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CRUDE ABOVE $100 AND SURPLUS LIQUIDITY STRENGTHEN CASE FOR TIGHTENING

Fed hike puts RBI October policy in spotlight

KSHIPRA PETKAR
Mumbai, September 17

THE US FEDERAL Reserve's 25-basis-point rate hike has put the Reserve Bank of India's October monetary policy review firmly in focus, with economists divided over whether the central bank will follow with a rate increase next month or wait for clearer evidence that inflationary pressures are becoming entrenched.

Crude oil above $100 a barrel, rising global yields and a large domestic liquidity surplus have strengthened the case for an earlier move. While most agree that a hike is expected, the main question is of timing.

Nilesh Shah, MD & CEO, Kotak Mahindra Asset Management Company, is in the camp that sees scope for a hike. With inflation on an upward trajectory, albeit still within the RBI's target range, the central bank may look to raise policy rates, he said. "The market has already priced in rate hikes," Shah added.

Aditi Nayar, chief economist, ICRA, said the timing would hinge on whether inflationary pressures persist and become more broad-based, with crude oil emerging as a key swing factor. "We were expecting a rate hike in December 2026, predicated on greater evidence of generalisation of inflationary pressures becoming visible," Nayar said. However, if elevated crude prices persist ahead of the Monetary Policy Committee's October review and begin feeding into retail and other output prices, "then the rate hike may get preponed to October 2026," she added.

Prateek Ancha, chief economist, Axis Capital, believes the Fed's latest hike and its dot plot strengthen the case for 50 basis points of RBI tightening in CY26, split between October and December. "We expect the overall hiking cycle to be limited to 75bp," he said.

Dipti Deshpande, principal economist at Crisil, however, does not expect the Fed's move to accelerate the RBI's rate action.

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RATE OUTLOOK

- Economists disagree on whether the central bank will raise interest rates next month or wait for clearer signs of entrenched inflation
- Kotak Mahindra AMC's Nilesh Shah says inflation is rising and stresses the market has already priced in upcoming rate hikes
- The timing would hinge on whether inflationary pressures persist and become more broad-based, with crude emerging as a key swing factor



- The RBI has been using Variable Rate Reverse Repo (VRRR) auctions & Open Market Operations to drain excess funds

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"AT THE MOMENT, we are not expecting a hike in this upcoming policy at all. Our base case is that there will be a hike more so towards the end of this fiscal," Deshpande said. Whether that comes in December or February would depend on the trajectory of inflation and the emergence of second-round effects, she added.

For now, Deshpande sees surplus liquidity as the more immediate challenge. With banks flush with funds, the RBI will need to ensure that liquidity is channelled into productive sectors, she said.

Murthy Nagarajan, head-fixed income, Tata Asset Management, expects the RBI to begin raising rates in October, citing rising inflation and excess liquidity in the banking system. He said the central bank could also raise the cash reserve ratio (CRR) to drain surplus funds.

"The market is already pricing in a 75 to 100 basis point rate hike at the prevailing market yields of corporate and government securities," Nagarajan said. Even after a repo rate hike and an increase in the CRR, banking-system liquidity is likely to remain in surplus, he added.

System liquidity stood at ₹7.38 lakh crore as of September 16, down from a record ₹11.16 lakh crore on September 6. The RBI has been using Variable Rate Reverse Repo (VRRR) auctions and Open Market Operations (OMOs) to drain excess funds.

On Thursday, the central bank conducted an OMO sale of government securities worth ₹50,000 crore, the first tranche of its planned ₹1 lakh crore liquidity operation.

Shriram Research, however, cautioned against the RBI responding to higher US yields or a narrowing interest-rate differential unless domestic inflation itself warrants tighter policy. With foreign exchange reserves of $785 billion, it said, the central bank has sufficient firepower to manage pressure on the rupee while separately dealing with surplus liquidity.

"Indian rates already sit among the highest in the emerging market universe, leaving the RBI with limited room to manoeuvre," Shriram Research said. Raising rates primarily to defend the currency could hurt growth and widen fiscal deficits, it added.

That leaves the October MPC meeting finely poised. Crude above $100, rising inflation and surplus liquidity are strengthening the argument for an earlier move, but the deciding factor could be whether the RBI sees enough evidence that price pressures are spreading beyond their initial drivers.