

## 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 2<sup>nd</sup> 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 3<sup>rd</sup> 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 3<sup>rd</sup> 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.

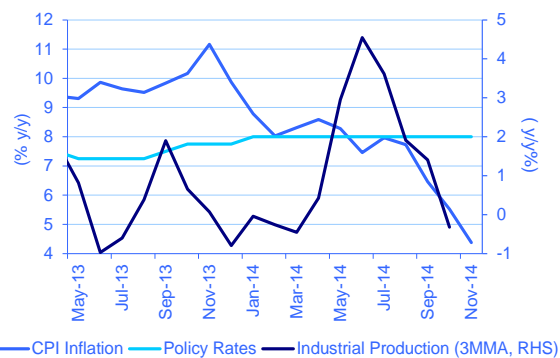
**An interest rate cut at this juncture would serve largely as a signal rather than a precondition to revive India's sluggish growth.** Monetary policy transmission will likely remain weak. Despite comfortable liquidity conditions and the sharp fall in monetary market rates since August 2014, Indian 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**

% Change Y/Y	India CPI Inflation				
	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
<b>Core CPI (Ex food and fuel)</b>	<b>41</b>	<b>5.5</b>	<b>5.9</b>	<b>5.9</b>	<b>6.8</b>

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

**DISCLAIMER**

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes. BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents. This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.