India: RBI Monetary Policy Review

Key Facts

- **RBI trimmed its key policy rate – the repo rate – by 25bp to 7.75% as expected.**
- **Less expected, RBI also cut the CRR by 25bp to 4% to add inter-bank liquidity.**
- **RBI's policy statement signals that there is limited policy 'space' for more ease.**
- **A prudent Union Budget next month should enable RBI to cut again in March.**

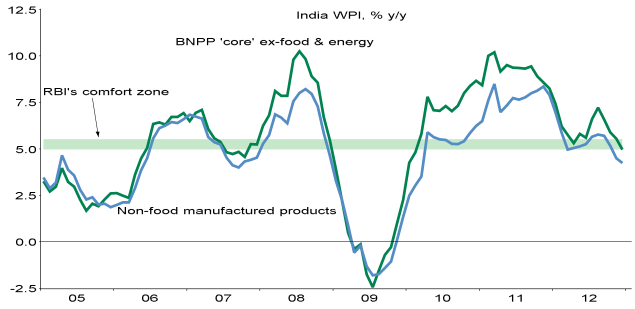
RBI nudged down its key repo rate as expected; the first reduction in the policy rate since last April. The accompanying statement made plain that clear evidence of fading demand-pull inflationary pressures allied to the government's continued reform push has been key in opening up limited policy 'space' for RBI to resume nudging policy rates down. Still high inflation expectations and the yawning current account deficit remain constraints on action, however. Provided that the Finance Minister delivers the prudent Union Budget he is promising next month, the benign short-term inflation outlook should allow RBI to trim rates again in March.

There were no real surprises from RBI as it concluded its first policy review of 2013. As widely expected, the central bank trimmed its key policy rate – the repo rate – by 25bp to leave it at 7.75%. This was the first reduction in policy rates since April 2012. In the interim, RBI has moved several times to infuse liquidity into the inter-bank market via CRR and SLR reductions. This trend continued today with the central bank, in a somewhat surprise move, cutting the CRR by a further 25bp to 4%; a move that will add around INR180 billion of liquidity into the banking system.

Sticky inflation, a lack of progress in restoring fiscal discipline and currency risks flowing from record external deficits were the three entwined factors that have kept RBI on the sidelines for the past eight months despite GDP growth sliding to a near 10-year low of 5.3% of 2012Q3. The usual detailed policy statement that accompanied today's decision made clear that a clear easing in two of these constraints has opened up space, albeit strictly 'limited', for RBI to resume the rate-cutting cycle to help support economic growth. Key has been a marked improvement in RBI's inflation comfort as headline and particularly 'core' measures of WPI inflation have eased markedly in the last few months (see Key Chart). This reflects the abeyance of demand pressures as sluggish economic growth has finally percolated through into improved inflation out-turns. Second, the various measures taken by the government since mid-September following the reappointment of P.Chidambaram as Finance Minister including FDI liberalisation, deferment of GAAR, some deregulation of administered fuel prices and the establishment of the Cabinet Committee on Investment have lifted market sentiment and laid the foundation for the re-establishment of fiscal discipline and an easing of India's chronic 'twin deficit' problem.

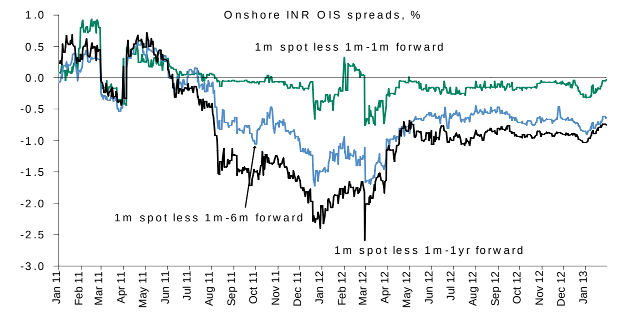
Taken together these two marked improvements have encouraged the central bank to cautiously re-engage the easing

Key Chart: Inflation Comfort



Source: BNP Paribas, Reuters EcoWin Pro

Key Chart: Fully Priced



Source: BNP Paribas, Reuters EcoWin Pro

cycle. But key constraints on RBI's to lower rates to support growth remain however. Most importantly, still elevated food inflation continues to leave household inflation expectations uncomfortably elevated. RBI's latest survey showed one-year expectations sticky at around 13% for example. Liberalisation of fuel prices will also bleed into higher costs and prices in the next few months, keeping inflation sticky. Second, the government's reform push, in reality, remains in its infancy and RBI rightly expects to see further action in terms of both fiscal consolidation and measures to kick-start investment spending, especially in the critical infrastructure sector. Lastly, the current account deficit will remain a substantial impediment to aggressive monetary ease until it is ameliorated by smaller budget deficits.

RBI's pressure points are therefore clear. Key to extending its rate cutting cycle will be further evidence of subsiding demand-pull price pressures (which we expect to be forthcoming in the next few months given our estimates of the output gap) and a continued reform push by the government. Critical will be the Union Budget delivered on 28th February. During his recent investor 'charm offensive', Mr. Chidambaram has made clear he intends to eschew the pressure for a populist Budget and stick rigidly to his demanding deficits targets. If he does so, RBI should be able to 'reward' the government with a further 25bp cut at its March policy review. The scope for further rate cuts beyond a likely 25bp move March are more debatable, however, suggesting that the OIS market is fully priced for now.

Richard Iley 852 2108 5104
richard.iley@asia.bnpparibas.com

Please refer to important information found at the end of the report

RESEARCH DISCLAIMERS:

IMPORTANT DISCLOSURES: *Please see important disclosures in the text of this report.*

The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. This report does not constitute an offer or solicitation to buy or sell any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein. Any reference to past performance should not be taken as an indication of future performance. To the fullest extent permitted by law, no BNP Paribas group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise Indicated in this report there is no intention to update this report. BNP Paribas SA and its affiliates (collectively "BNP Paribas") may make a market in, or may, as principal or agent, buy or sell securities of any issuer or person mentioned in this report or derivatives thereon. BNP Paribas may have a financial interest in any issuer or person mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon. Prices, yields and other similar information included in this report are included for information purposes. Numerous factors will affect market pricing and there is no certainty that transactions could be executed at these prices. BNP Paribas, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any person mentioned in this report. BNP Paribas may, from time to time, solicit, perform or have performed investment banking, underwriting or other services (including acting as adviser, manager, underwriter or lender) within the last 12 months for any person referred to in this report. BNP Paribas may be a party to an agreement with any person relating to the production of this report. BNP Paribas, may to the extent permitted by law, have acted upon or used the information contained herein, or the research or analysis on which it was based, before its publication. BNP Paribas may receive or intend to seek compensation for investment banking services in the next three months from or in relation to any person mentioned in this report. Any person mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

BNP Paribas is incorporated in France with limited liability. Registered Office 16 Boulevard des Italiens, 75009 Paris. This report was produced by a BNP Paribas group company. This report is for the use of intended recipients and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of BNP Paribas. By accepting this document you agree to be bound by the foregoing limitations.

Certain countries within the European Economic Area:

This report is solely prepared for professional clients. It is not intended for retail clients and should not be passed on to any such persons. This report has been approved for publication in the United Kingdom by BNP Paribas London Branch. BNP Paribas London Branch is authorised and supervised by the Autorité de Contrôle Prudentiel and authorised and subject to limited regulation by the Financial Services Authority. Details of the extent of our authorisation and regulation by the Financial Services Authority are available from us on request.

This report has been approved for publication in France by BNP Paribas SA, incorporated in France with Limited Liability and is authorised by the Autorité de Contrôle Prudentiel (ACP) and regulated by the Autorité des Marchés Financiers (AMF) whose head office is 16, Boulevard des Italiens 75009 Paris, France.

This report is being distributed in Germany either by BNP Paribas London Branch or by BNP Paribas Niederlassung Frankfurt am Main, a branch of BNP Paribas S.A. whose head office is in Paris, France. BNP Paribas S.A. – Niederlassung Frankfurt am Main, Europa Allee 12, 60327 Frankfurt is authorised and supervised by the Autorité de Contrôle Prudentiel and it is authorised and subject to limited regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

United States: This report is being distributed to US persons by BNP Paribas Securities Corp., or by a subsidiary or affiliate of BNP Paribas that is not registered as a US broker-dealer to US major institutional investors only. BNP Paribas Securities Corp., a subsidiary of BNP Paribas, is a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority and other principal exchanges. For the purposes of, and to the extent subject to, §§ 1.71 and 23.605 of the U.S. Commodity Exchange Act, this report is a general solicitation of derivatives business. BNP Paribas Securities Corp. accepts responsibility for the content of a report prepared by another non-U.S. affiliate only when distributed to U.S. persons by BNP Paribas Securities Corp.

Japan: This report is being distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited or by a subsidiary or affiliate of BNP Paribas not registered as a financial instruments firm in Japan, to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. BNP Paribas Securities (Japan) Limited is a financial instruments firm registered according to the Financial Instruments and Exchange Law of Japan and a member of the Japan Securities Dealers Association and the Financial Futures Association of Japan. BNP Paribas Securities (Japan) Limited accepts responsibility for the content of a report prepared by another non-Japan affiliate only when distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited. Some of the foreign securities stated on this report are not disclosed according to the Financial Instruments and Exchange Law of Japan.

Hong Kong: This report is being distributed in Hong Kong by BNP Paribas Hong Kong Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Hong Kong Branch is registered as a Licensed Bank under the Banking Ordinance and regulated by the Hong Kong Monetary Authority. BNP Paribas Hong Kong Branch is also a Registered Institution regulated by the Securities and Futures Commission for the conduct of Regulated Activity Types 1, 4 and 6 under the Securities and Futures Ordinance.

Some or all the information reported in this document may already have been published on https://globalmarkets.bnpparibas.com

© BNP Paribas (2013). All rights reserved.