Economic Analysis

RBI cuts 25 bps, lifts liquidity; expect to cut more

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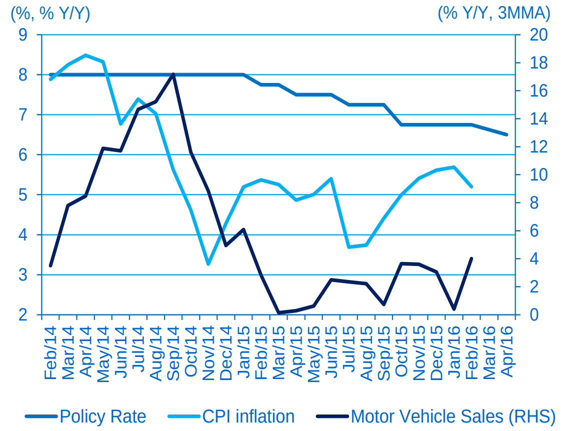
The Reserve Bank of India today cut its benchmark repo rate by 25 bps to 6.5%, in line with expectations; and positively surprised by boosting and streamlining liquidity in the Indian banking system. RBI's latest rate cut is aimed mainly at reviving weak private investment in the face of low capacity utilization, and aiding government's ongoing efforts to stimulate economic growth. In addition, a refined liquidity management framework aims to bolster bank credit to productive sectors in the wake of tightening financing conditions.

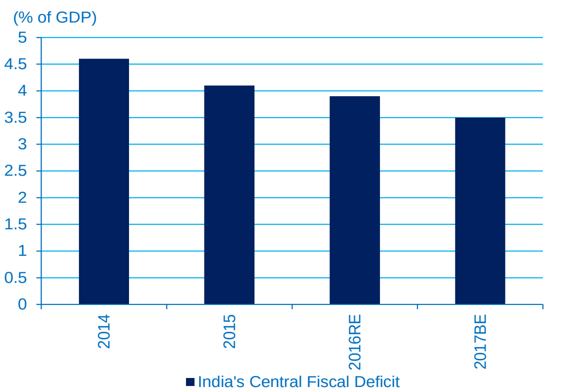
Looking ahead, we think RBI's rate cutting cycle isn't over yet with a one last 25 bps rate cut expected at its next meeting on June 7th. Inflation expectations have declined and CPI inflation remains well anchored at around 5.0% y/y with the balance of risks slightly tilted to the downside. India's growth prospects, meanwhile, are subject to downside risks in the wake of tepid global growth, a muted capex cycle at home and a relatively weak domestic banking sector. Led by a supportive fiscal and monetary stance, we peg India's real GDP growth for FY17 (year ending March 2017) at 7.6%y/y, marginally up from 7.5% y/y in FY16.

Figure 1
RBI cuts policy repo rate by 25 bps to stimulate growth as inflation remains well anchored and…



Source: BBVA Research, CEIC

Figure 2
… Government's fiscal consolidation commitment create much needed room for RBI to ease



Source: BBVA Research, CEIC

The lack of 'Policy transmission' remains a pressing concern for RBI: Today's credit policy re-emphasized the need to ensure that current and past policy rate cuts fully transmit to lending rates. RBI today introduced measures to ease liquidity management for banks by cutting minimum daily maintenance of Cash Reserve Ratio to 90% from 95%. Further, RBI aims to narrow the policy corridor to 50 bps from 100 bps while progressively lowering the average banking system liquidity deficit to neutral from deficit mode through timely open market operations and market repo transactions. Past policy rate cuts (150 bps so far over the past year) are yet to be fully transmitted by banks in India. Recent efforts by the RBI to push banks lower lending rates such as reduction in small savings rates and a shift towards marginal cost of funds based lending rates for banks have been fairly successful in bridging the policy transmission gap.

Improved sync between monetary and fiscal policy is aiding India's growth prospects: We believe that the Indian government's focus on incremental yet progressive policy reforms, productive public spending and addressing supply side inflation concerns while adhering to fiscal consolidation has helped create necessary room for RBI to maintain its accommodative policy stance in a challenging macro backdrop.

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