Monetary Policy Tightened In India

- **In line with our expectation, the Reserve Bank of India (RBI) reacted to stronger inflationary pressures and raised the benchmark repo and reverse repo rates by 25 basis points to 6.25% and 6.00%, respectively, following its bi-monthly monetary policy meeting on June 4–6.**
- **Amid India's nascent economic recovery, the RBI kept a neutral policy stance and will likely proceed very cautiously with further monetary tightening.**

A monetary tightening phase has commenced 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 6.25% and 6.00%, marking the first hike since January 2014. 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 RBI's Monetary Policy Committee (MPC) will likely take a cautious approach to monetary tightening. We expect the next interest rate hike to take place in the first half of 2019.

The key reason behind today's decision is the country's worsening inflation outlook. Headline inflation picked up to 4.6% y/y in April from 4.3% a month earlier (chart 1), continuing to hover above the midpoint of the RBI's medium-term target of 4% ±2% y/y. We estimate that headline inflation will pick up further over the coming months—peaking at 5¾% y/y in June 2018—before easing to 4⅔% by year-end. Reflecting persistent upside risks to inflation, higher oil prices and a significant rise in households' inflation expectations, the RBI revised its inflation forecast upward; it estimates that headline inflation will average 4.7% y/y in the October 2018–March 2019 period, up from the prior forecast of 4.4%. Moreover, the central bank assesses that risks continue to be tilted to the upside.

In recent months, the MPC has shown particular concern about the upward trajectory of core inflation. Today, the MPC pointed out that core inflation has seen "an abrupt acceleration", which suggests "a hardening of underlying inflationary pressures". Indeed, core inflation has accelerated more notably than the headline print, approaching 6% y/y in April (chart 1). Increasing housing rental prices, which reflect the impact of higher housing rent allowances given to government employees, and miscellaneous costs, such as household goods, health, transport, education, and personal care, are the key drivers of core inflation. We assess that today's action will help limit future demand-driven price pressures; moreover, it will strengthen the RBI's policy credibility regarding its inflation-targeting monetary policy framework.

The Indian economy's growth signals are robust, allowing for gradually tighter monetary conditions. Indeed, investment activity is reviving and credit growth is picking up. In addition, the nation's fiscal policy stance remains growth-supportive with a focus on the rural economy and infrastructure. The first quarter real GDP growth was solid at 7.7% y/y following a 7.0% gain in the final three months of 2017. Given favourable growth traction, several members of the MPC estimate that India's output gap has almost 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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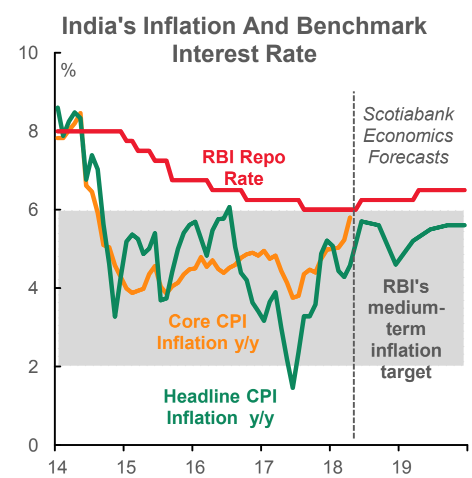
Chart 1



Sources: Scotiabank Economics, Bloomberg.