Economic Analysis

# Softer march CPI inflation reassures RBI's policy stance, raises scope for further rate cut

Sumedh Deorukhkar / Le Xia

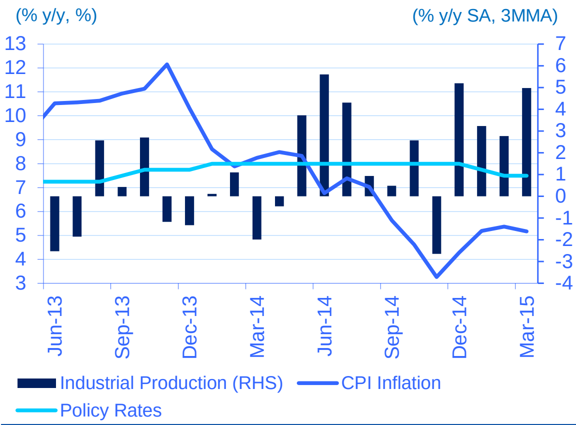
India's March CPI inflation outturn echoed ongoing disinflationary momentum across the economy and provides comfort to RBI given its present accommodative policy stance. The latest CPI outturn edged lower to 5.2% y/y compared to 5.4% y/y in February (BBVA Est.: 5.2%, Consensus Est.: 5.4%), led mainly by a broad-based let up in food inflation, which has a 46% weight in CPI, besides a pass through of slumping international crude oil prices into transport and communication. Core inflation, which excludes food and fuel, held steady near record low of 3.8% y/y as weak demand pressures and well anchored inflation expectations cause a gradual cool off in housing prices and softer services inflation.

Looking ahead, the Government's ongoing efforts to offset the effects of recent hailstorms and untimely rains on food crops by adequate supply side measures will determine CPI inflation trajectory in 2Q15. We expect CPI inflation to pick-up marginally this quarter, led largely by a gradual improvement in final demand, although staying well within RBI's comfort target of below 6% (BBVA Est. 5.6% y/y vs. 5.3% y/y in 1Q15).

**Room for another policy rate cut but don't expect aggressive easing in 2015.** RBI decided to maintain status quo on interest rates at 7.5% (benchmark repo) in its last credit policy on April 7th. It cited the need to wait and watch while the previous two front-loaded interest rate cuts fully transmit into lower bank lending rates. The transmission mechanism has not really worked quicky enough so that borrowing rates are now in accordance with such cuts; and this is despite a weak credit offtake. Looking ahead, given existing growth inflation dynamics, we expect another 25 bps policy rate cut as early as by June. However, room for further policy easing in 2015 is limited and contingent on 1) the extent of global financial market volatility ahead of imminent Fed rate normalization, 2) Government's progress on fiscal reforms and in easing food and energy supply bottlenecks and 3) the nature of monsoon rains starting June-July.

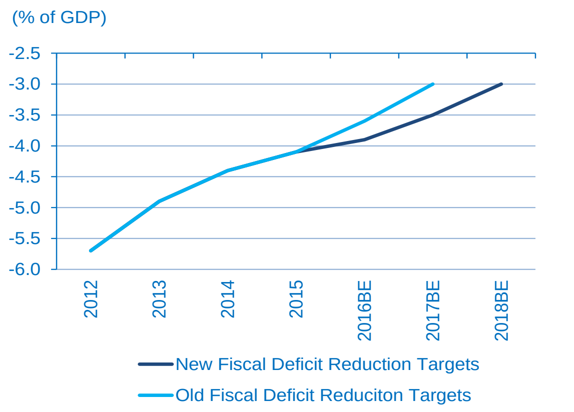
**India much better prepared for imminent Fed rate normalization.** India's improving fundamentals hold it in good stead against the imminent Fed interest rate lift off although a short term knee jerk reaction to local financial markets cannot be discounted. Unlike the QE taper tantrum in May 2013, India, today, is much better equipped to handle global financial volatility given its record high FX reserves at USD 343 bn, narrowing current account deficit and ongoing policy reforms. The outlook for growth is gradually improving with real GDP growth estimated at 7.6% y/y in calendar year 2015 compared to 7.2% last year.

Figure 1
**Indian economy is in a sweet spot amid easing inflation and gradually improving growth…**




Source: BBVA Research, CEIC

Figure 2
**… but, Government's fiscal consolidation efforts will be a key for incremental RBI policy easing**




*Fiscal year ending March; Source: BBVA Research, CEIC