December 5, 2018

The Reserve Bank of India Extends Its Break From Monetary Tightening

- **The Reserve Bank of India left the benchmark repo rate unchanged at 6.50% following its bi-monthly monetary policy meeting that concluded on December 5.**
- **The central bank maintained the policy stance of "calibrated tightening", implying that further hikes are in store.**

The Reserve Bank of India (RBI) continues its wait-and-see policy approach for the time being. Following the scheduled monetary policy meeting that concluded today, the benchmark repo and reverse repo rates were left unchanged at 6.50% and 6.25%, while the stance of "calibrated tightening" was kept in place. The RBI raised the policy rates at the June and August meetings; in October, it left the policy rate unchanged but adopted a monetary tightening bias. Given the policy stance and various upside risks to inflation, we assess that the RBI will raise the policy rates by 25 basis points in early 2019.

We assess that the decision to keep interest rates on hold reflects the perceived need to support the Indian economy. The Monetary Policy Committee (MPC) noted trade tensions, tighter global financial conditions, and weaker global demand as downside risks to the domestic economy. Indeed, India's real GDP growth weakened to 7.1% y/y in the July-September period from the 8.2% pace in the prior quarter. This challenging backdrop combined with continued distress within the country's non-bank financial companies likely justified the status quo of monetary policy.

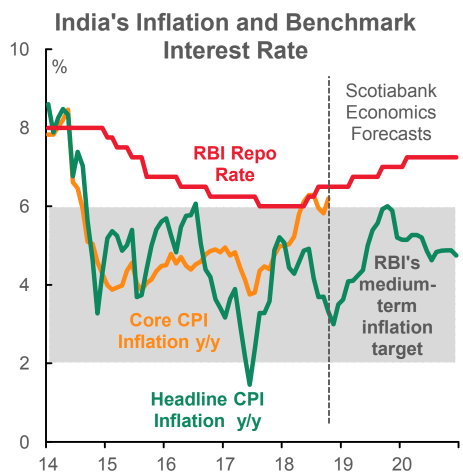
India's headline inflation eased to 3.3% y/y in October, giving the RBI some breathing room to focus on supporting the economy. Nevertheless, we note that the lower inflation reading reflects base effects as well as muted food and energy price developments. Meanwhile, India's core inflation has continued to accelerate, reaching 6.1% y/y in October, warranting close monitoring by the RBI. In this respect, the MPC continued to highlight various upside risks to inflation: 1) prices of several food items are unusually low, posing a risk of a sudden reversal; 2) the inflationary impact from the central government's decision to implement minimum support prices for certain crops remains unclear; 3) the outlook for global crude oil prices is uncertain; 4) global financial markets continue to be volatile; 5) households' inflation expectations for one year ahead remain elevated; 6) there is a risk of a fiscal slippage ahead of the 2019 general election, and 7) higher housing rent allowances given to government employees may push headline prices higher. We estimate that India's headline inflation will rebound in early 2019, returning to the midpoint of the RBI's 4% ±2% target. However, on the back of our expectation for further gradual monetary tightening by the RBI, India's inflation will likely remain within the central bank's target range through 2020.

The relationship between the RBI and the Indian government has received increased attention in recent weeks, given that the government seems to prefer a more stimulative monetary policy stance while the RBI prioritizes inflation-targeting, as per its mandate. Despite the RBI's decision to refrain from monetary tightening today, we assess that its tightening bias implies that the MPC continues to give high priority to preserving policy credibility and central bank independence.

CONTACTS

Tuuli McCully, Head of Asia-Pacific Economics
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.