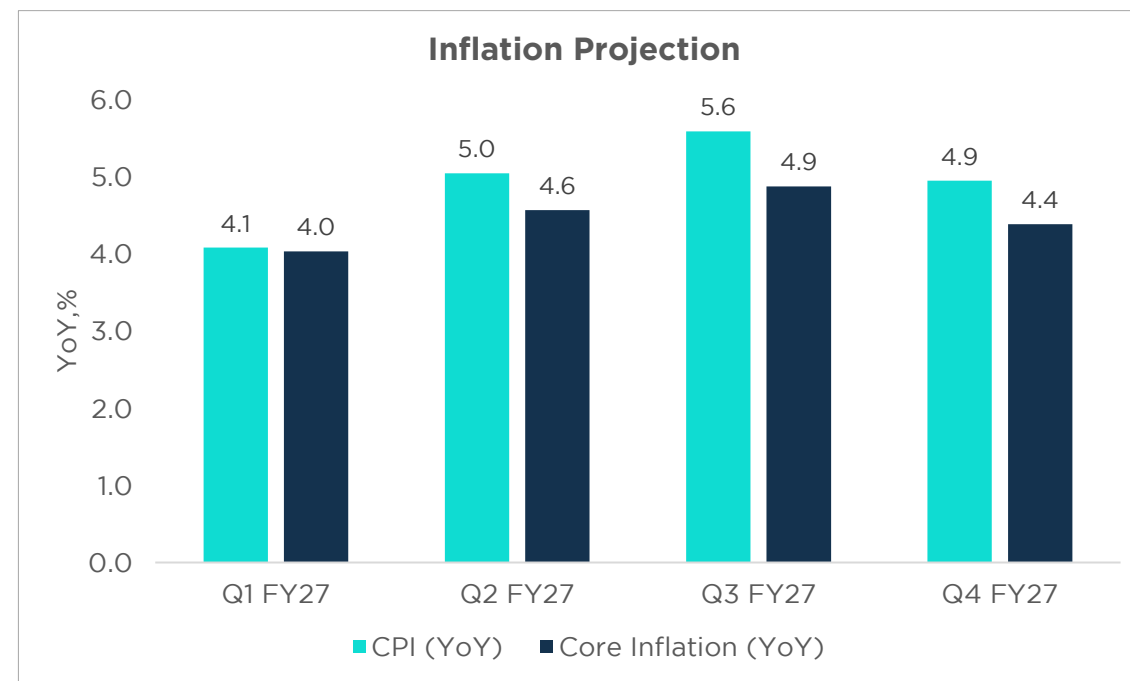
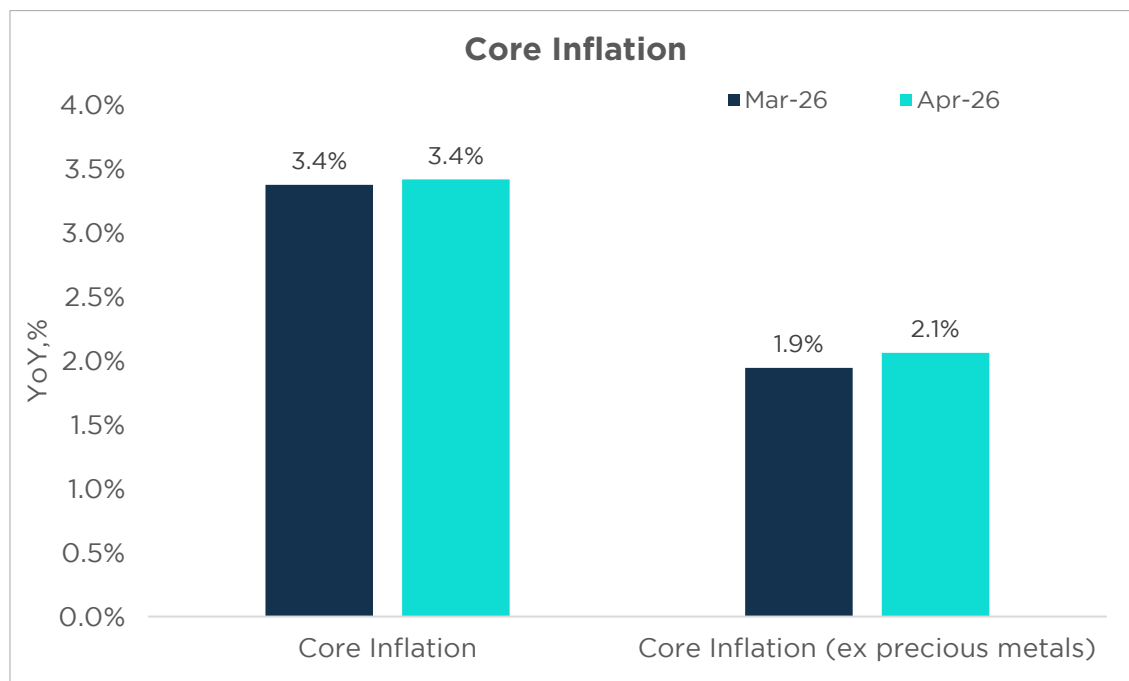
Growth Projections to be Revised Downward



Sources: CareEdge Projections.

- We expect Q4 FY26 GDP growth to moderate to around 6.8-7.0%, compared with 7.8% in Q3FY26. Q4FY26 remained partially insulated from the adverse effects of the crisis, as the first two months of the quarter were relatively unaffected.
- In addition, companies likely relied on existing inventories to cushion the impact of rising input costs. Moreover, the government and OMCs absorbed a major portion of the increase in energy prices before the pass-through to consumers began in Q1FY27.
- However, growth momentum is likely to weaken further in Q1 FY27 as impact of the West Asia crisis gradually transmits through the economy.
- Furthermore, potential impact of El Nino conditions poses downside risks, particularly for the agricultural sector, which is already facing pressures from elevated fertiliser and input costs.
- Growth projected at 6.7% in FY27 assuming crude averages \$90/bbl. However, it can inch closer to 6% if conflict lingers longer with average crude oil price at \$110/bbl.
- We expect the MPC to lower growth projections from its earlier projection of 6.9% .

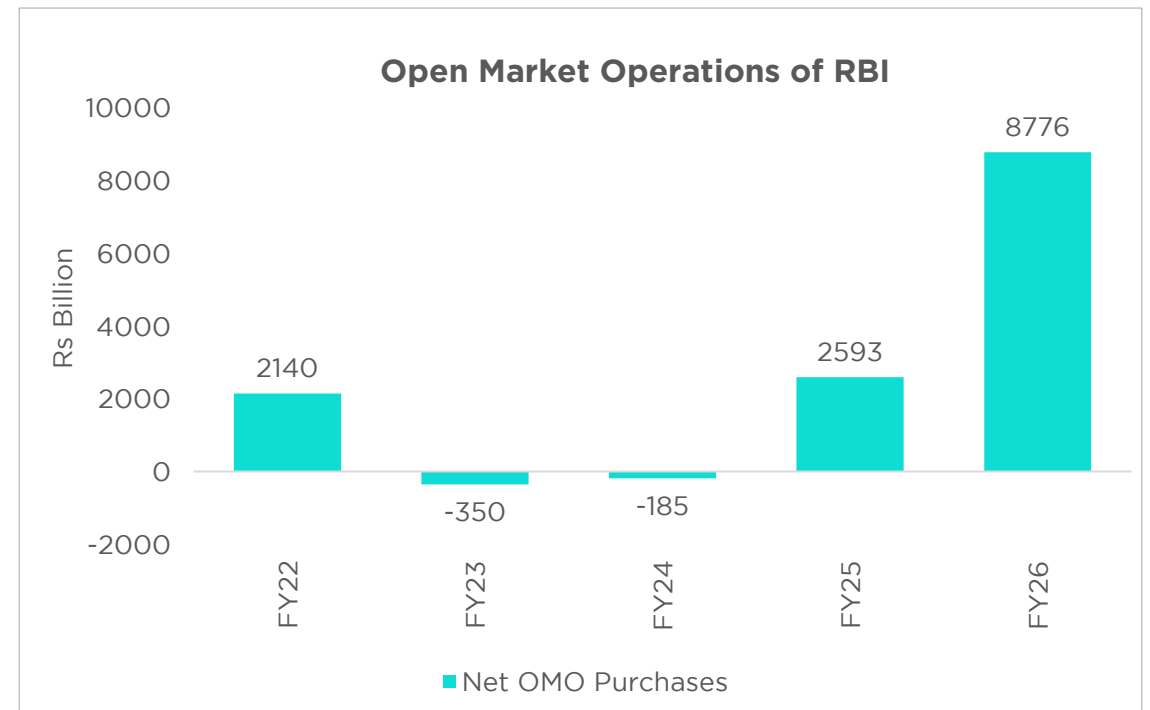
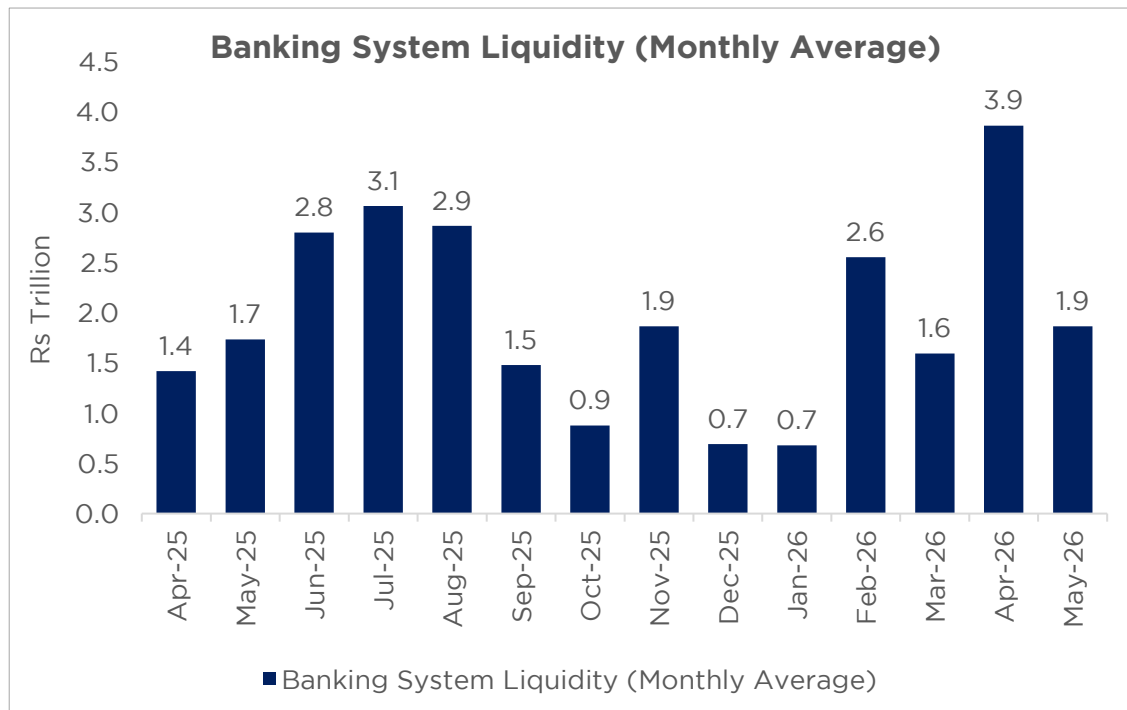
Inflation Projections to Be Revised Up



Sources: CEIC, CareEdge.

- The cumulative increase in retail fuel prices following the conflict in West Asia is estimated to have a direct impact of around 35 bps on headline CPI inflation. Indirect inflationary pressures may add another 10-15 basis points to overall CPI inflation.
- High WPI inflation in April to 8.3% increases the risk of faster pass-through to consumers. Considering the higher pass-through of costs to consumers and impact of El-Nino, we expect CPI inflation in FY27 to average in the range of 4.6-5.0% (assuming Brent oil prices average \$90/bbl). RBI is likely to revise its inflation projection upward inline with our projection.
- The MPC is likely to derive some comfort from the recent correction in Crude prices following expectations of positive developments in West Asia.
- Additionally, core inflation (excluding precious metals) has remained benign so far, at 2.1% in April, which should also provide reassurance to the MPC. However, core inflation is expected to average around 4.5% in FY27.
- Despite the recent increase in retail fuel prices by Rs 7.5/lit, there remains further scope for upward revisions, depending on the trajectory of global crude oil prices.

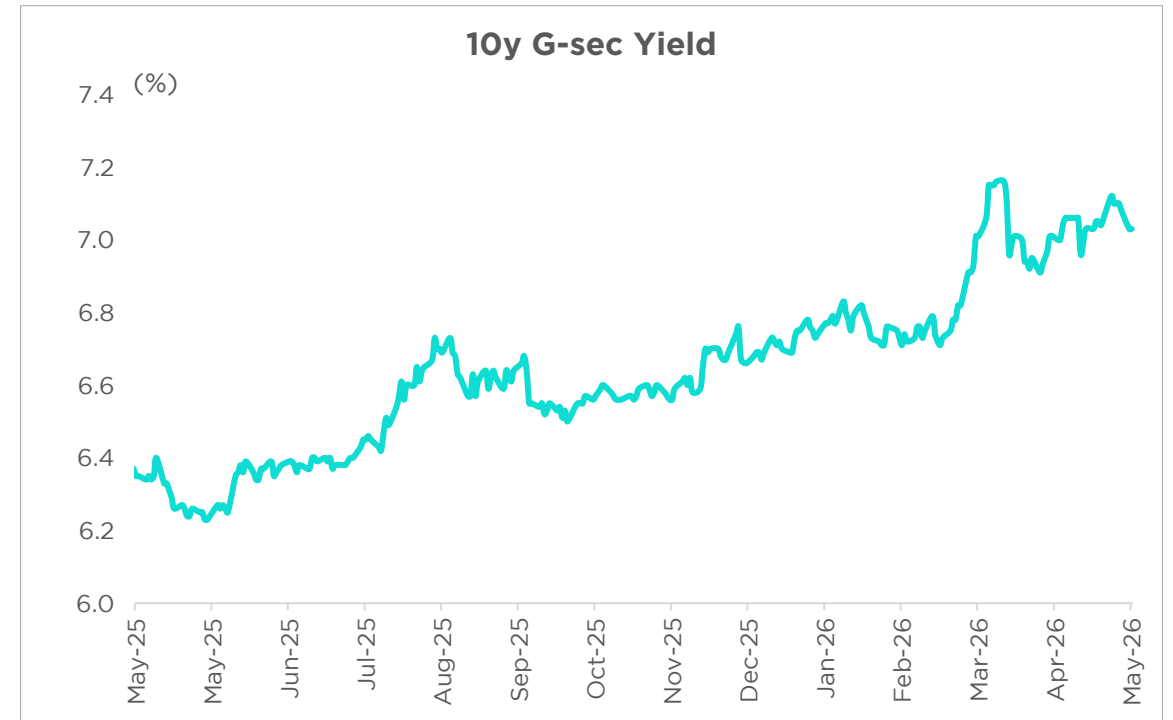
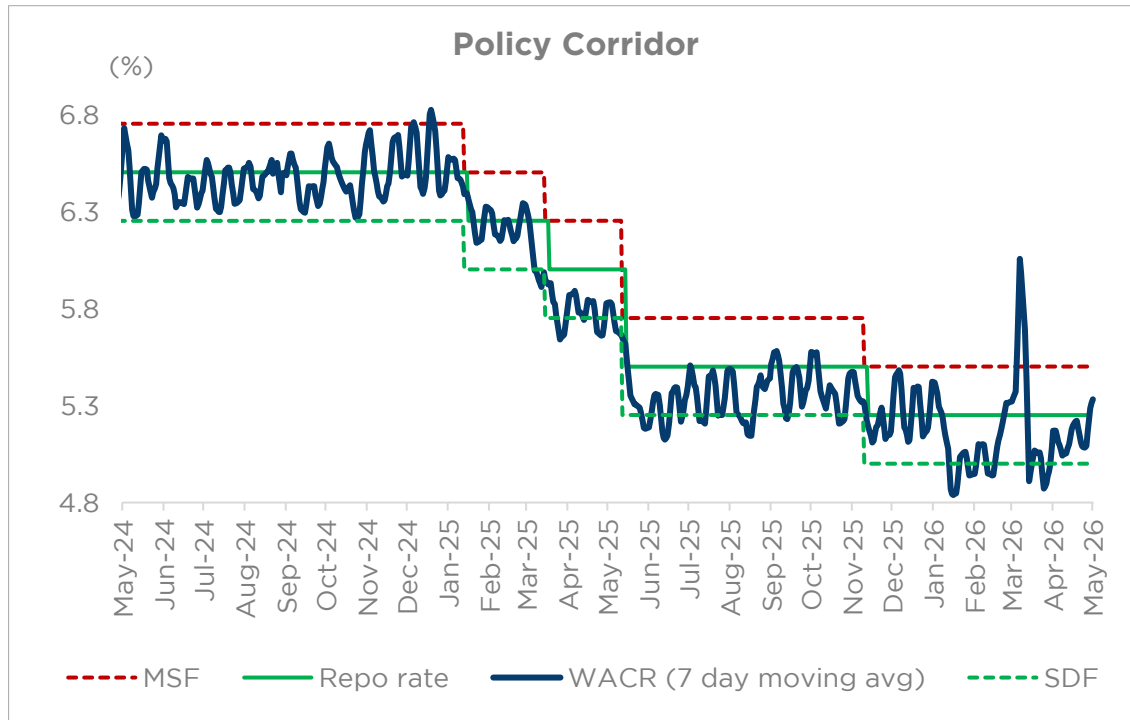
Liquidity has Narrowed but Remained Comfortable



Sources: RBI, CEIC, CareEdge. Data as of 26 May. Positive values denote liquidity surplus

- Average surplus in banking system liquidity narrowed to Rs 1.9 trillion from Rs 3.9 trillion in April. Tax related outflows, absence of support from OMOs and FPI outflows have narrowed the banking system liquidity.
- However, surplus liquidity still remains comfortable at 0.6% of NDTL.
- RBI has performed OMO purchase of ~Rs 8.8 trillion in FY26 but no major OMOs were there in the past two months. Recent forex swap of ~USD 5 billion is likely to support liquidity conditions.

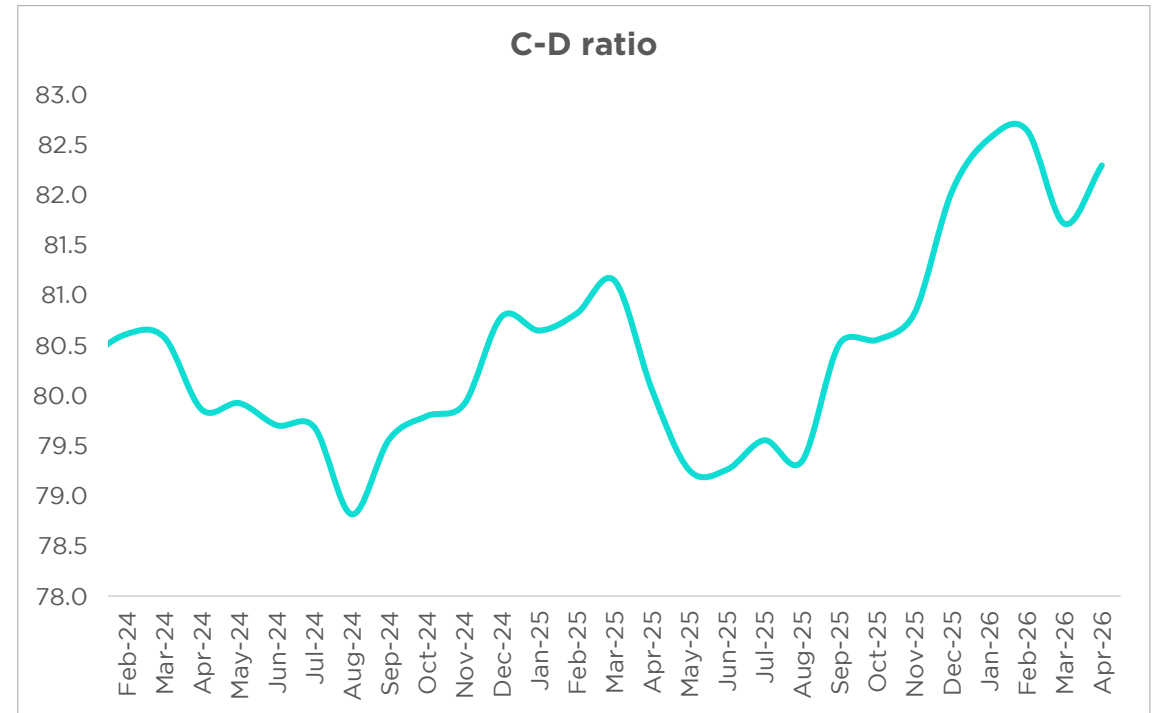
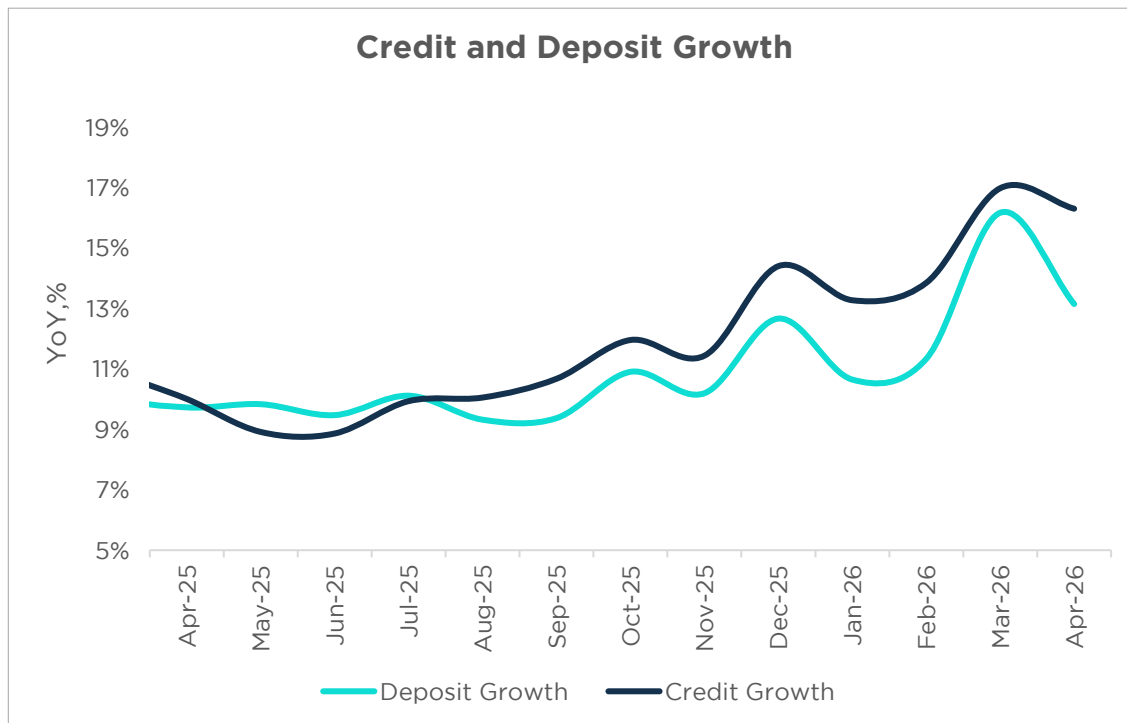
Yields Remained Elevated



Sources: RBI, CEIC, CareEdge.

- Weighted averaged call money rate has inched up as liquidity surplus narrowed in May. However, it remains within the policy corridor.
- At the same time, rising risk of fiscal slippages, rising global yields and growing inflationary concerns have kept domestic yields elevated.
- We estimate the fiscal burden from the excise duty cut on petroleum products, along with the possibility of an increase in fertiliser and fuel subsidy burden and lower tax revenue collections, to be around 0.5% of GDP in FY27.
- We expect G-sec yields to average 6.8 – 6.9% over the year, assuming early resolution of the conflict with Brent crude oil averaging USD 90/bbl.

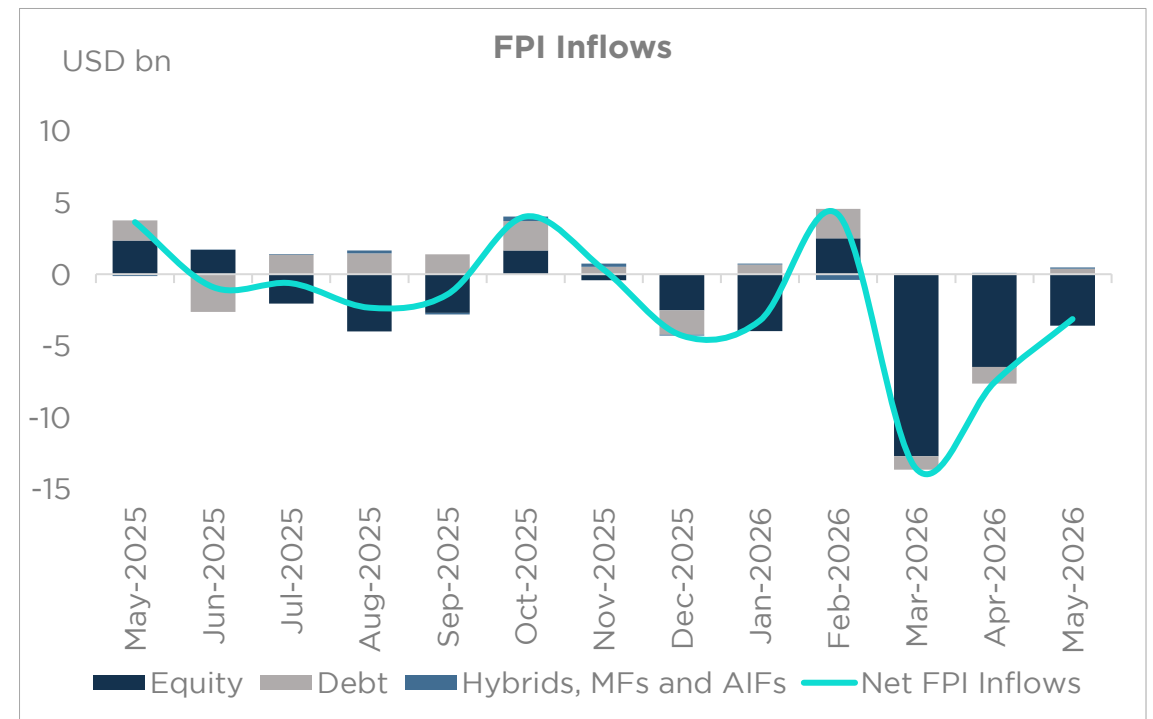
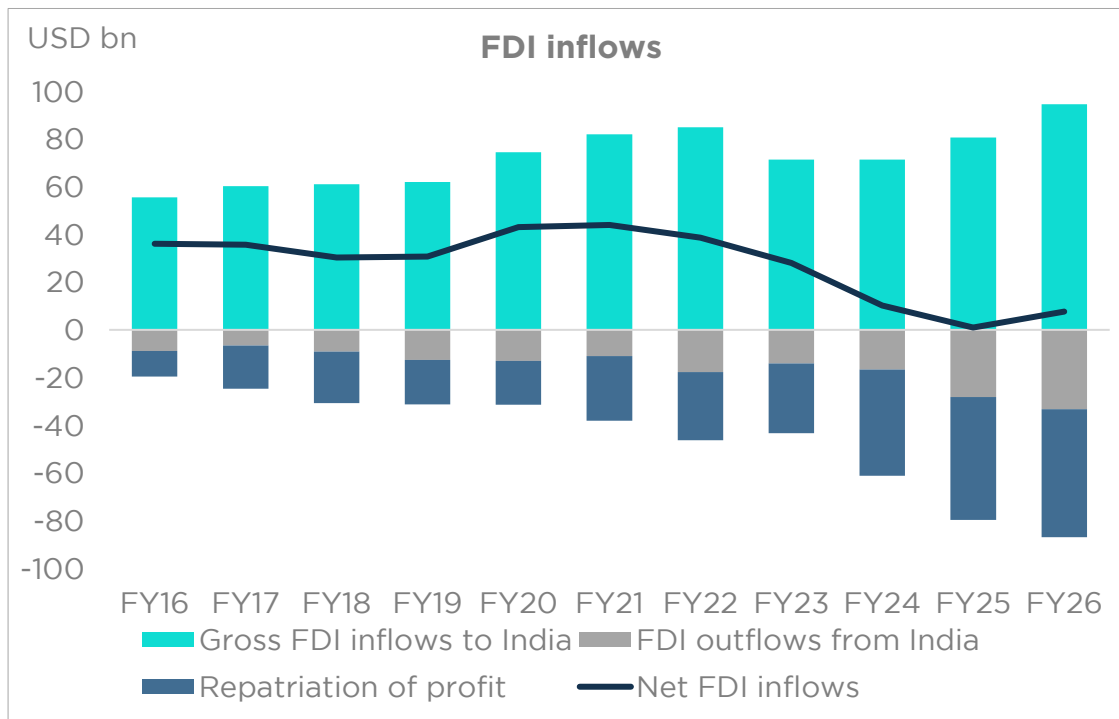
Credit and Deposit Growth Strengthen



Source: CMIE, CareEdge

- Bank credit growth stood at 16.3% YoY in April, significantly higher than around 10% during the corresponding period last year. Deposit growth also remained robust at 13.1% YoY, compared with 9.7% in the same period a year ago.
- Credit-deposit (C-D) ratio remained elevated at 82.3 in April, compared with 80.1 during the corresponding period last year, reflecting the continued outpacing of credit growth.
- Acceleration in credit growth was broad-based, with sectors such as agriculture (15.7% YoY), industry (15%), and services (19%) witnessing stronger credit offtake in March relative to the corresponding period last year. The rise in bond market yields has also likely increased the preference for bank credit as a source of financing.
- Against the backdrop of heightened global uncertainty, borrowings related to private investment activity are likely to remain subdued. However, rising input costs are expected to increase working capital requirements for firms, thereby continuing to provide support to overall credit growth.

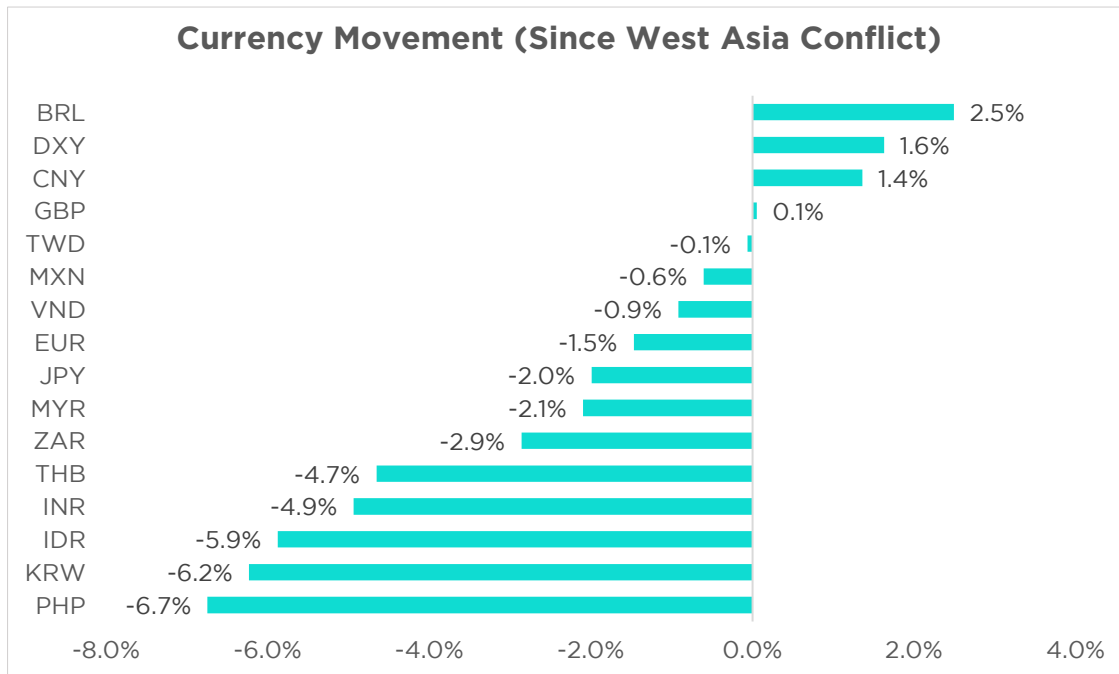
Weak Foreign Investments Remain a Key Concern



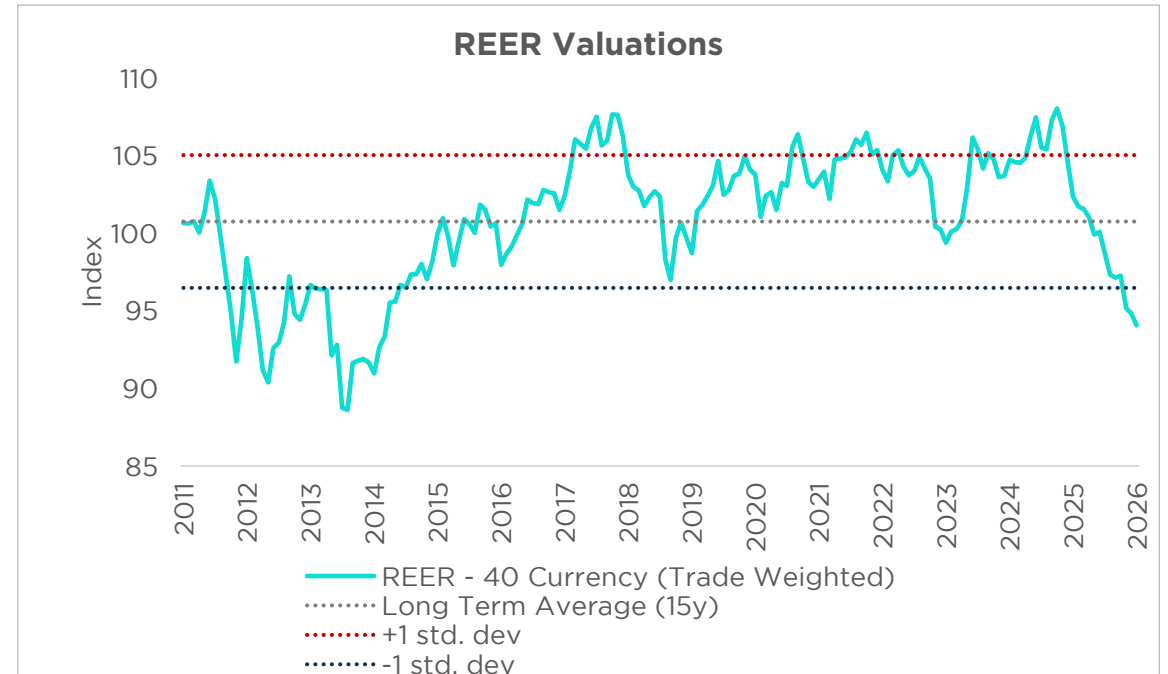
Source: CEIC, CMIE, CareEdge. FPI data as of 27th May.

- Net FDI inflows (gross inflows- outflows- profit repatriation) showed a modest improvement to USD 7.7 billion in FY26 from USD 1 billion in FY25. Despite this improvement, net inflows remain significantly below the 10-year average of USD 30.6 billion (FY15-FY24).
- FPI outflows gather pace with cumulative outflows of USD 24.6 billion following the onset of the West Asia crisis. Simultaneous weakness in capital inflows and expected widening of the CAD has weakened the BoP position. This, in turn, has exerted downward pressure on the Indian Rupee.
- Factors such as rising global risk aversion due to geopolitical tensions, relatively stretched equity valuations compared to peers and limited availability of pure-play AI investment opportunities has impacted foreign investment inflows. However, with the recent correction in equity market, the valuations have come down.

Currency Movement Since West Asia Crisis



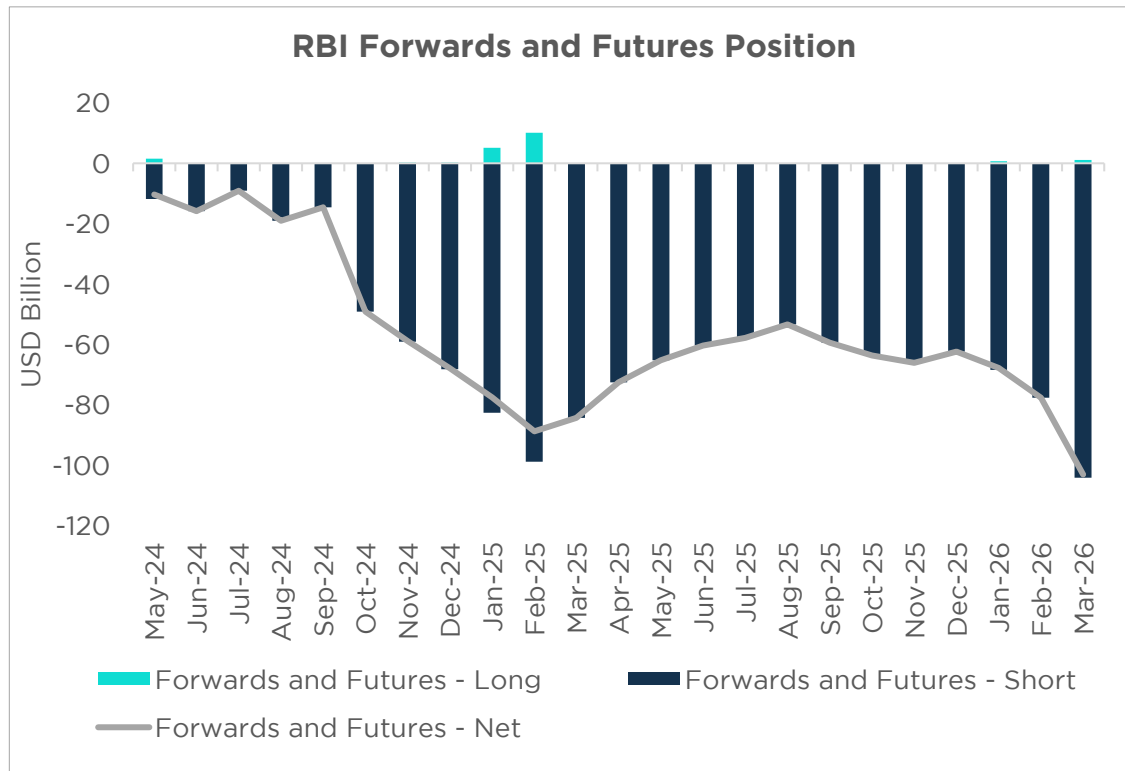
Source: Refinitiv, CareEdge; Changes in Currency compared to 26th February. Negative value denotes depreciation



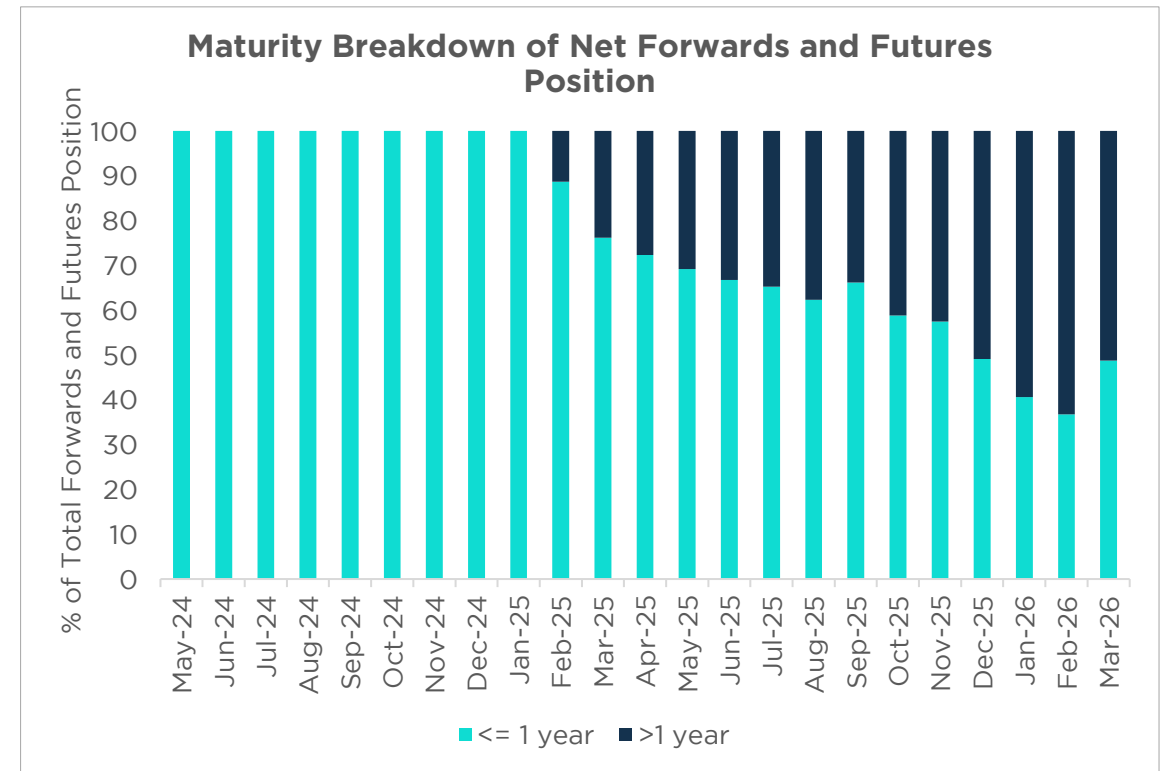
Source: CEIC, RBI, CareEdge.

- USD/INR has depreciated by 4.9% since the onset of the crisis. However, following the recent recovery in the rupee, its performance relatively better than Asian peers such as the PHP, KRW, and IDR. Nevertheless, the extent of depreciation has been larger than that witnessed in currencies such as the JPY, VND and MYR.
- Assuming average global crude oil prices of around USD 90/bbl for the full year, along with some moderation in exports and remittance inflows, we estimate India's current account deficit to widen to around 2.1% of GDP. However, CAD levels is more comfortable compared to previous episodes of sharp rupee depreciation such as taper tantrum.
- Weak foreign investment flows remain an area of concern. During earlier episodes of stress, relatively resilient FDI inflows provided a cushion against sharp FPI outflows — a factor that is absent in the current environment.
- In REER terms, rupee continues to remain undervalued, but the extent of undervaluation could narrow as inflation is projected to pick up.
- If the conflict de-escalates in the near term and global crude oil prices average around USD 90 per barrel in FY27, we expect the rupee to average in the range of 92-93 against the US dollar. However, if Brent Crude prices average closer to USD 110 per barrel, the rupee could depreciate towards the 96 per US dollar level.

RBI Uses Forward Book to Stabilise Currency



Source: CEIC, CareEdge; Note: Negative values denote Short Positions and positive values denote Long Positions



Source: CEIC, CareEdge

- RBI has stabilised volatility in the rupee by intervening significantly in the currency derivatives market, thereby increasing its net forwards and futures position.
- In the forward book, forward short positions with maturity greater than 1 year account for 51% of total forward short positions, indicating no immediate stress on forex reserves.
- RBI has comfortable forex reserves of around USD 690 bn. However, RBI's forward position stands above USD 100 billion.
- While still at comfortable levels, the RBI is likely to act prudently to preserve reserve buffers, although it retains some capacity for spot market intervention going ahead.

Rajani Sinha	Chief Economist	rajani.sinha@careedge.in	+91 - 22 - 6754 3525
Sarbartho Mukherjee	Senior Economist	sarbartho.mukherjee@careedge.in	+91 - 22 - 6754 3424
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Tel. : +91-22-6754 3456 | CIN: L67190MH1993PLC071691

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