# RBI POLICY PREVIEW

## 25bps repo cut likely; CRR cut not ruled out

India Equity Research | Economy

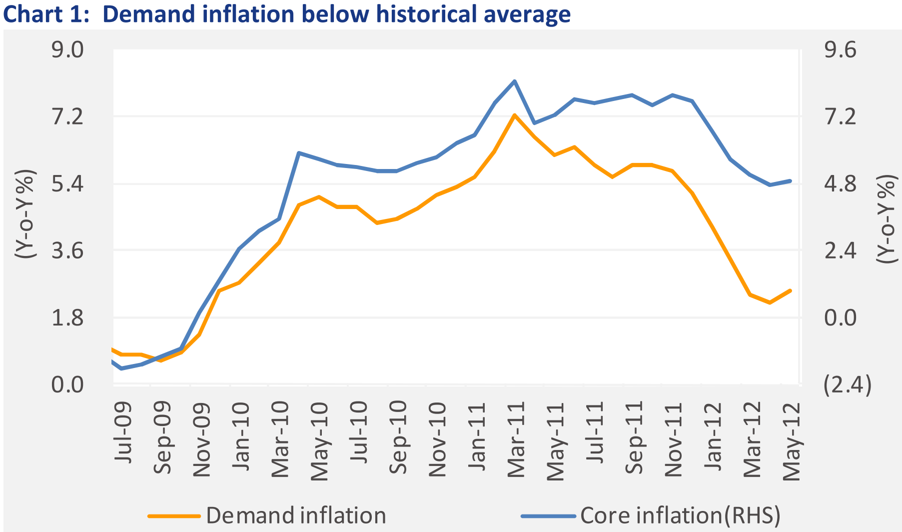
**In the forthcoming mid quarter monetary policy review, RBI is likely to cut repo rate by 25bps, while the possibility of 50bps CRR cut cannot be ruled out. The domestic economy is operating far below potential and lag impact of high interest rates is here to stay. This will keep core inflation under check. Besides, global macro and financial market environment has worsened materially, adding to downside risks related to domestic economy while global commodity prices have softened even in INR terms. In fact, we argue that current elevated interest rates are actually becoming counter-productive. Arguments against rate cut (such as weak INR, stretched CD ratio) are not convincing, in our view.**

### Case for repo rate cut quite strong

We think that the current macroeconomic backdrop offers ample reason for the central bank to continue with the monetary easing (that started in April 2012) and with more conviction than last time.

1) **Core/demand inflation falling:** Demand/core inflation has seen a sharp decline over the past few months, suggesting that demand is slowing in the economy and price and wage pressures are receding. This means that any rise in inflation due to supply side issues (like agriculture prices due to low rainfall) should not get translated into generalized inflation pressures as intermediaries/businesses are lacking pricing power.

**Chart 1: Demand inflation below historical average**




*Source:CMIE,Edelweiss research*

*Note: Demand-led inflation is based on our re-arranged WPI basket*

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Since economic activity has already slipped far below potential, the central bank should be reasonably confident that core inflation will remain contained, especially when global commodity prices are easing even in INR terms.

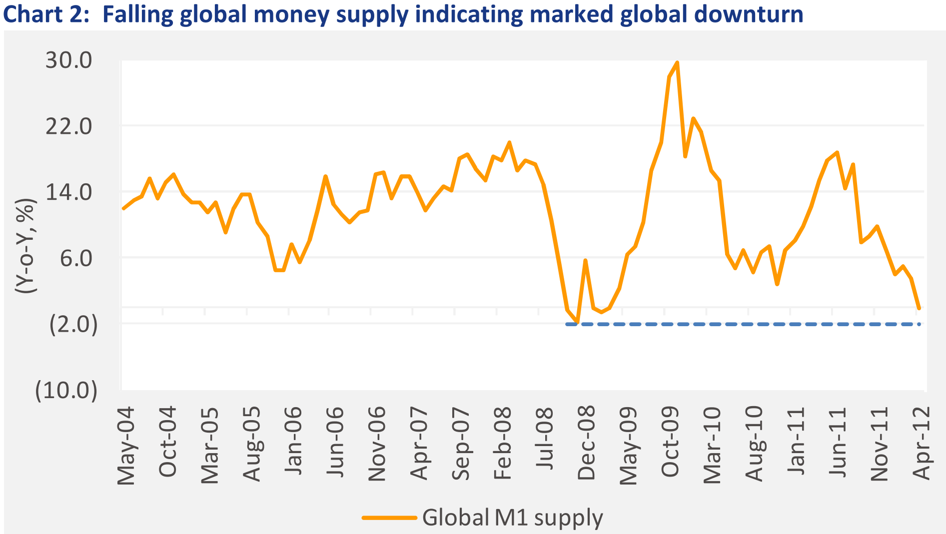
Indeed, as per our calculations (based on re-arranged WPI basket), the domestic demand led inflation has fallen very sharply from 6-7% to 2.5% in last few months (below its historical average).

2. **Supporting growth is priority:** Host of recent data releases like GDP, IIP, auto sales, declining corporate margin, clearly show that economy is growing much below its potential (also corroborated via declining core/demand inflation) and if this is allowed to continue, it would start hurting medium-term growth trajectory.

   In fact, we think that if the monetary conditions continue to remain elevated, they will become extremely counter-productive. Fiscal deficit would worsen further (as tax revenues falter due to weakening growth), investment slowdown would deepen (hurting medium-term growth trajectory) and inflation could remain sticky (as high interest rates hinder capacity creation). In other words, growth revival is now essential to improve the overall dynamics of the economy, be it fiscal deficit or boosting investments and sentiments or attracting capital flows. Accordingly, aggressive easing of policy rates to support growth has become essential and timeliness is also important as transmission takes place with a lag.

3. **Considerable deterioration of external environment:** Global economic data from past couple of months confirms that global economy is slowing at a faster rate than anticipated earlier and downturn is quite synchronized. Global narrow money supply (M1) is falling quite rapidly, on the lines very similar to late 2008. This downturn could impact India severely, if RBI does not adopt a flexible and pro-active approach. In fact, several other EMs like Brazil, China and Indonesia have been proactive and already slashed interest rates by 400bps, 150bps and 100bps, respectively, from their peak levels.

**Chart 2: Falling global money supply indicating marked global downturn**




*Source: Bloomberg, Edelweiss research*

*Note: Global M1 is calculated by aggregating money supply (M1) of US, Euro zone and China*

## Arguments against rate cuts that do not stand up to scrutiny

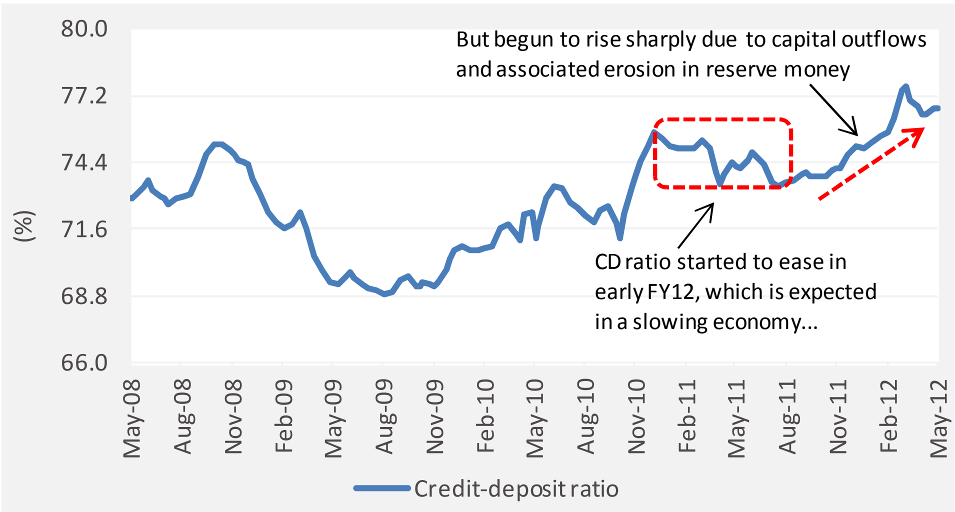
Following are some popular arguments that RBI ought not to consider to reduce policy rates:

1. **Credit deposit (CD) ratios are at elevated levels:** The argument made is that any reduction in policy rates would mean lower deposit growth and higher credit growth which would worsen the CD ratio further. Accordingly, policy rates should be kept elevated in order to avoid worsening of CD ratio.

   We think that this argument is flawed, as policy rates are not a dominant factor impacting CD ratio. Typically, CD ratio tends to stretch when the domestic demand is overheating, in which case raising interest rates may be a help. However, today, domestic economy is actually very weak. In our view, the reason CD ratio is stretching is because of capital outflows and depletion of reserve money since August 2011 when the European debt crisis escalated and subsequently RBI intervened in the FX market. For example, during period of capital outflows when external credit becomes scarce, domestic businesses either have to pay-back their maturing foreign debt through their internal savings or will have to resort to domestic borrowing to replace the maturing external debt. This, apparently, leads to rise in the CD ratio. It is no coincidence, therefore, that CD ratio started to rise since Aug 2011, when European crisis escalated.

   In sum, capital outflows and low reserve money creation is the key reason for the increase in CD ratio. Accordingly, to alleviate high CD ratio, reserve money growth must be boosted via larger quantum of OMOs (which RBI is already undertaking). Keeping rate high to reduce CD ratio will not work. It is notable that CD ratio continued to rise during Aug-Oct 2011 even as RBI hiked policy rates by 50bps.

**Chart 3: Erosion of reserve money is the reason behind high CD ratio**




*Source: CMIE, Edelweiss research*

2. **INR needs to be supported by keeping policy rates elevated:** Again, we think this is a flawed argument as high policy rates would end up hurting INR more than helping it. Elevated interest rates would hurt growth, fiscal consolidation and increase macroeconomic vulnerability of the country. Also, the capital flows which high interest rates will attract would be fickle in nature compared with those which accompany a better growth environment.

## 25bps repo cut likely; CRR cut not ruled out

Overall, the present growth–inflation dynamics clearly warrant a rate cut at this point of time. Given the slack in economy, core inflation and not headline, has become a benchmark for the central bank. Now as core inflation is on a declining trajectory, RBI will not be reluctant to reduce policy rates. If anything, high interest rates are becoming increasingly counter-productive, hurting fiscal consolidation (via hurting growth and hence government tax revenues), depending investment slowdown and impeding inflation easing (by discouraging capacity creation). Meanwhile, global macroeconomic and financial markets environment has also deteriorated considerably in recent months.

Based on above, we are of the view that RBI should reduce its policy rates by 25bps on June 18. Further, the possibility of reduction in CRR rates by 50bps cannot be ruled out as it would help transmission in the monetary policy. However, we cannot be confident about CRR cut (in current monetary policy) as RBI has already undertaken OMOs on an extensive scale.

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