Scotiabank

GLOBAL ECONOMICS

FLASH REPORT

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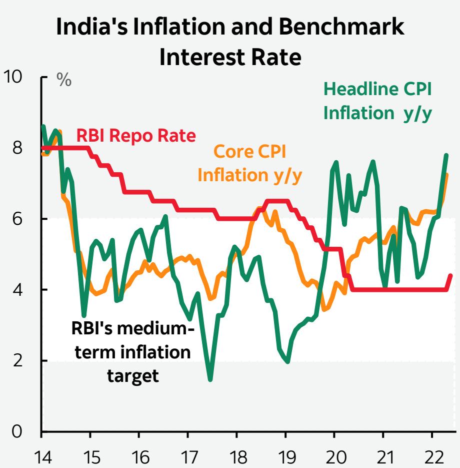
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Reserve Bank of India Hikes Again to Tame Inflation

- **India's central bank joins the club of front-loading central banks, raising the benchmark repurchase rate by 50 basis points to 4.90%.**
- **Inflation containment is taking policy priority despite the fact that India's domestic economic recovery is incomplete.**

The Reserve Bank of India (RBI) raised the benchmark repurchase rate by 50 basis points to 4.90% following the monetary policy meeting that concluded today (chart 1). The decision marks the second hike in the monetary policy normalization phase that commenced on May 4 when the RBI raised the repurchase rate by 40 bps following an unscheduled policy meeting. The front-loading of hikes highlights the sense of urgency within the central bank to prevent inflation expectations from rising rapidly and to support the Indian rupee, which has faced a weakening bias against the US dollar on the back of capital outflows. Accordingly, more interest rate increases are in sight; the central bank pointed out that it will "remain focused on withdrawal of accommodation to ensure that inflation remains within the target going forward". We expect additional hikes to be announced at each of the policy meetings in August, September, and December, taking the benchmark repo rate to 5.75% by the end of the year.

Fighting inflation has become a policy priority for the RBI. The policy statement emphasized that calibrated monetary policy action is needed to "keep inflation expectations anchored and restrain the broadening of price pressures". Indeed, the central bank pointed at various uncertainties surrounding the domestic inflation outlook, such as "the tense global geopolitical situation and the consequent elevated commodity prices". Moreover, it noted that persisting supply side price shocks may trigger second round inflationary consequences.

Inflationary pressures have intensified in India and will likely remain elevated for a considerable time. Headline inflation reached 7.8% y/y in April, pushed up by increased materials prices, high logistics costs, and rebounding domestic demand. We forecast headline inflation to remain well above the RBI's inflation target range of 2%–6% until the second quarter of 2023. Meanwhile, the RBI is somewhat more optimistic; it foresees inflation remaining above the 6% target ceiling only until the end of 2022. Regardless, we note that the forecasts are subject to notable uncertainties that reflect food and energy price movements (which together take up over 50% of the Indian CPI basket) as well as the Indian rupee outlook in the context of an aggressive monetary normalization bias in the US. Similarly, India's core inflation—CPI inflation excluding food, fuel, and light—remains persistently elevated, hovering at 7.2% y/y in April. The upward pressures on prices will be partially offset by the government's recent decision to not only reduce excise duties on petrol and diesel, but also freeze domestic fuel prices.

The Indian economy is rebounding, yet it is simultaneously facing various headwinds, such spillovers from geopolitical tensions, elevated commodity prices, supply chain bottlenecks, and tightening global financial conditions. Despite many uncertainties, the RBI seemed confident about the economy's continued recovery. Indeed, sentiment indicators in the country's manufacturing and services sectors point to robust momentum, fiscal policy remains supportive of economic growth, and prospects for urban and rural consumption are favourable. We forecast India's economy to grow by 7% in 2022, virtually in line with the RBI's view that anticipates a 7.2% expansion in the fiscal year 2022–23 (April–March).

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