February 7, 2019

Reserve Bank of India Eases Monetary Policy

- **The Reserve Bank of India cuts benchmark interest rates in contrast to its policy stance of "calibrated tightening" in order to support the economy; the policy stance was subsequently revised to "neutral".**
- **The shift in monetary policy direction calls the central bank's independence and policy credibility into question.**

The Reserve Bank of India (RBI) unexpectedly lowered the benchmark repo and reverse repo rates by 25 basis points to 6.25% and 6.0%, respectively, following the bi-monthly Monetary Policy Committee (MPC) meeting that concluded today. The rate cut took place under the RBI's monetary policy stance of "calibrated tightening"; the stance was subsequently revised to "neutral".

The decision to cut interest rates was justified by the need to boost India's economic growth amidst low headline inflation. The MPC noted that high-frequency indicators point to some softening in economic activity and that the economy's output gap has opened up modestly. Nevertheless, monetary authorities foresee India's real GDP growth at 7.4% y/y in the fiscal year 2019–20 (April–March), which is in line with our growth projection for India through 2020. According to the MPC, looser monetary conditions are intended to buttress Indian private investment and consumption.

While the RBI's monetary policymakers highlighted that low headline inflation provided them with room to ease policy, we point out that India's inflation outlook is rather complicated: headline inflation is low while core inflation is high (chart 1). Lower food and fuel prices pushed headline inflation down to 2.2% y/y December, compared with 5.1% in January 2018. Meanwhile, core inflation remained elevated at 5.6% y/y in December. We also note that the government's shift to a looser fiscal policy stance—ahead of the 2019 general election that will take place in April–May—forms a notable inflation risk. Against this background, our view regarding India's inflation trajectory differs from the RBI's forecast; we foresee headline inflation rebounding to 5½% y/y within the next 12 months, while the MPC's inflation forecast for the end of the year is 3.9% y/y.

The RBI's monetary policy trajectory is undergoing a fundamental shift under the central bank's new governor. Today's MPC meeting was the first rate decision for Governor Shaktikanta Das, who took office in December. The RBI's prior leader, Governor Urjit Patel, resigned in the aftermath of disagreement with the government over desirable monetary conditions. The government preferred a more stimulative monetary policy stance while the RBI under Governor Patel was focusing on inflation-targeting, as per the central bank's mandate. Given Governor Das' background in India's Ministry of Finance and his ties to Prime Minister Narendra Modi, we have highlighted our concerns regarding the RBI's shifting policy biases and eroding independence. Against the changing policy backdrop, we have removed interest rate hikes from our policy rate forecast. We see no further changes to the policy stance or rates in the foreseeable future, yet we will be studying policy biases of the MPC members carefully once the meeting minutes are published on February 21.

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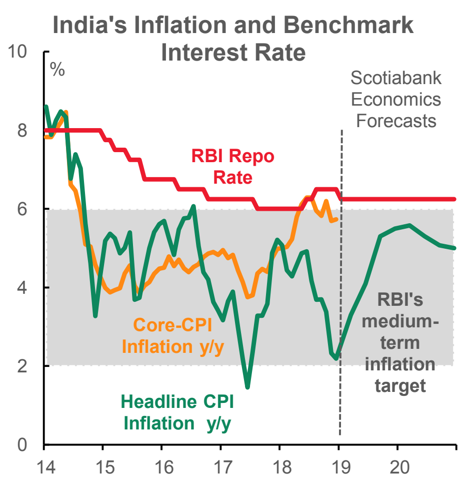
Chart 1



Sources: Scotiabank Economics, Bloomberg.