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# India – RBI turns dovish, with a caveat

- **RBI cuts repo rate and CRR by 25bps each, shifting its focus towards growth**
- **Dovish monetary policy guidance indicates further rate reductions; we expect repo rate at 7.00% in 2013**
- **Stay *Overweight* duration; Buy 10Y GoISec, current: 7.86%, entry: 8.19%, target: 7.50%, stop-loss: 7.95%**
- **Policy mix is supportive of the INR, but elevated C/A deficit is likely to limit gains**

## RBI turns pro-growth

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The decision by the Reserve Bank of India (RBI) to cut the repo rate by 25bps to 7.75% and the cash reserve ratio (CRR) by 25bps to 4.00% is welcome. In addition to these moves, there were two key takeaways from the monetary policy guidance.

First, after a long period with a clear focus on inflation, the RBI turned dovish in today's monetary policy guidance, and the policy bias has clearly shifted towards supporting growth. It made a third downward revision to its GDP growth projection for FY13 (year ending 31 March 2013) to 5.5% from 5.8%, and also reduced its March 2013 inflation projection for a third time, to 6.8% from 7.5%.

The RBI's shift to a more dovish stance is evident in its statement that the economy is now at a "tipping point in the balance of risks between growth and inflation on the domestic front". The use of the phrase "tipping point" is a significant departure from previous monetary guidance, where the RBI has typically highlighted upside risks to inflation and has refrained from stating a clear bias towards supporting growth. This – along with an acknowledgement of ebbing demand-side inflationary pressures, expected range-bound inflation in FY14, and significantly below-trend GDP growth – clearly indicates the RBI's preference for easier monetary conditions going forward.

Second, although the RBI provided a caveat to its dovish statement by citing "limited" space for monetary easing, this does not alter our view on further rate reductions. The RBI's mention of this condition is not surprising – given the current macroeconomic backdrop and existing supply-side bottlenecks, the central bank will want to avoid triggering market expectations of an aggressive easing cycle and thus a strong rebound in demand-side inflation pressures (see *On the Ground, 15 January 2013, 'India – RBI to front-load rate cuts'*).

**Figure 1: Our forecasts – India's economic data**

| | Q4 2012 | Q1 2013 | Q2 2013 | Q3 2013 | Q4 2013 | FY13F | FY14F |
|---|---|---|---|---|---|---|---|
| Average WPI, % y/y | 7.3 | 6.8 | 6.7 | 6.4 | 6.8 | 7.5 | 6.5 |
| Repo rate (end-period) | 8.00 | 7.50 | 7.25 | 7.00 | 7.00 | 7.50 | 7.00 |
| USD-INR (end-period) | 54.99 | 54.50 | 55.00 | 53.50 | 53.00 | 54.50 | 53.00 |
| 10Y GoISec yield (end-period) | 8.10 | 7.50 | 7.25 | 7.25 | 7.25 | 7.5 | 7.75 |

Source: Standard Chartered Research

## Implications for monetary policy

*We maintain our call of another 25bps reduction in the repo rate on 19 March*

After today's policy action and the guidance provided by the RBI, we reiterate our call of another 25bps repo rate cut to 7.50% at the next policy meeting on 19 March. We believe further easing is justified given our expectation that February WPI inflation – which policy makers will have before the March decision – will fall below 7%. There will also be more clarity on fiscal consolidation after the FY14 budget presentation in February.

We also maintain our call of another 50bps of repo rate cuts before the end of 2013, taking the rate to 7.00% by year-end. Further reductions look unlikely, as 7.0% is close to a neutral policy setting given our forecast inflation trajectory. Average WPI inflation of c.6.5% in FY14 (according to our forecast) and a stronger global and domestic outlook are unlikely to prompt the RBI to adopt a more aggressive stance, as it will be concerned about the re-emergence of inflation risks.

A significant upside inflation surprise, or the failure of recently announced fiscal consolidation measures to lower the fiscal deficit, would pose risks to our repo rate projections.

## Market implications

### Rates market

Although the repo rate cut was positive for GoISecs, the market seems to be disappointed with the RBI's preference for a CRR cut over open-market operations (OMOs) or bond buybacks to inject liquidity.

*The CRR cut reduces the likelihood of OMOs in the near term*

Against consensus expectations, the RBI reduced the CRR by 25bps, injecting c.INR 180bn of liquidity into the banking system. In January, the banking system has borrowed c.INR 930bn a day (on average) from the RBI, well above RBI's comfort level of c.INR 700bn. Although this large liquidity deficit can be attributed to the government's significant cash surplus (estimated at c.INR 622bn as of 11 January), the RBI aims to keep banking-system liquidity within its comfort zone. We estimate that banking-system liquidity will remain in deficit even after government spends its entire cash surplus. An important driver of this is the seasonal increase in currency in circulation in February and March (c.INR 346bn in FY12, c.INR 310bn in FY11 and c.290bn in FY10). We therefore expect the overnight call money rate (and MIBOR fixing) to hover around the repo rate of 7.75% in the near term.

With this CRR reduction, market participants now see a reduced likelihood of RBI OMOs in the near term. The c.480bn of GoISec issuance scheduled for February may cause demand/supply dynamics to turn slightly unfavourable in the near term.

We think unfavourable demand/supply dynamics will be transient and will have a limited impact on GoISecs, however. With the government reiterating its FY13 fiscal deficit target of 5.3% of GDP, the possibility of additional market borrowing has declined. With no GoISec issuance scheduled in March, and with further rate cuts expected, we expect GoISec yields to decline further, albeit gradually.

We maintain our *Overweight* stance on GoISec duration on the back of softening WPI inflation and easing policy rates, and recommend buying the 10Y GoISec (current: 7.86%, entry: 8.19%, target: 7.50%, stop-loss: 7.95%).

### Impact on the INR

The positive policy mix – with the RBI's pro-growth stance complementing the government's fiscal consolidation efforts – is likely to underpin the positive turn in investor sentiment towards India since late 2012. However, the key question is whether foreign inflows will be enough to plug India's large external financing gap. Portfolio inflows to Indian markets totalled USD 14bn between September and December 2012, up 11.2% y/y, but this fell significantly short of the USD 76.5bn trade deficit over the same period. While the government has stepped up its efforts to curb the trade deficit, primarily by increasing import duties, the impact of these measures is unlikely to be felt immediately. Thus, the fundamental backdrop remains mixed for the Indian rupee (INR). As such, we expect USD-INR to remain range-bound but volatile until there are discernible signs of a sustained improvement in India's balance of payments.

# Disclosures Appendix

**Analyst Certification Disclosure:** The research analyst or analysts responsible for the content of this research report certify that: (1) the views expressed and attributed to the research analyst or analysts in the research report accurately reflect their personal opinion(s) about the subject securities and issuers and/or other subject matter as appropriate; and, (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in this research report. On a general basis, the efficacy of recommendations is a factor in the performance appraisals of analysts.



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