

# Asia Policy Watch

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## The Reserve Bank of India cuts policy rates by 25 bp

The Reserve Bank of India (RBI) cut the reverse repo and repo rates by 25 bp against the consensus and our expectation of no change in the reverse repo rate and a cut of 50 bp to the repo rate. This cut will take the repo rate to 4.75% and the reverse repo rate to 3.25%. With these cuts, the RBI has delivered 425 bp in cuts to the repo rate and 275 bp in cuts to the reverse repo rate since the rate-cutting cycle began.

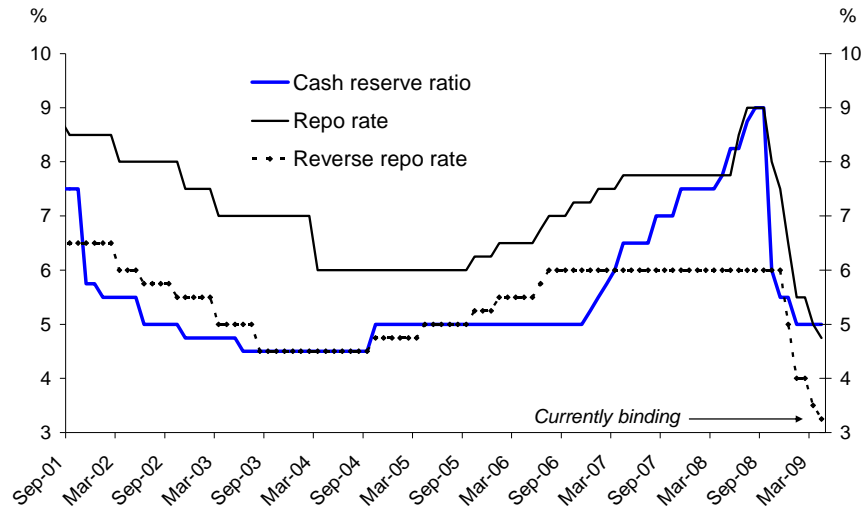
**The RBI revised its GDP growth target for FY10 to 6%.** The RBI also announced targets for broad money (M3) growth, and inflation at 17% and 4% respectively. These are broadly in line with our forecasts of 5.8% GDP growth, 17% yoy M3 growth, and year-end inflation at 3% for FY10. The RBI will continue to encourage banks to reduce their deposit and lending rates. It came down very strongly against the practice of lending below the Prime Lending Rate. We think that with moral suasion and policy rate cuts, banks will reduce their deposit and lending rates further.

**Although the timing was a bit unexpected, the small cut continues the dovish stance of the RBI.** Given the political cycle, market and our expectations were for the RBI to wait till after the elections before announcing policy cuts. The RBI statement clearly came out with risks skewed more towards lower growth rather than higher inflation.

**We think that we are nearing the end of the rate cutting cycle.** The smaller magnitude of the rate cut by the RBI, excess liquidity in the system (see Exhibit 2), a substantial easing of financial conditions (see Exhibit 3), and a dramatic decline in corporate bond spreads (see Exhibit 4) suggest to us that growth will recover in the second half of FY10, and that the rate-cutting cycle is nearing its end. The real concern is not at the short end, but at the long end of the rate curve. Although this move by the RBI will provide some temporary relief, we think that structurally, long bond yields will push higher given the large government borrowing requirement (see *India liquidity watch: A scrutiny of the RBI's balance sheet*, March 30). The RBI, in our view, will continue to pursue limited quantitative easing to try to prevent yields from ratcheting up sharply. We continue to expect the RBI to cut the cash reserve ratio of banks by 150 bp.

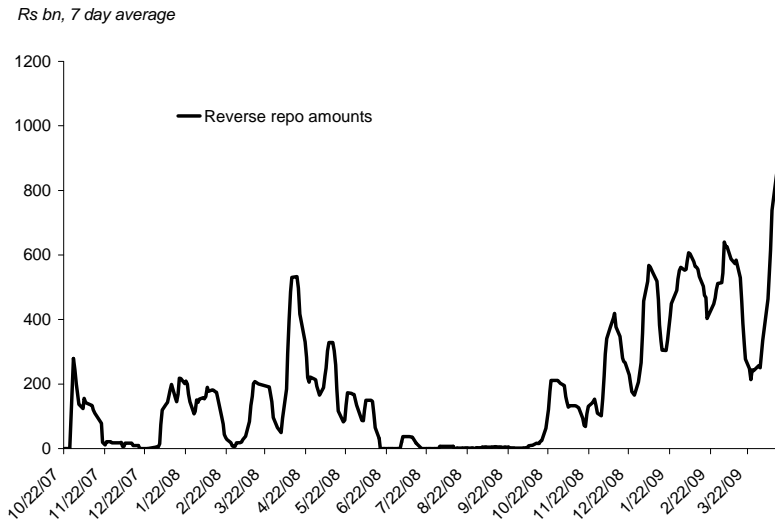


**Exhibit 1: the RBI has delivered 425 bp in cuts to the repo rate and 275 bp in cuts to the reverse repo rate since the rate cutting cycle began**



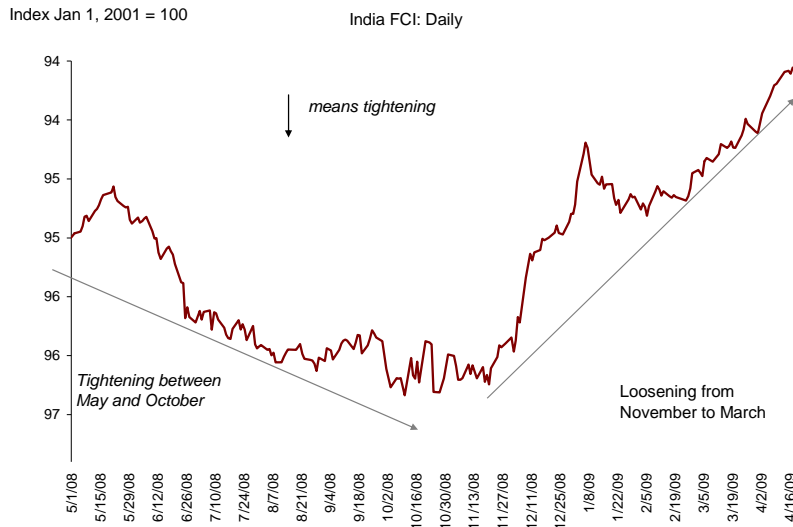
Source: CEIC, GS Global ECS Research

**Exhibit 2: Record transactions in the reverse repo window**



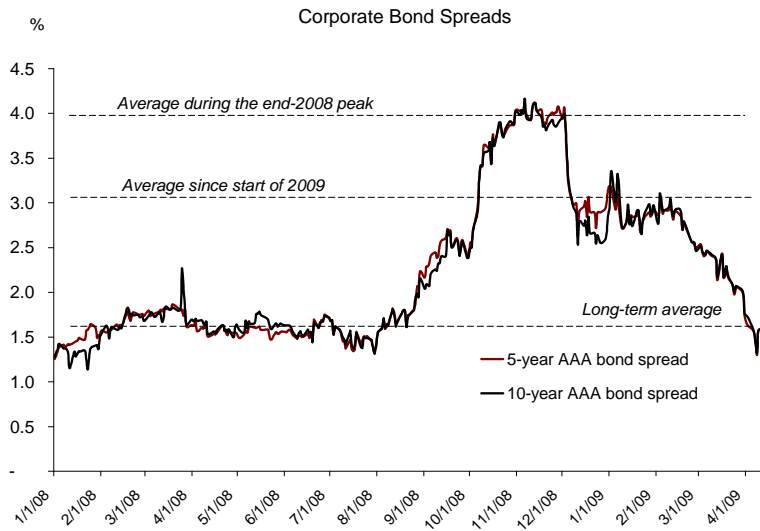
Source: CEIC, GS Global ECS Research

**Exhibit 3: Financial conditions have eased substantially**



Source: CEIC, GS Global ECS Research

**Exhibit 4: Corporate spreads back to pre-crisis levels**



Source: Bloomberg, GS Global ECS Research

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