RBI POLICY

Global winds may alter RBI's course

India Equity Research | Economy & Strategy

Recent developments in the global economy are likely to have a meaningful bearing on RBI's macroeconomic assessment and policy action when it meets in September. Sharp fall in global commodity and crude oil prices go a long way in addressing the central bank's key concerns—inflation and fiscal deficit. Besides, mounting downside risks to global growth mean that domestic policymakers will have to be proactive and agile, especially when impact of past monetary actions is yet to be fully felt in the economy. Accordingly, in our view, chances of another 25bps hike in repo rate have dimmed substantially.

The global macroeconomic and financial markets environment has turned highly uncertain, given the developments in US and Europe, since RBI's last 50bps hike in repo rate in mid-July. The central bank's rationale for aggressive move and hawkish guidance had hinged on the following assessment:

1) **Inflation**: Strong demand pressures, higher commodity prices and recent hike in administered fuel prices were expected to keep inflationary pressure at an elevated level.

2) **Growth**: Despite some moderation, there is no sharp or broad-based slowdown so as to impact demand meaningfully.

3) **Fiscal spending**: Surge in fiscal spending due to higher subsidies bill (fueled by high crude prices) is leading to resilient consumption demand.

We believe recent developments in the external environment may have a meaningful bearing on Mint Street's assessment of the domestic macro environment when it meets next in September. First, falling commodity and crude prices will significantly reduce inflationary pressures in the economy. As per our estimate, imported inflation (from energy, metals etc.) is contributing a substantial ~ 41% to headline inflation currently. With easing commodity prices, one should expect meaningful reduction in imported inflation and as input prices ease, so would the pressure on output prices.

Second, persistently high crude prices were posing an upside risk to India's fiscal deficit through higher fuel and fertilizer subsidies. With sharp fall likely in crude prices (Indian crude basket has corrected ~12% in August itself), the recent hike in domestic retail fuel prices should help contain government's oil and fertilizer subsidy bill. This should be quite comforting for the central bank.

Third, downside risks to global growth have heightened and past experience indicates that India is linked to the global economy through trade, capital flows and sentiment channels. Indeed, currently, India's macroeconomic environment is characterized by unusually strong exports, weak investment sentiments and considerable reliance on external financing e.g., ECB. If the global environment weakens, exports will slowdown, sentiments could worsen and capital inflows could get disruptive.

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In such an environment, policymakers will have to be proactive and agile. RBI has acknowledged in a recent statement that “downside risks to growth may have increased in the wake of global development”. We believe that the policy rates are already at restrictive level, the impact of past monetary actions is yet to be fully felt and the growth–inflation outlook is changing rather rapidly. Accordingly, chances of a rate hike in September policy meeting have dimmed substantially.

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