

Economic Analysis

Lower-than-expected September inflation does not signal an imminent policy rate cut

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India's benchmark CPI inflation softened to a near three year low of 6.5% y/y in September (Consensus: 7.0%), compared to 7.8% y/y in August. Meanwhile, wholesale price inflation (WPI) retreated to 2.4% y/y in September from 3.7% y/y in the previous month. The extended downtrend in CPI inflation was led by favorable base effects, lower food inflation and waning price pressures across service-oriented segments such as 'transport and communication' and 'household requisites'. Core CPI inflation dropped sharply to 5.9% y/y from 6.8% y/y in August, pointing to weakening purchasing power in the economy.

RBI is hawkish on inflation risks: For the Reserve Bank of India, which has been aggressive in its anti-inflation drive since last year; and has raised policy rates by three times with a cumulative 75 bps since September 2013 to 8.0%, the extended inflation downtrend is reassuring. At current levels, headline CPI inflation remains well within RBI's desired glide path of disinflation at 8% y/y by January 2015, with sharply eased core CPI, sluggish global crude oil prices and the stable exchange rate of rupee. Nevertheless, India's near term inflation trajectory remains clouded by significant unfavorable base effects during Dec '14 – Feb '15 and upside risk to food inflation from a deficient summer crop. In its recent policy meeting on September 30th, RBI flagged that India's medium term inflation risks are still to the upside and *'future monetary policy stance will be influenced by the Reserve Bank's projections of inflation relative to the medium term objective (6% y/y by January 2016), while being contingent on incoming data'*.

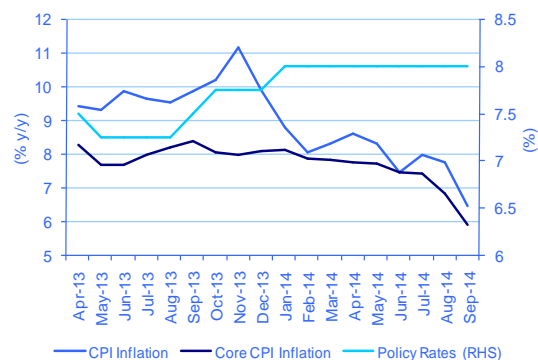
RBI is unlikely to cut interest rates anytime soon: Given RBI's focus on achieving its medium term inflation target and its check for sustainability of the ongoing inflation downtrend, we now expect RBI to deliver its first interest rate cut in 2Q15 against our previously projected rate cut in 4Q14. We maintain that an interest rate cut would serve largely as a signal rather than a precondition to revive India's still sluggish growth. Industrial production growth during July-August 2014 has been dismal at 0.5% y/y (+4.4% y/y in Q3). Effective government action in building infrastructure capacity and enhancing energy security is critical for sustaining high growth in India. We expect India's GDP growth to improve gradually from 5.3% y/y in 2014 to 5.8% in 2015 led by a step up in investment activity and an improving external demand.

Figure 1
India's September CPI inflation extends downtrend led by a broad based let up in prices

% Change Y/Y	India CPI Inflation				
	Weight	Sep-14	Aug-14	Jul-14	Jun-14
Consumer Price Index (CPI)	100	6.5	7.7	8.0	7.5
Food	50	7.6	9.1	9.1	8.0
Fuel	9	3.5	4.2	4.5	4.7
Clothing	5	7.6	8.4	8.7	8.6
Housing	10	8.1	8.5	8.9	9.1
Services	26	4.7	5.9	6.6	6.5
Core CPI (Ex food and fuel)	41	5.9	6.8	7.4	7.4

Source: BBVA Research

Figure 2
RBI to maintain status quo for a longer while given medium term upside risks to inflation



Source: BBVA Research

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