Economic Analysis

RBI expected to cut policy rates next month as India stands to benefit from falling oil prices

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India's benchmark CPI inflation rose at a slower-than-expected pace last month at 5.0% y/y (Consensus: 5.3%), after easing to 8 year low of 4.4% in November 2014 (Table-1). The pick-up was mainly led by an unfavorable base effect and higher food inflation. This brings India's full year 2014 CPI inflation to 7.2% y/y (BBVA est.: 7.3%) from 10.1% in 2013. Reassuringly, core CPI inflation corrected further to 5.2% y/y (5.5% previously), reflecting weak consumer purchasing power; and underscores our expectations of a 25 bps policy rate cut (benchmark repo rate at 8.0% currently) at RBI's next meeting on 3rd February.

Looking ahead, assuming oil prices remain stable, we project headline CPI inflation to average 6.0% y/y for full year 2015. Risks to inflation are broadly balanced, on the upside by - existing wage rigidities and an unfavorable base effect; and on the downside by - well anchored inflation expectations, a benign commodity price outlook and the government's efforts to ease domestic supply side bottlenecks across food and energy.

As a net oil importer, India stands to benefit from the sharp fall global crude oil prices: We expect the near 50% fall in international oil prices since June 2014 to – 1) foster a benign inflation environment in India, 2) lift real incomes of households, 3) reduce input costs for domestic industry, in turn abetting profitability and investments, 4) aid external balance (about 31% of India's total imports are oil imports), 5) provide scope for the government to augment fiscal space through energy subsidy reforms (Figure–1), in turn boosting productive spending; and 6) enhance room for RBI to exercise growth supportive rate cuts. The real income effect is particularly pronounced for an energy intensive economy such as India whose share of oil consumption in GDP is high at 7.5% (3.8% for the US). That said, domestic currency weakness alongside successive hikes in excise duties on petroleum products have led to an incomplete pass-through of falling oil prices to consumers (Average gasoline prices in India have fallen 14% since June 2014).

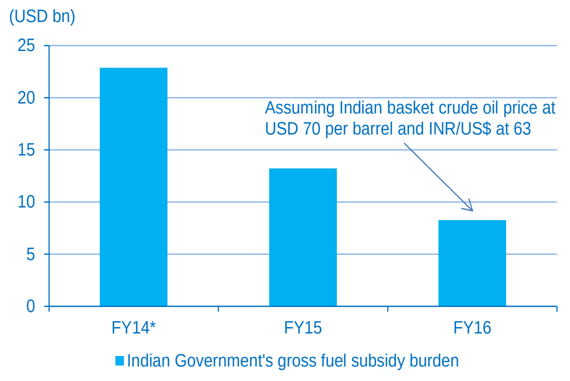
Estimating India's trade balance sensitivity to falling oil prices. Our regression model (See Chart-2 footnote** for details) suggests a 0.46 percentage point improvement in India's trade balance (as a percent of GDP) following a 10% fall in the price of Brent crude.

Table 1
Headline CPI inflation picks up while Core eases

	India CPI Inflation				
% Change Y/Y	Weight	Dec/14	Nov/14	Oct/14	Sep/14
Consumer Price Index (CPI)	100	5.0	4.4	5.5	6.5
Food	50	5.1	3.6	5.7	7.6
Fuel	9	3.4	3.4	3.4	3.5
Clothing	5	6.5	6.9	7.4	7.6
Housing	10	7.8	7.9	8.1	8.1
Services	26	4.0	4.2	4.7	4.7
Core CPI (Ex food and fuel)	41	5.2	5.5	5.9	5.9

Source: BBVA Research, CEIC

Figure 1
Reforms, falling oil, to cut India's subsidy burden



* Fiscal Year ending-March; ** Our trade balance sensitivity model regresses oil imports on nominal effective exchange rate, Brent price and aggregate imports; Source: BBVA Research, CEIC

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