India's Reserve Bank maintains the pace of tightening

The Reserve Bank of India (RBI) maintained the pace of tightening at its latest meeting, raising the repo rate by 50bp to 5.4%. Further tightening will be needed, but the urgency for such rapid tightening may be diminishing as inflation looks as if it could go lower over the coming months

Reserve Bank of India Governor Shaktikanta Das

5.4% Repo rate

Higher than expected

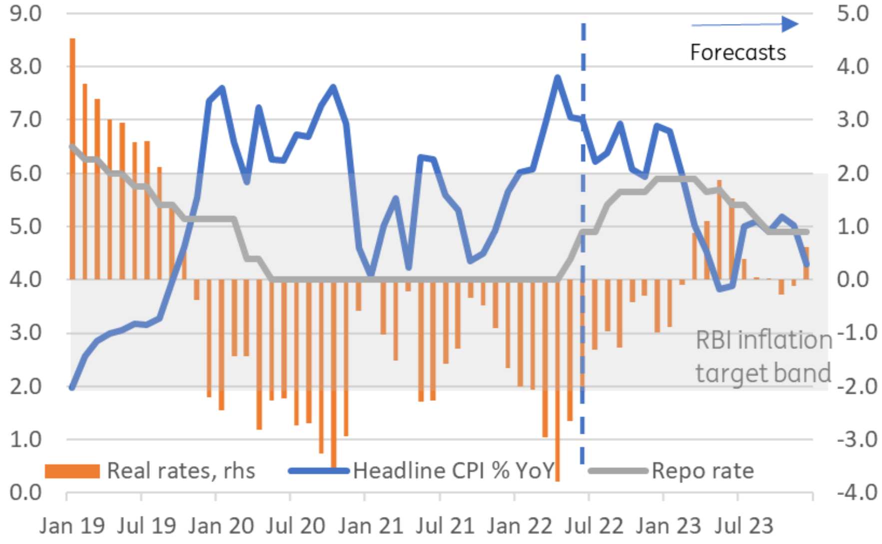
RBI sticks with the 50bp playbook

There was never much doubt that the Reserve Bank of India (RBI) would hike rates at its meeting today. What was in doubt was the amount by which rates would be raised. And in the end, the committee decided to raise the repo rate by 50bp, the same pace as in June, and more than the 35bp consensus view. This takes the policy repo rate to 5.4%.

With inflation currently at 7.0% year-on-year, the monetary policy committee judged that further calibrated removal of accommodation was warranted and all but one of the committee felt that this was likely to be the case at coming meetings as well. But we don't believe that this necessarily needs to be done at quite the same pace.

Recently, there have been some signs that inflation in India is beginning to moderate. Retail gasoline prices have been lowered by the state petroleum companies as crude prices have backed off their highs, and further softness in crude indicates that there may be more of this to come. Global agricultural prices are also much lower than they were a few months ago. So while there is certainly still an argument to take some accommodation away from the demand side of the economy, the supply side looks as if it may be slowly righting itself.

India's policy rates and inflation



Source: CEIC, ING

Destination zero real rates

If the destination for the RBI is to get real rates (policy rates minus inflation) to approximately zero, then continuing at even a 25bp pace over the remainder of the year (in line with our forecasts) should see the repo rate rise to 5.9% by the year-end. By then, we think that inflation will have fallen to about 6.5%. That still leaves a gap of about 60bp, but that can be closed later in 2023 when further moderation in inflation should deliver approximately zero real rates by early 2023, and possibly a small positive real rate, which would be consistent with gently squeezing remaining inflation out of the system. This would also be consistent with the RBI's aim to remove accommodation while at the same time "supporting growth".

If this is the path the RBI takes, then there are certainly some risks that need to be acknowledged. The main one of which is that inflation doesn't come down as both we and the RBI expect. This would ultimately require a bigger and more prolonged period of tightening to counter rising inflation expectations and more deeply embedded inflation than currently exists. But equally, by taking its time, the RBI would be giving the economy the best chance it can have to keep growing and supporting employment as it addresses the imbalances reflected in excessive price growth. With the support of growth mentioned twice in the RBI statement, we think this is consistent with a further 25bp of tightening at the September and December meetings.

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