APAC Economic Comment

India: RBI looks into 2017, cuts more than expected

Economics

India

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Repo rate cut 50bps, still looking for RBI repo rate of 6.5% by end FY 2015-16

RBI Governor Rajan pointed to the weaker external environment as a key reason for reducing policy rates 50bps at today's policy review (against UBS and consensus forecasts of a 25bps cut). However, the Governor also stressed the front loaded nature of the easing and a switch to focusing on the transmission mechanism of policy easing to bank lending rates. As such a further policy rate cut in December seems unlikely but we do still see room for further policy rate cuts in February 2016 and during FY 2016-17. We continue to project a repo rate at 6.5% come end FY 2015-16 and 6.0% come end FY 2016-17, down from 6.75% after today's policy decision.

Inflation focus switches to 2017, lower UBS inflation forecasts

As expected, the Governor switched the intermediate goal for inflation to 5% CPI inflation in March quarter 2017 from 6% in January 2016. This is consistent with the inflation target of 4.0% in FY 2018-19. The RBI judged the inflation target for early 2016 would be met and that 5% inflation in early 2017 was achievable. We continue to agree. Moreover, lower than we expected commodity prices lead us to reduce our near term CPI inflation trajectory: we lower our March quarter 2016 inflation projection from 6% to 5.5%). Our March quarter 2017 inflation projection remains 4.2%, below the RBI's central tendency projection of 4.8%. Accordingly we project inflation of 5.0% in FY 2015-16 and 4.6% in FY 2016-17 versus 5.3% and 5.0% previously. Our long held view that inflation can be brought down towards 4% is predicated on i) political priorities; ii) RBI policy goals; iii) below potential growth; and iv) a subdued monetary environment associated with balance sheet repair (see also link, link and link).

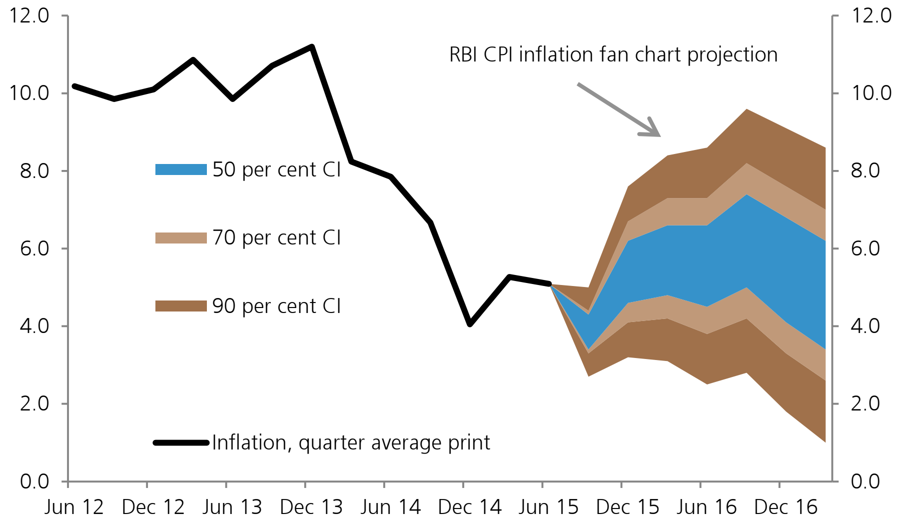
Real rate math implies room to cut next year

In the policy statement the Governor argued one year expected Treasury Bill real interest rates of about 1.5-2.0% are appropriate for this stage of the recovery. That was reconciled with the nominal repo rate of 6.75% by taking the RBI inflation forecast in one year of 5.0-5.5% and a repo rate to T-Bill spread of 25bps. Because both the RBI and ourselves expect inflation to drop below 5% in 2017, space for further policy rates should open up on a 6-12 month view even if the 'appropriate' real interest rate edges higher with some improvement in real GDP growth momentum. However, we also take note of Mr Rajan's views, reiterated in the Monetary Policy Report, that while investment needs to be kindled it is structural reform that needs to play a leading role and that monetary policy should not be the primary actor. Those longstanding views combined with the comments at the press conference that policy cuts had been 'front loaded' and the imminent focus would be on ensuring monetary transmission lead us to expect no further policy rate cut at the December policy review.

More structural reforms

In addition to easing policy more than expected the RBI also introduced a series of financial sector reforms and implied more to come. Specifically the Governor seemed to expect further regulatory moves as part of co-ordinated policies with the government and banks to improve monetary policy transmission to lending rates. The incremental liberalisation announced today included i) a framework for increasing foreign participation in the bond market through March 2018; ii) a trend reduction in the Statutory Liquidity Ratio (i.e. the required holding of government approved assets by banks); iii) permission for Indian corporates to issue rupee 'Masala' bonds in overseas markets (subject to restrictions); iv) reduced restrictions on G-Sec trading; and v) reduced documentary requirements for OTC FX hedging transactions. These are all consistent with the general trend towards a more liberal Indian economy in recent years. A growth positive trend we expect to continue.

Figure 1: RBI inflation projection



Source: UBS, RBI

RBI expects inflation to rise into year-end as favourable base effects wear off. The underlying disinflationary process the RBI (and UBS) believes is underway in India is then to drive inflation lower over the subsequent year.

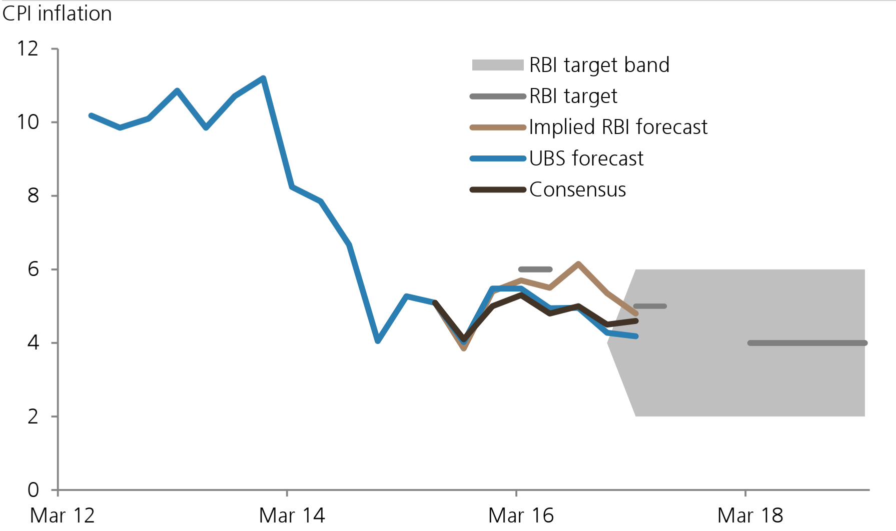
Figure 2: RBI sensitivity analysis

Scenario	
Exchange rate movement	RBI econometric model estimates a 10% depreciation in the rupee versus the US dollar could lead to 20-30bps increase in headline inflation over two to four quarters, while boosting growth (with a lag) by 10bps.
Global growth slowdown	RBI assumes global real GDP growth of 3.3% in FY 2015-16. One percent lower global growth is estimated to reduce India's real growth by 20-40bps versus baseline. Associated fall in commodity prices could lower inflation by 10-20bps.
Food price pressures	Deficient SW monsoon already in RBI forecasts. Successful supply management could result in inflation 100bps below baseline in 2015-16. Worse than expected crop yields could reduce growth by 30-40bps and add 100bps to CPI inflation.
Oil price uncertainties	RBI assumes Brent Oil at USD 50 a barrel in H2 FY 2015-16. If oil prices settle at USD40 a barrel instead, inflation could be 20-30bp lower in March 2016 and growth about 10bps higher. If supply pressures push oil to USD 70 then inflation could be 40bps higher and growth 20bp lower over same timeframe.
Boost to investment	Data shows acceleration in public investment. If sustained, and private investment crowded in, then real GDP growth could be 50bps higher than baseline with little impact on inflation due to negative output gap.

Source: UBS, RBI

The RBI's inflation projection depends on a number of assumptions. The RBI assumes real GVA growth of 7.3% in H2 FY 2015-16 for a full year average of 7.4%. This, the RBI believes, is consistent with sustained excess capacity in the Indian economy. UBS assumes weaker growth of 7.1% and greater excess capacity than the RBI. This table presents the RBI's assessment of the risks to its forecast.

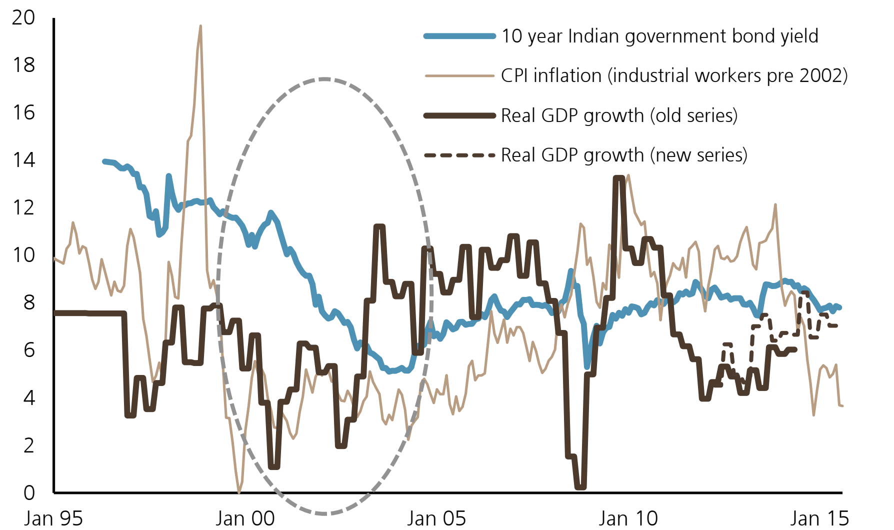
Figure 3: Now everyone believes the RBI



Source: UBS, RBI, Bloomberg

In April 2015 (link) we asked whether consensus believed the RBI. Then the consensus for CPI inflation was 5.7% in December 2016. Now the consensus for the same period is 4.5%. Consensus almost believes RBI's inflation targeting prowess even more than the RBI.

Figure 4: First inflation down, then growth recovery



Source: UBS, CEIC, Haver

Near term, muted growth (relative to expectations) and balance sheet repair continue to put downward pressure on inflation. A sustained downtrend in inflation will ultimately allow a downshift in the yield curve. As was the case in the early 2000s, that should help balance sheet repair and set the stage for a medium term recovery in growth.

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