Economic Analysis

Inflation cools while industry sputters – How, why and when will RBI respond?

Sumedh Deorukhkar / Le Xia

High inflation has severely undermined India's economic growth since 2012, prompting RBI to unveil a series of aggressive interest rate hikes and adopt inflation targeting as its monetary policy regime. Reassuringly, the past six months have seen inflation pressures dissipate beyond RBI's expectations, raising the clamor for the RBI to cut policy rates to aid the weakening industrial activity.

Inflation cools while industry sputters. Benchmark CPI inflation decelerated further in November to 4.4% y/y, its lowest since April 2006, compared to 5.5% in October, while core CPI inflation corrected to 5.5% y/y from 5.9% in October. The broad-based let up in price pressures was driven mainly by weakening demand, favorable base effects, a seasonal decline in vegetable prices and the second round effects of the sharp fall in global crude oil prices. Separately, industrial production (IP) slumped -4.2% y/y in October (+2.8% in September), attributed in part to the post festive season production lull, although the sharp contraction in consumer durables (-35% y/y) suggests significant erosion in consumer purchasing power.

Although still wary of premature policy easing, last policy meeting saw RBI signal likely rate cuts early 2015. RBI has long cautioned against premature policy easing that could re-stoke demand-led inflation and jeopardize the incipient recovery underway. However, at its December 2nd credit policy, RBI maintained status quo but noted that rate cuts were likely early next year if current inflation momentum continues. Furthermore, the central bank lowered its CPI inflation forecast for March 2015 to 6% y/y from 8.0% previously.

While we expect RBI to ease policy rates by 25 bps at its next meeting on February 3rd 2015, a surprise pre-policy cut cannot be discounted. Looking ahead, we believe that near to medium term inflation risks are broadly balanced with CPI inflation expected to stay within RBI's target band of 4% (+/-) 2% in 2015. Notwithstanding an unfavorable base effect and risks of sub-normal monsoon rains next July, we believe that ongoing disinflationary momentum is quite strong, characterized by soft crude and other commodity prices, fiscal consolidation, limited adjustments to administered prices, and weak wage growth. Against this backdrop, we expect RBI's next policy move to be a 25 bps rate cut to 7.75% for the repo rate, announced either at its next meeting on February 3rd 2015 or even earlier, as a pre-emptive measure to address downside growth risks. The December inflation outturn, which releases mid-January 2015, will be a key input for RBI in timing its next policy move.

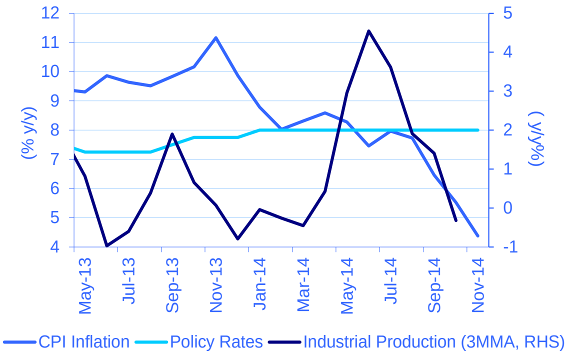
An interest rate cut at this juncture would serve largely as a signal rather than a precondition to revive India's sluggish growth. Monetary policy transmission will likely remain weak. Despite comfortable liquidity conditions and the sharp fall in monetary market rates since August 2014, Indian banks are yet to lower lending rates. A rate cut at this stage, is thus unlikely to ignite a boom in credit growth. We expect RBI to cut policy rates by a cumulative 50-75 bps in 2015. As underscored by the RBI recently, "*A durable revival of investment demand continues to be held back by infrastructural constraints and lack of assured supply of key inputs, in particular coal, power, land and minerals".* Against the backdrop of ongoing Government efforts to expedite stalled infrastructure projects and unlock resources to finance the investment push, we expect India's GDP growth to improve gradually from 5.3% y/y in 2014 to 5.8% y/y in 2015.

Figure 1
Sharp deceleration in inflation since August 2014, led by easing food price pressures

India CPI Inflation					
% Change Y/Y	Weight	Nov/14	Oct/14	Sep/14	Aug/14
Consumer Price Index (CPI)	100	4.4	5.5	6.5	7.7
Food	50	3.6	5.7	7.6	9.1
Fuel	9	3.3	3.4	3.5	4.2
Clothing	5	7.0	7.4	7.6	8.4
Housing	10	7.9	8.1	8.1	8.5
Services	26	4.3	4.7	4.7	5.9
Core CPI (Ex food and fuel)	41	5.5	5.9	5.9	6.8

Source: BBVA Research, CEIC

Figure 2
Expect RBI to cut policy rates at its next meeting, or even earlier to aid weakening industrial activity



Source: BBVA Research, CEIC