The Reserve Bank of India’s (RBI) move to cut the repurchase rate by 25 basis points (bps) outside of their scheduled meetings surprised and boosted markets. The rate cut, the first since May 2013, was also the first by the central bank governor, Dr. Rajan.

The move however was not a complete surprise. RBI’s December policy document suggested that a change in the monetary stance could arise outside the policy review cycle should inflation momentum, changes in inflationary expectations and fiscal developments remain encouraging.

Fig.1. Key Indian Rates

<table>
<thead>
<tr>
<th>Rates</th>
<th>New rates</th>
<th>Old rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repurchase</td>
<td>7.75%</td>
<td>8%</td>
</tr>
<tr>
<td>Reverse Repurchase</td>
<td>6.75%</td>
<td>7%</td>
</tr>
<tr>
<td>Marginal Standing Facility</td>
<td>8.75%</td>
<td>9%</td>
</tr>
<tr>
<td>Cash Reserve Ratio</td>
<td>No change</td>
<td>4%</td>
</tr>
<tr>
<td>Statutory Liquidity Ratio</td>
<td>No change</td>
<td>22%</td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India, as at 15 January 2015.
WHAT POSSIBLY LED THE RBI TO MAKE THE MOVE:

- In January 2014, when CPI hovered close to 10%, RBI had set consumer price inflation target at 8% for January 2015 and 6% in January 2016. Since then, both the consumer price and wholesale price indices have witnessed sharp and sustained declines to their all time lows of 5% and 0% respectively in the latest prints. RBI appears confident that the 6% 2016 target is achievable.

- Household inflation expectations (an important anchor for RBI) have adapted to easing inflation data; having fallen to single digits for the first time since September 2009.

- RBI expects the crude prices to remain low in 2015. Oil prices have been dropping; an additional 30% decline since RBI’s last policy meeting in December 2014.

- Faith in the government’s resolve to meet the fiscal targets and overcome structural supply constraints.

POSITIVE IMPLICATIONS ON ALL COUNTS

**Growth** – Lower rates will likely bolster domestic demand and lend strength to the economy (refer to Fig.2). A sharper decline in cost of capital will also support a capital expenditure recovery.

**Currency** – The Rupee reacted positively to the move. Separately the fundamentals of the Rupee have improved over the last year. Foreign exchange reserves have hit USD 320 billion\(^1\) providing a much improved import cover and lending support to the Rupee (refer to Fig.3).

**Flows** – Despite 2014 being a political watershed year, India only received USD 16 billion of equity flows versus USD 24 billion in 2012. Foreign investors were likely awaiting the start of the easing cycle from the central bank, and the lift-off on reforms from the government. India could witness accentuated flows given the recent moves.

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\(^1\)Reserve Bank of India (RBI) as at 2 January 2015.
Separately, US Federal Reserve is widely expected to increase rates this year; however, a significant improvement in real rates differential compared with May 2013, is also likely to lend support to flows into India (refer to Fig.4).

<table>
<thead>
<tr>
<th>India’s real rate differential versus the US</th>
<th>January 2014</th>
<th>May 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-Term (3 months)</td>
<td>4.9%</td>
<td>-2%</td>
</tr>
<tr>
<td>Long-Term (10 years)</td>
<td>2.5%</td>
<td>-3.8%</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley. India Economics, as at 15 January 2015.

**Earnings** – The latest out of policy review move by RBI is leading many to believe that the bank may get aggressive and is signalling the start of a sustained easing cycle. Market participants expect the cumulative cuts in 2015 to range between 50-150bps.

We think that inflation trend, growth indicators and the government’s sustained resolve to mend fiscal deficit as well as the trend in global interest rates will determine RBI’s subsequent moves. Nevertheless consensus is already considering rate cuts in estimating future earnings; a sharper cut could trigger upward revisions to earnings’ estimates (refer to Fig.5).

**OUTLOOK**

Improved macroeconomic factors coupled with a fast track clearance of stalled projects will likely accelerate growth recovery while improved business and consumer sentiment post election is likely to bolster investments and demand. India is also poised to harness the lower commodities’ price dividend. The country is one of the biggest beneficiaries of lower oil prices owing to its reliance on imported crude oil to meet domestic consumption. Against this backdrop corporate earnings growth is expected to improve significantly over the next few years.

Current valuations are fair but may not be reflecting entirely the benefits of a range of reforms and measures that are underway. Our Indian strategies are positioned to benefit from a pickup of domestic economic activity amidst a lower rate environment.
Investing in India: India’s surprise rate cut boosts markets

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