April 4, 2019

The Reserve Bank of India Eases Monetary Policy Further

- **The Reserve Bank of India cuts benchmark interest rates in order to support the economy.**
- **The window of opportunity to stimulate the economy is closing as inflation is set to rebound.**

The Reserve Bank of India (RBI) lowered the benchmark repo and reverse repo rates by 25 basis points to 6.0% and 5.75%, respectively, following the bi-monthly Monetary Policy Committee (MPC) meeting that concluded today. Four out of six MPC members supported the rate cut while two voted to leave monetary conditions unchanged. The RBI's neutral monetary policy stance—which was introduced in February 2019—was kept in place. Today's policy move was the second consecutive interest rate reduction; the monetary easing so far this year reverses the 50 basis points of tightening conducted in 2018.

The decision to loosen monetary policy reflects the apparent need to boost India's economic growth. Indeed, the MPC expressed concerns regarding elevated global uncertainties and the sluggishness of India's domestic momentum. The policymakers noted that high-frequency indicators point to softening in activity and that the economy's output gap remains negative. Accordingly, they concluded that it is necessary to strengthen domestic growth impulses by underpinning private investment. We forecast India's real GDP growth to average 7.2% y/y in fiscal year 2019–20 (April-March), which is in line with the RBI's projection.

We believe that the MPC's sense of urgency to cut rates reflects its expectation of gradually rising inflation. Prior communications from the RBI reveal deep divisions within the MPC regarding India's inflation outlook and risks. As inflation continues to rebound, the policymakers with a dovish bias will face difficulties in rationalizing further rate cuts given the RBI's inflation-targeting mandate. Accordingly, we do not foresee further interest rate reductions over the coming quarters.

India's inflation signals are mixed. Core inflation has been decelerating gradually but remains elevated. In February, prices at the core level increased by 5.3% y/y, down from slightly over 6% in October. Nevertheless, we note that the recent disinflation has not been broad-based across all index components. Meanwhile, headline inflation has been soft in recent months on the back of lower food and energy prices, yet the trend is now reversing. After reaching the low point of 2.0% y/y in January, inflation has rebounded to the current level of 2.6%. The year-ago base effect will likely continue to inch the headline inflation higher over the coming months. We expect price gains to reach 5% y/y by the end of 2019; nevertheless, headline inflation is estimated to remain within the RBI's 4% ±2% target through 2020. We continue to observe carefully the development of the following risks to inflation: 1) financial market volatility and potential depreciation pressure on the Indian rupee; 2) volatile food prices; 3) international crude oil price developments; 4) ongoing global trade tensions that may cause a growth slowdown and softer commodity prices; 5) the approaching southwest monsoon (June–September) that will have an impact on food prices and rural incomes; and 6) fiscal measures announced in the Interim Union Budget may trigger inflationary implications.

CONTACTS

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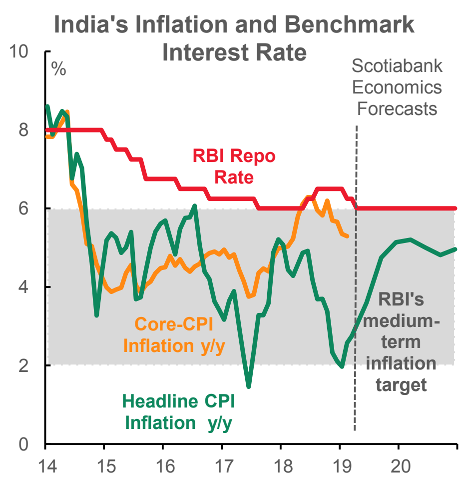
Chart 1



Sources: Scotiabank Economics, Bloomberg.