Upside inflationary risks may see interest rate hardening by year end

As anticipated, the Reserve Bank of India mainted “status quo” on key interest rates with a cautious note on rising inflationary pressures. Since the announcement of the last monetary policy meeting, significant changes have been observed in the domestic and the international environment. Global economic activity has continued to gain momentum, especially finer prints have become visible across US and Euro area with unemployment marking gradual deductions. Domestically, there have been reasons to cheer with healthier production prints and significant improvement in manufacturing growth, especially a healthy pick up in capital goods. Inflation numbers have eased over the last months and with a likely deceleration in March data, inflation is expected to be wthin RBI’s 4% medium-term target for FY 2017-18. The larger than expected softening in the recent month came primarily on the back of a slowdown in the more volatile food price inflation. Basis expectations of normal monsoon and effective supply management, overall food inflation is expected to remain in comfortable range and may contain possible increase in prices emanating from crude price hike as well as uptick in domestic demand, at least to some extent. However, the overall mark-up on inflation on average remains high on anticipated lines. Recognizing this, the inflation projections for the coming year have been revised downwards against the estimations made in Feb’18 to 4.7-5.1% in H1FY 2018-19 and 4.4% in H2.

More clarity is needed from data perspective as positive shoots in the statistics possibly remain affected by favourable base impacts and to some degree may be a result of restocking. In the period ahead, a relatively higher base is expected to cushion against higher inflationary readings and as such we believe that the RBI is likely to assess such statistical effects while making monetary policy adjustments. The projected easing in inflation in the second half of the coming fiscal should prompt the MPC to stay on hold. Further, the 10-year yield have remained at elevated levels and risks of a larger fiscal deficit may dissuade from a rate hike, at least until the market corrects itself. Despite the positive news on the food inflation front and the likely moderation in the coming period, we believe that inflationary pressures remain tilted to the upside. As such, inflation in FY 2018-19 is expected to hover around the 5% mark with projected risks from fiscal slippage, higher input costs and MSP hikes. Separately, financial sector volatility passing through uncertainty in US mormalization policy and brewing trade wars are likely to becoming cause of further tension. These disruptions are likely to create disrutions in domestic capital markets and may possibly yield negative results for domestic trade activity. That said, inflation expectations in the period ahead will possibly be determined by oil price movement, impact of minimum support prices (MSP) inclusion, fiscal slippage as GST collections remain low, rising input costs, and monsoon forecasts. A greater challenge would be for the RBI to correctly set policy sentiments in the coming period as higher yields, inflationary pressures and election cycle in India and US both are likely to lead to market volatility.

Given the outlook on crude oil prices and domestic inflation risks, the committee is likely to take a more hawkish stance in the months to come. Rising crude oil prices on the back of further output cuts is expected to remain a key inflationary risk while the incoming signals of further policy tightening in the US should impact domestic policy decision. Overall, the RBI is expected to take note of building inflationary pressures despite a likely reduction in food inflation while altering interest rates. Given these conditions, we would like to reiterate that risks on monetary policy are tilted to the upside and an interest rate hike may come through toward the end of the year.

Information for the editor for reference purposes only

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