The Reserve Bank of India Eases Monetary Policy

- **The Reserve Bank of India (RBI) reduced the benchmark repo and reverse repo rates by 25 basis points to 6.00% and 5.75%, respectively, following its scheduled bi-monthly monetary policy meeting on August 1–2.**

The RBI opted to ease monetary policy, taking advantage of the quickly narrowing window of opportunity to inject monetary stimulus into the economy. The decision was justified by recent—yet temporary—disinflationary developments and current economic weakness. We assess that no further rate cuts are in sight.

India's inflation headline inflation has decelerated significantly, reaching 1.5% y/y in June compared with a 5.8% rate recorded a year earlier. Lower food prices are the key factor behind the disinflationary trend. Indeed, core inflation has not declined in tandem with the headline rate, which had been a key concern for policymakers over recent months. Our estimated core inflation index increased by 3.9% y/y in June, representing only a small deceleration from the 4.6% rate recorded a year earlier. Nevertheless, the Monetary Policy Committee (MPC) assessed that inflationary risks have abated since the June policy meeting, opening up room for policy accommodation.

The MPC acknowledged that there was no conclusive evidence on whether disinflation is driven by temporary or structural factors. Regardless, the policymakers expect inflation to accelerate in the near term due to base effects. In prior months, the RBI had looked through the dip in headline inflation, highlighting that monetary policy must be forward-looking and that particular attention must be paid to the projected upward path for inflation. We share the MPC's view on future inflation and foresee the headline rate reaching close to 4% y/y by the end of the year. Overall, however, India's inflation outlook is favourable as we anticipate inflation to remain contained, hovering within the RBI's medium-term target of 4% ± 2% y/y through 2018.

The MPC expressed concerns regarding the state of the Indian economy, emphasizing that there is an urgent need to buttress private investment. Indeed, a contraction in fixed investment in early 2017 highlights a substantial area of weakness in India's economic outlook. In our view, one of the key reasons for the muted performance is the burden of bad debt in the Indian banking system that has yet to be cleared. Being somewhat contrary to today's decision, the MPC had previously emphasized that resolving the bank balance sheet issue would be a more efficient way to stimulate the economy than benchmark interest rate cuts.

In our assessment, the key difference between now and the June monetary policy meeting—when the benchmark repo rate was kept unchanged—is the lower headline inflation rate. As other fundamental factors, such as inflation and growth projections as well as structural issues, have changed only slightly since June, we assess that political reasons may have played a part in the decision to ease monetary policy. While we agree that the Indian economy could benefit from further monetary stimulus, we point out that conducting monetary policy under pressure raises questions about central bank independence, potentially undermining policy credibility and investor confidence toward India.

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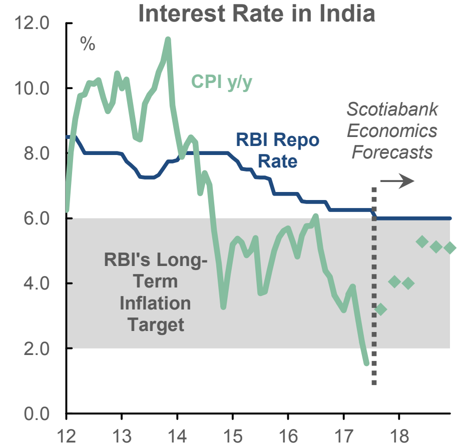
Inflation and Benchmark Interest Rate in India



Sources: Scotiabank Economics, Bloomberg.