JUN 06.19.2015

ECONOMICS: ASIAN PERSPECTIVES

INDIA'S RATE-CUT CYCLE COMING TO AN END

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With economic activity picking up after a long lull and disinflationary pressures easing, India's rate cut cycle is coming to an end. In fact, a rate hike—perhaps next year—might be in store, particularly if the decline in oil and commodity prices over the past year reverses course and/or poor weather pushes up food prices.

A pickup in output growth and signs of receding disinflationary pressure have reinforced our expectation—a minority view until recently—that India's monetary easing cycle is coming to an end. Moreover, the Reserve Bank of India (RBI) also strongly hinted at such a policy path after its 25 basis point (b.p.) rate cut on June 2.

In fact, we now believe that a rate hike in 2016 is not out of the question, especially in the absence of the windfall benefit from falling oil, commodity and food prices. In the worst case, a combination of a spike in global commodity prices and poor local weather resulting in food price inflation, may scupper the favorable inflation environment of the past two years.

Economic Activity Revived

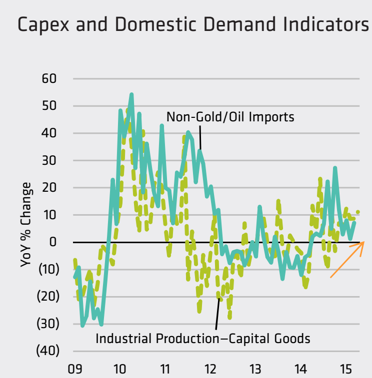
India's growth cycle has finally turned up after stagnating for almost three years. A pickup in capital goods output suggests a strengthening in the capital expenditure cycle, and a revival of non-oil/gold imports indicates a recovery in domestic demand. Both of these trends have gained traction over the past quarter or so, although the level of the expansion remains modest by past standards (*Display 1*).

We have been skeptical that the Indian government can keep its promise of a capex-led recovery. After all, we would be hard pressed to say the government has successfully implemented effective supply-side policies, pushed through infrastructure investment or truly removed bureaucratic barriers. However, we think that a combination of increased policy efficiency under prime minister Narendra Modi's helms and a cumulative 75 b.p. rate cut since last year has helped to provide a bounce in activity from a very low base.

Structural Inflation May Return

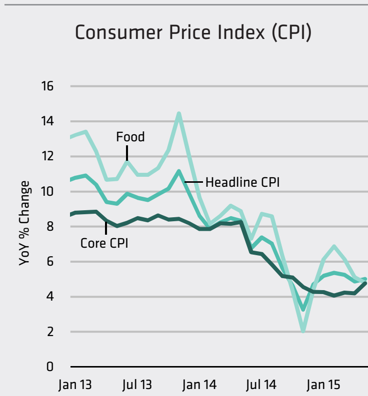
We are not too sure how sustainable the current upturn can be without true structural reform. A big problem is that, after a dramatic upward revision to India's historical GDP growth—by more than 200 b.p.—by government statisticians, the economy is already running at a 7.5% clip in first quarter 2015. No one really knows the true level of the Indian economy's potential growth rate after that abrupt revision, but we suspect that a recovery from the current pace can easily reduce any slack in India's economy and result in a narrower GDP gap. This points to a reemergence of structural inflationary pressure, typically caused by transportation bottlenecks and demand-supply

Display 1
India's Growth Starting to Recover



As of April 2015
Source: CEIC Data and AB

Display 2
Core CPI Marking a Floor for Disinflation



As of May 2015
Source: CEIC Data and AB

imbalances—especially in raw materials and food.

The concern is underscored by a bounce in core consumer price inflation (excluding food and energy) to 4.7% year on year in May from a trough of 4.1% in January. Equally important, the core inflation is marking the floor for disinflation. The risk for headline consumer price inflation, currently at 5% year on year, is more on the upside rather than the downside from here (*Display 2, previous page*).

Risk of Higher Interest Rates Next Year

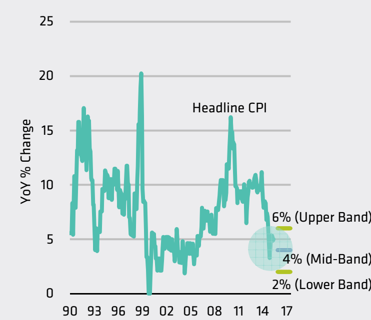
Indeed, the RBI's inflation target (mid-rate) for 2017 is 4%, while headline inflation and core inflation rates are both running at around 5%.

So, strictly speaking, the central bank should be tightening policy to bring inflation down to 4% if this is a more rigid, longer-term target (*Display 3*). Otherwise, it would be relying on other government agencies to resolve structural inflation through other policy means, such as boosting supply or improving the efficiency of distribution and transportation of goods and services.

The current real repo rate and the reverse repo rate (both are the RBI's policy rates), of about 2% and 1% respectively, might be prudent for an economy that is just about to restart its growth engine. But as the recovery takes hold, accompanied by higher inflation, particularly if energy and other commodity prices also gather pace, the RBI may need to avoid negative real yields to make its longer-term inflation targets credible (*Display 4*). ■

Display 3
Little Room for RBI to Cut Rates

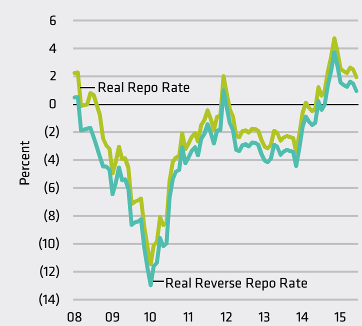
Headline CPI Inflation and RBI's 2017 Target Band



As of May 2015
Source: CEIC Data and AB

Display 4
Real Rates Start to Fall

Real Policy Rates



As of June 17, 2015
Source: CEIC Data and AB