Monetary Policy Tightened In India

- **The Reserve Bank of India (RBI) raised the benchmark repo and reverse repo rates by 25 basis points to 6.50% and 6.25%, respectively, following its bi-monthly monetary policy meeting on July 30–August 1.**
- **The RBI's policymakers maintain a neutral monetary policy stance. Inflation is seen as the main domestic risk while rising trade protectionism, geopolitics, and elevated oil prices were flagged as the biggest risks to the global outlook.**

Monetary tightening continues in India following the RBI's scheduled three-day policy meeting that concluded today. The benchmark repo and reverse repo rates were raised by 25 basis points to 6.50% and 6.25%, building on a similar policy step taken at the previous meeting on June 4–6. Five out of six members of the Monetary Policy Committee (MPC) voted in favour of the hike, while one member voted against the decision. Given that the Indian economy is at the early stages of economic recovery following disruptive reform implementations over the past year and a half, the MPC will likely take a cautious approach to further monetary tightening. We do not expect any additional interest rate hikes before year-end.

The key reason behind today's decision is India's challenging inflation outlook. Core inflation has continued to rise, reaching 6.4% y/y in June. Meanwhile, headline inflation accelerated to 5% y/y in June, hovering above the midpoint of the RBI's medium-term target of 4% ±2%. The MPC highlighted several risks to the inflation outlook, such as elevated crude oil prices, ongoing financial market volatility (and the associated depreciation of the Indian rupee), households' rising inflation expectations, higher input price pressures in the manufacturing sector, uncertain rainfall during the ongoing monsoon and its impact on food prices (as of July 31, the cumulative rainfall was 6% below the long-period average), the central government's decision to implement minimum support prices for certain crops, potential fiscal slippage (ahead of the 2019 general election), as well as higher housing rent allowances given to government employees. Accordingly, the RBI revised its inflation forecast slightly upward; headline inflation is expected to average 4.8% y/y in the October 2018–March 2019 period (up from the prior forecast of 4.7%). We estimate that India's inflation will ease somewhat over the next few months on the back of base effects, before starting to reaccelerate in 2019. Nonetheless, we believe that the RBI's monetary tightening measures will help keep inflation within the central bank's target range through 2019.

In addition to inflation considerations, we assess that the need to underpin the RBI's policy credibility played a role in today's decision. Several MPC members have expressed concerns regarding the dent that recent price developments may be causing to the credibility of the central bank's inflation commitment. Given that the RBI's inflation-targeting policy framework is still relatively new, this matter was likely treated with a great sense of urgency.

The Indian economy's growth signals are solid, allowing for gradually tighter monetary conditions. Indeed, rural demand, investment activity, and the manufacturing sector momentum continue to be robust. In addition, the nation's fiscal policy stance remains growth-supportive. Accordingly, the MPC concluded that India's output gap has "virtually closed". We forecast India's real GDP to grow by 7½% y/y over the next two years following a 6.3% advance in 2017.

CONTACTS

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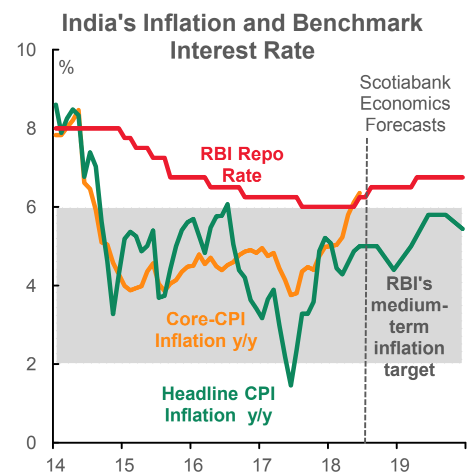
Chart 1



Sources: Scotiabank Economics, Bloomberg.