India Flash

RBI leaves rates unchanged, but cuts the cash reserve ratio as government acts on reforms

As expected, the Reserve Bank of India (RBI) today left its key repo rate unchanged at 8.0% in light of persistent inflation, but reduced the cash reserve ratio (CRR) by 25 bps to 4.5% to help ease liquidity and lower funding costs for banks. In its policy statement, the RBI reiterated that sustained policy actions by the government, as seen last week (details below), will be needed to provide room for monetary policy easing to support growth. We expect another 50 bps of cuts in the repo rate during the rest of the year, to 7.5% with growth averaging at 5.6% y/y for 2012.

- **Government hits the right notes on investment reforms.** After almost a two year long hiatus in policy reforms, the Indian authorities got their act together last week as they initiated significant reforms in the fiscal and investment space. These include; 1) hikes in regulated fuel prices 2) permitting partial foreign direct investment in multibrand retail (up to 51%), civil aviation (49%), broadcasting (74%) and power (49%), and 3) divestment in four state owned undertakings. Opening of the multibrand retail sector had been delayed last year, and was a notable sign of policy paralysis that had dented investor confidence.

- **Positive implications but growth weakness to persist.** While growth momentum remains weak, the recent policy measures should cushion the slowdown by boosting sentiment, contributing to greater capital inflows and over the long run lead to higher productivity, particularly in the food supply chain. Big portfolio flows also bode well for investments in other sector's, raise additional funds for capital expenditure, strengthen the rupee and improve India's weak external balances.

- **Policy reversals remain a key risk ahead.** Cues from the past suggest evident risk of partial policy rollback, particularly in bolder measures such as FDI in retail and the price hike in regulated fuel. That said, the stronger consensus within government to revive flagging growth this time around raises hopes of full scale implementation. Going ahead, the recent measures further action on a variety of important issues including addressing coal shortage issues, significant steps to improve the fiscal deficits, timely implementation of goods and services tax and direct tax code and addressing governance issues.

Chart 1
Cut in cash reserve ratio to help ease funding pressures for banks, enabling a reduction in elevated lending rates

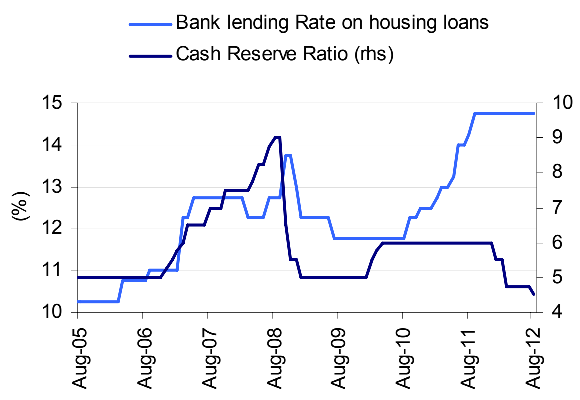
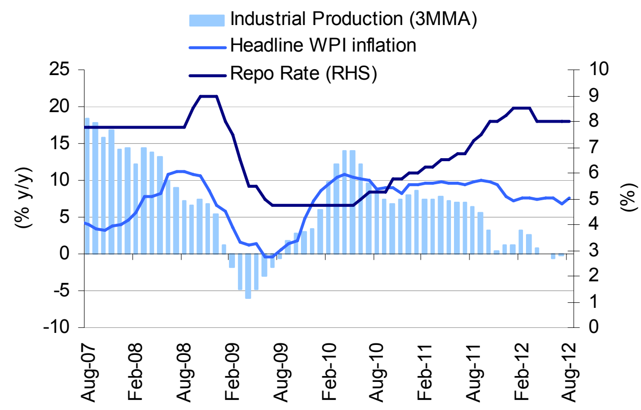


Chart 2
Fiscal reforms provide greater headroom for RBI to address weakening growth prospects despite high inflation



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