Economic Analysis

RBI eases interest rates by 50 bps, steps up financial market reforms

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The Reserve Bank of India today provided a shot in the arm to a gradually recovering Indian economy by cutting the benchmark policy interest rate, the repo rate, by 50 bps to 6.75%. RBI's decision positively surprised consensus expectations (25 bps cut) while we expected RBI to maintain status quo until January 2015 in light of upside inflation risks emanating from deficient monsoon rains and the lack of transmission by banks from interest rates cuts earlier in the year (30 bps fall in lending rates for 75 bps policy cut). However, RBI emphasized that prudent food supply management by the government has helped contain inflation pressures arising from a deficient monsoon, while further transmission of lower borrowings costs by banks is possible amid easy liquidity conditions across domestic markets.

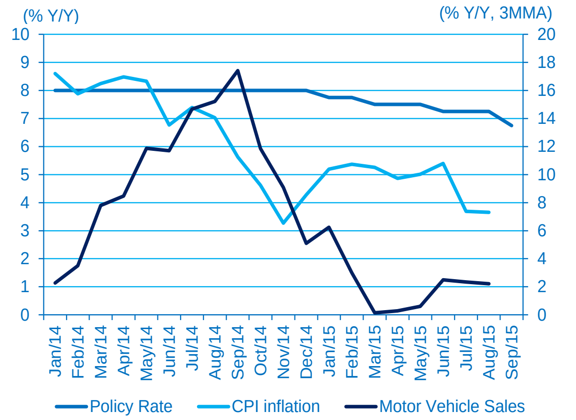
RBI's rate cutting cycle is not over yet: RBI noted that today's policy action was front loaded and its stance going forward will continue to be accommodative but contingent on two main factors, 1) banks passing the bulk of cumulative 125 bps rate cut since January 2015, and 2) the economy's ability to remain on the target disinflationary path. On the latter, CPI inflation has currently dropped to a nine month low and is on track to achieve RBI's downwardly revised 5.8% y/y target for January 2016. However, the Central Bank would be cognizant of upside inflation risks emanating from an unfavorable base effect starting September and the government's ability to pro-actively manage supply to contain food price pressures. These risks are particularly more relevant for RBI in achieving its FY17 (fiscal year ending March 2017) inflation target of 5.0% y/y, which has now come center stage for RBI. Furthermore, the Fed's delayed lift off to the end of 2015 and its implication on global financial stability would also be a key input in RBI policy decision tool kit going forward. Against this backdrop, we believe that RBI's rate cutting cycle is not yet over although the central bank would likely maintain status quo at its next policy meeting on December 1st 2015.

RBI tempers India's FY15 growth target to 7.4% y/y from 7.6% previously (BBVA: 7.4%): Governor Rajan noted that India's economy recovery was far from robust amid a protracted contraction in exports growth, deficient rains, weaker than expected momentum in industrial production and investment activity, weak asset quality of banks and subdued business confidence. These concerns would continue to weigh on India's GDP growth, partly offsetting upside stimulus from stimulative monetary and fiscal policy, disinflation, easy liquidity conditions and government efforts to de-clog stalled projects.

RBI goes full throttle on financial market reforms: Alongside today's monetary policy decision, the RBI in consultation with the government today announced a series of measures aimed at 1) strengthening India's Banking Structure, 2) deepening domestic debt securities market, both across government and corporate debt segment, 3) diversifying participation in the currency futures market, 4) expanding eligible currency pairs for exchange traded currency derivatives, and 5) enhancing the use of technology to further financial inclusion and a move towards a 'cash less' society by putting forth a concept paper on card acceptance infrastructure in the country.

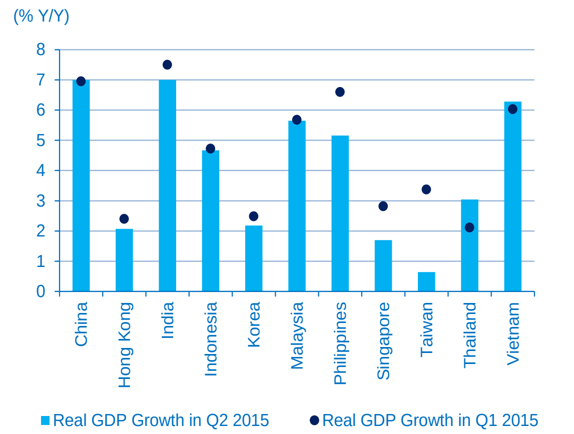
Easier and more predictable norms for investments by foreign portfolio investors in India's debt securities: RBI has announced a clear medium term framework for foreign portfolio investment limits in India's debt securities. In aggregate terms, the new policy has opened room for additional Rs. 1200 billion (USD 181 million) in the limit for central government securities and an additional Rs. 500 billion (USD 75 million) in state development loans by March 2018.

Figure 1
RBI cuts policy repo rate by 50 bps to stimulate subdued investment activity amid benign inflation



Source: BBVA Research, CEIC

Figure 2
India's Q2 GDP growth amongst highest in region but domestic demand is still far from robust



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