18 September 2026

# Doing more with less

**Economics**
India

## What the RBI needs

- Markets are pricing in tighter liquidity and rate hikes…
- …but should they happen simultaneously (all at once) or sequentially (hikes follow later)?
- Research suggests a governor's first hiking cycle is also a credibility cycle; hiking early could mean fewer hikes later

Global and domestic conditions have shifted quickly. The FCNR(B) scheme has pulled in USD127bn, lifting spot FX reserves, but leaving a domestic liquidity glut. The oil price is up 20% since July, the Fed hiked 25bp (on 16 Sep) and hinted at further rises, and the USD has rallied accordingly – all of which matters for USD-INR. In India, market expectations are now converging on two themes: removal of liquidity and RBI rate hikes.

**On liquidity,** FCNR(B) inflows have created a core liquidity surplus of cINR15trn. Excess liquidity can quickly become inflationary and can raise financial stability risks if banks become dependent on abundant liquidity (Acharya et al., 2022). The RBI has already deployed VRRRs, OMO sales, and FX swaps/spot sales. CRR hikes and MSS issuance are options under consideration. Each of these comes with side effects (which we discuss in this note), hence the central bank's 'mix-and-match' approach. We expect the RBI to withdraw INR5-6trn durably. Of this, withdrawal of cINR2.5trn is already in process.

**On rates,** inflation risks look less 'transitory' and more 'sticky'. CPI is at 4.8% and the next print is tracking around 5.5%. It could stay above 5% for about three quarters. With WPI/PPI at c10%, elevated oil, and the possibility of a very strong El Niño, it is little surprise that markets have started pricing in rate hikes.

**Where markets are still divided is on the process.** Should the RBI move **sequentially** (drain liquidity more surely in the October meeting, hike in December) or **simultaneously** (drain and hike in October)? Moving sequentially helps in transmission when liquidity is abundant. But this time around, we believe the RBI has much to gain by doing it all at once, soon, and with purpose.

This is where **"hiking early to hike less"** matters. The report's key point is credibility. In a governor's first hiking cycle, markets are still learning their reaction function. Backus and Driffill (1985) frame this as a reputation problem – early moves help markets infer whether the governor is genuinely inflation-averse. Acting early signals a response to prospective inflation, strengthening credibility. That can do more than the mechanical impact of a 25bp hike as it anchors expectations, supports the currency, and reduces the inflation risk premium. So, credibility does some of the tightening, and fewer hikes may be needed later.

We maintain our long-held view of two 25bp hikes in the October and December meetings respectively, taking the repo rate to 5.75%. We also expect further clarity/steps on liquidity removal in the October meeting.

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Big shifts have transpired – domestically and internationally, both policy-led and exogenous. The FCNR(B) scheme attracted USD127bn in inflows, lifting spot FX reserves as well as domestic liquidity. Meanwhile, the Brent oil price is up 20% to USD105/b after falling briefly in July. The Fed hiked by 25bp on 16 September, the first rise since 2023, and suggested there may be further hikes. The USD has rallied accordingly, with implications for the USD-INR pair.

In India, market expectations around what the RBI might do have been shifting quickly (though since the onset of the energy crisis, we have held on to our two rate hikes in 2026 view).

There are now two areas where market expectations are converging: (a) the removal of liquidity; and (b) RBI rate hikes. We discuss these briefly below.

## Views aligning – removal of liquidity

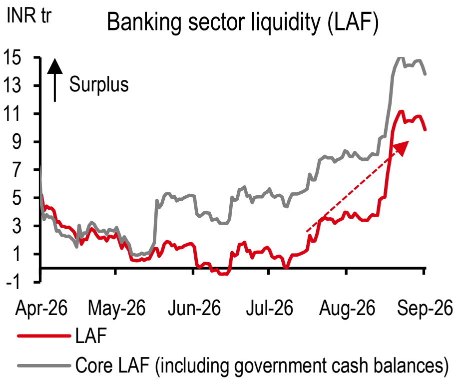
The FCNR(B) scheme has led to a glut of core surplus liquidity of about INR15trn (note: the numbers keep moving each day; see exhibits 1 and 2). At c5% of deposits, this is much higher than the RBI's comfort zone, particularly at a time of rising inflation risks (more on this later). There is a general understanding that excess liquidity must be removed for some good reasons:

First, it can quickly become inflationary, particularly at a time of strong credit growth.

Second, it can lead to financial instability risks over time. As noted by Acharya, Rajan, Chauhan, and Steffen (2022)[1], once banks become dependent on abundant liquidity, putting it up for permanent use (e.g. issuing more credit lines), they struggle when it is removed.

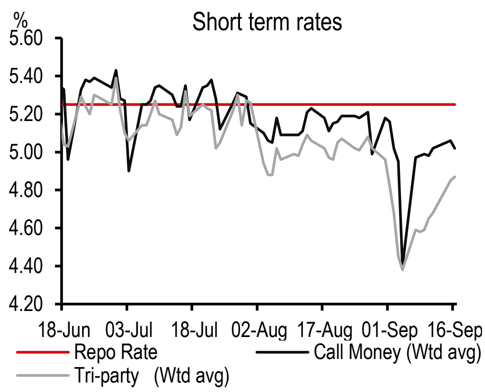
Where there is less consensus among market participants is the tool that should be employed. Here, however, the RBI governor has articulated clearly in a recent interview that all options to drain liquidity are on the table. Notably, over the past 10 days, several instruments have already been deployed: VRRRs, OMO sales and FX swaps.

**1. The FCNR(B) scheme has led to a glut in domestic liquidity**




Source: Bloomberg, CEIC, HSBC

**2. Short-term rates have dipped below the repo rate**




Source: Bloomberg, HSBC

It is important to note that each instrument used to remove liquidity has a side-effect that cannot be ignored; hence, the RBI's decision to spread this out using a variety of instruments.

1 Acharya, Viral V., Rahul S. Chauhan, Raghuram Rajan, and Sascha Steffen (2022), "Liquidity Dependence: Why Shrinking Central Bank Balance Sheets Is an Uphill Task," in Reassessing Constraints on the Economy and Policy, Federal Reserve Bank of Kansas City Economic Policy Symposium, Jackson Hole, pp. 345–421

Tools employed already:

- VRRRs – The RBI has issued VRRRs of various maturities in recent weeks, ranging from overnight to 30-day, even allowing early exit to incentivise uptake. This instrument is voluntary in nature, and the early exit option suggests it may not be an effective drainer.
- FX spot sales – The RBI seems to be active in the market, but large intervention can drain spot FX reserves quickly, keeping less available for later, which could stand out at a time of a significant short forward book.
- Sell/buy FX swaps – According to some media reports (e.g., Reuters, 10 Sep 2026), the RBI has been doing swaps since last week. Alongside draining liquidity, the resultant rise in FX forward points could lead to INR-supportive behaviour (more exporter hedging, less importer hedging). But too large a rise could be disruptive for genuine importer and FII hedging activity.
- OMO sales – The RBI has announced INR1trn of OMO sales (to be conducted in three tranches[2]). This could be an effective tool, but tends to push up bond yields (and hurt RBI income if done in large quantities).

Tools not used yet:

- CRR hike – The RBI hasn't used this route yet. For every 1% hike, this tool could remove about INR3trn of liquidity. This could be disruptive for banks, especially when not all banks have benefited from FCNR(B) deposits equally. However, one could argue that credit growth is too strong and could do with some easing.
- MSS bond issuance – This tool has not been used. These bonds are issued by the government, but the proceeds are cordoned off and cannot be used for spending. As such, their issuance effectively drains liquidity. But the central government pays the coupon on such bonds, and may not want to take on more expenses at a time when other fiscal pressures are mounting.

Between these tools, we believe the **RBI could be looking at withdrawing INR5-6trn of liquidity** durably[3]. Adding up the more permanent tools employed so far, we believe the amount already being taken out is about INR2.5trn[4]. Meanwhile, subscriptions in VRRRs currently stand at INR3.2trn. This could either be replaced by another tool such as a temporary CRR hike, or remain as a VRRR, or even be released in the banking system. (In some sense, this will be the balancing factor to ensure that the call money rate is aligned with the repo rate.)

## Views aligning – RBI rate hikes

Another area where views are aligning, is rate increases. We find that both market pricing and Bloomberg polls show a rise in rate hike expectations, with many moving swiftly from none to 2-3 hikes (see exhibit 3)[5]. And for some good reasons.

The latest CPI print shows a determined climb (to 4.8% in August from 4.5% in July), with the next print likely around 5.5%. Core inflation is also rising faster than the long-term sequential average. And within that, we find services inflation has finally started to show a clear rise (see exhibit 4). Given that WPI/PPI inflation is running at c10% (see exhibit 5), corporates have still

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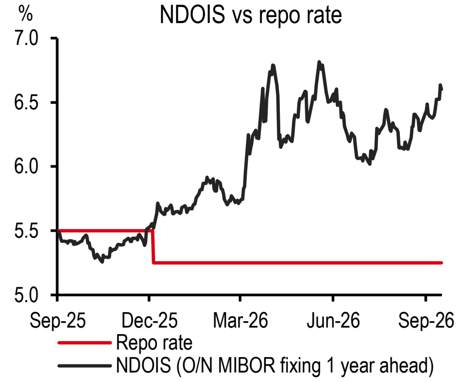
2 The RBI announced OMO sale of government securities worth INR1trn across three tranches in September 2026 – INR0.5trn on 17 September, INR0.25trn on September 21 and INR0.25trn on 28 September 2026
3 We believe around INR3trn can be drained due to the rise in currency in circulation. INR3trn or so could be government deposits at RBI for the next few months. And the remaining INR3trn is in VRRRs.
4 We add up spot FX sales, estimates of FX swaps and announcements of OMO sales
5 Money Control Poll | RBI rate hike bets build, repo rate to be at least 5.75% by FY27-end| 15 September 2026

not passed on higher costs to consumers fully, and oil prices are elevated, the upside pressure is likely to keep CPI inflation above 5% for about three quarters. And the possibility of a very strong El Niño could push inflation higher (see exhibit 6). We think this combination cannot be ignored by the RBI.

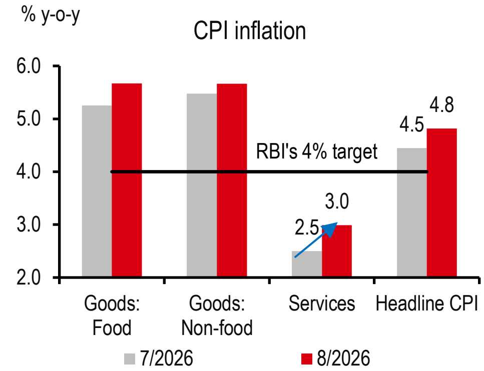
But the bigger question is on timing. When should a rate hike be delivered?

**3. Market pricing shows a rise in rate hike expectations**



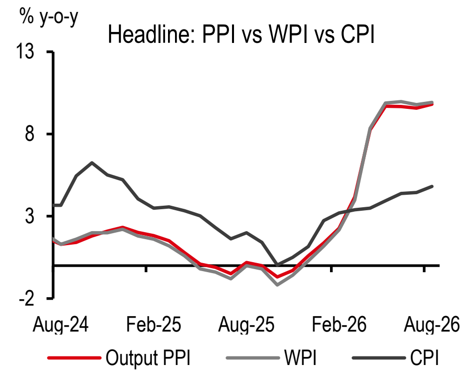

Source: Bloomberg, HSBC

**4. Services inflation, the last to budge, has finally started to show a rise**



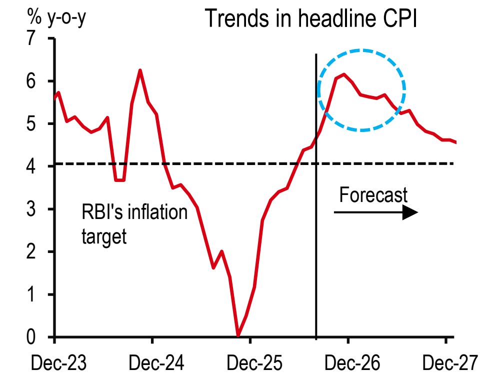

Source: CEIC, HSBC

**5. WPI and PPI inflation running at c10%, well above CPI**




Source: CEIC, HSBC

**6. A very strong El Niño could push inflation even higher than current forecasts**




Source: CEIC, HSBC forecasts

## Sequentially or simultaneously?

One view is that the RBI should focus on removing liquidity in the upcoming RBI meeting on 7 October and leave rate hike for December. In short, that the RBI should move sequentially. The argument is that the transmission process following a rate increase would be impaired if there is too much liquidity sloshing around. And the last inflation print was still sub-5%, so it would be fine to see higher prints before acting.

**But our view is different.** We believe the RBI has much to gain this time around by moving simultaneously – taking out liquidity and hiking rates in the October meeting.

## Hiking early to hike less

The case for an early RBI rate hike is strengthened by the economics of reputation. In their seminal 1985 paper, *Inflation and Reputation,* David Backus and John Driffill argue that **when a governor is approaching their first rate-hiking cycle,** markets are still learning their reaction function – how quickly and forcefully they will respond when inflation risks rise.

Acting early would signal that the RBI responds to prospective inflation, rather than waiting for high inflation to become entrenched. In the language of the model, markets would revise upwards the probability that the governor is genuinely inflation-averse, a process that strengthens policy credibility.

The benefit could extend well beyond the direct impact of a 25bp hike. If an early move helps anchor household, corporate and market expectations, it could limit second-round price pressures, support the currency and reduce the inflation risk premium.

This is even more important at a time when there are overlapping external shocks at play: the Fed's recent rate hike, high oil prices, and the possibility of a very strong El Niño.

The choice, therefore, may not be between hiking now and avoiding hikes altogether. It may be between a modest, credibility-enhancing increase now and larger, more economically costly tightening later.

**Put simply, the governor's first hiking cycle is also their first credibility cycle. Hiking early may allow the RBI to hike less later.**

We continue to expect two rate hikes, one at each of the October and December policy meetings, taking the repo rate to 5.75%.

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