India – Monetary Policy Review

National Australia Bank

- **At its Quarterly Monetary policy review on the 29th of October, the Reserve Bank of India (RBI) raised the Repo rate by 25bp to 7.75%.**
- **It simultaneously cut the MSF (Marginal Standing Facility Rate) by 25bp to 8%; this follows a prior 50bp cut on the 7th October. The interest rate corridor has now been tightened to 100bp.**
- **The decision reflects an increasing focus on anchoring inflationary expectations, boosting financial savings while easing liquidity, amid an improved external backdrop.**
- **Following the RBI decision, State Bank of India and HDFC raised their minimum lending rate by 20bp.**
- **The RBI discussed a number of issues and issued guidelines about how foreign banks could expand their footprint in India by converting to Wholly Owned Subsidiaries.**
- **The Indian economy remains weak, although the performance of the Infrastructure Industries has been positive during the September.**
- **The trade figures are encouraging and supportive of an improved Current Account position. Concerns about financing the Current Account have receded considerably, with an estimated USD12.1bn of inflows from the Concessional Foreign Currency Non Resident Swap Facility and the increasing flexibility accorded to banks to secure overseas funding.**
- **Inflationary pressures have risen, with the Wholesale Price Index rising due to rising food and elevated fuel prices. The Consumer Price Index too remains uncomfortably high, reflecting high Service prices.**
- **NAB Economics is forecasting a further 25bp rise, which should see the Repo rate end the 2013-14 financial year at 8%. This balances high inflation, long lead times in monetary policy and a weak economic environment.**

RBI's Decision

At its 2nd Quarter Review of Monetary policy on the 29th of October, the RBI (Reserve Bank of India) made the following decisions:

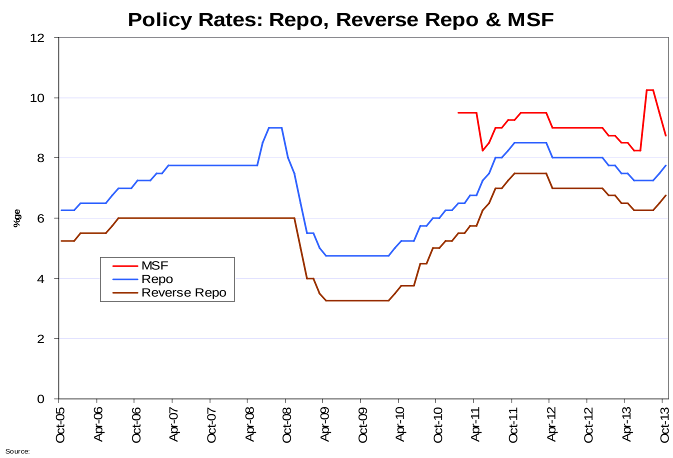
- Reduced the Marginal Standing Facility (MSF) rate by 25 basis points to 8.75%. This follows the 50 basis points reduction on the 7th of October.
- Increased the policy Repo rate under the Liquidity Adjustment Facility by 25bp, from 7.5% to 7.75%.
- Raised the liquidity provided by the 7-day and 14-day tenor to 0.5% of Net Demand and Time Liabilities. This was previously set at 0.25%, when the RBI launched this facility, commencing from the 11th of October.
- The Cash Reserve Ratio (CRR) was maintained at 4%, and the Statutory Reserve Ratio at 23%.

This Statement continues on from the Mid Quarter Review on the 20th of September. The aim is to anchor inflationary expectations, boost real interest rates, improve domestic savings and thereby provide a foundation for more sustainable growth. At the same time, with a measure of stability in the foreign exchange market, the Government has unwound most of the exceptional liquidity measures and improved the liquidity in the banking system, through a reduction in the MSF rate as well as increasing the amount available through term repo facilities. This accounts for the dual objectives of a higher policy (Repo Rate) and a reduction in the MSF rate.

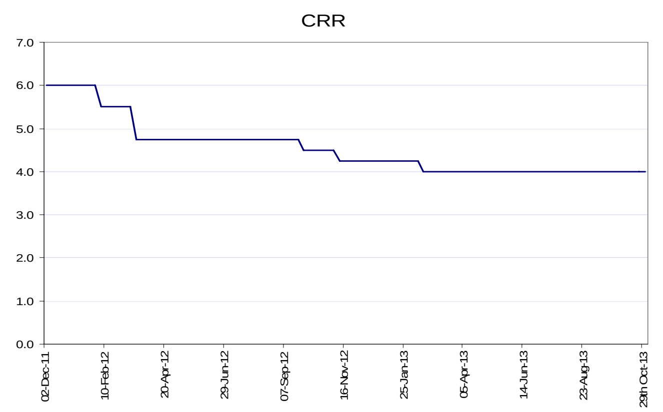
The MSF rate is the overnight rate at which banks borrow from the RBI when there is an acute cash shortage or an asset-liability mismatch. Banks usually provide approved Government securities as collateral. The Repo rate is the rate at which the RBI lends to commercial banks for a short period in return for securities, and the Reverse Repo rate is the rate at which the RBI borrows from them.

The CRR represents the proportion of net demand (e.g. current deposits) and time liabilities (e.g. fixed deposits) the scheduled commercial banks are required to maintain with the RBI. They don't earn any interest on these reserves; the purpose is to ensure solvency and liquidity of the banking system. The SLR (Statutory Liquidity Ratio) was also maintained at 23%. The SLR is typically used to expand or contract the rate of credit growth in the economy.

Policy Rates



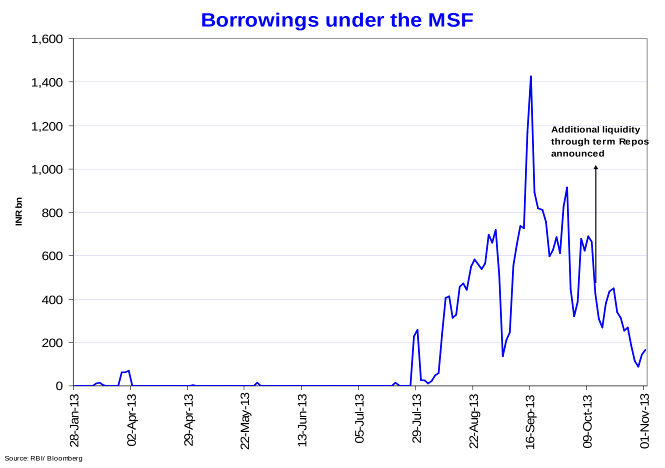
CRR



SLR

We can clearly see the impact of the Government's liquidity enhancing measures since the term (7 and 14 day term repo) facilities were provided from the 11th of October. It is likely that borrowings under the MSF will decline further with the term Repo facility expanded to 0.5% (previously 0.25%) of Net Demand and Time Liabilities. The lower MSF, notwithstanding, Financial Institutions such as HDFC and SBI raised their base rate (minimum lending rate) by 20 bp, following the increase in the repo rate.

Borrowing under MSF



Another key objective of this Monetary Policy Statement was to lower inflationary expectations so as to boost financial savings and thereby provide a firmer foundation for economic growth. A higher rate of financial savings would generate reduced external strains, as India would be less reliant on overseas funding. The recent convulsions in India's exchange rate are a salutary reminder of the importance of domestic savings. It is in this context that the authorities are expected to release Inflation Indexed National Savings Certificates (IINSSs) around November-December 2013.

The RBI did reference a number of other measures it was working on, including: Strengthening the monetary policy framework; Providing greater clarity on dealing with Domestic systemically important banks; Improving the ability of the system to cope with both financial and corporate distress; Improving access to SMEs and underprivileged segments. Finally, it has provided greater clarity on the subsidiarisation of systemically important foreign banks. In order to expand their footprint in India, these banks will be offered the opportunity to convert to Wholly owned subsidiaries (WOSs) with near national coverage, as opposed to operating in a more restricted manner in the form of branches. However, they will be subject to heightened regulatory oversight. Details of these measures are included in the attached link:

http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29922

Growth and Production

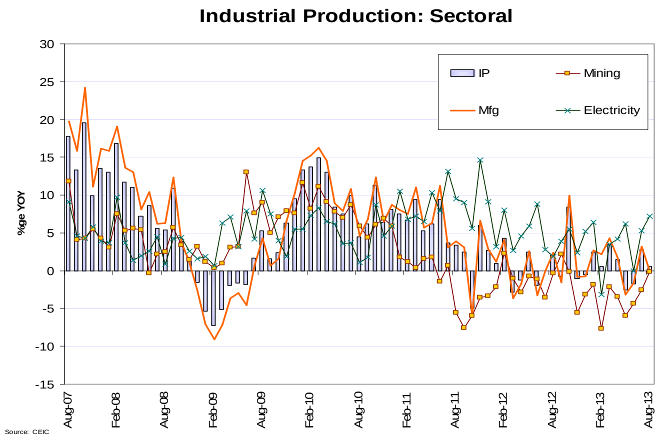
The Indian economy continues to remain weak, although there are some promising signs.

The economy grew by 4.4% over the year to June quarter 2013, the slowest pace since March 2009. Other activity indicators remain weak, although it is all not downbeat. The pace of industrial production decelerated to 0.6% over the year to August 2013 (2.75% over year to July). Electricity (7.2%) was the standout, with both mining (-0.2%) and manufacturing (-0.1%) contracting. The contraction in manufacturing was disappointing, given the improvement recorded in July; the reduced pace of mining contraction has provided some measure of comfort, but it is still disappointing overall.

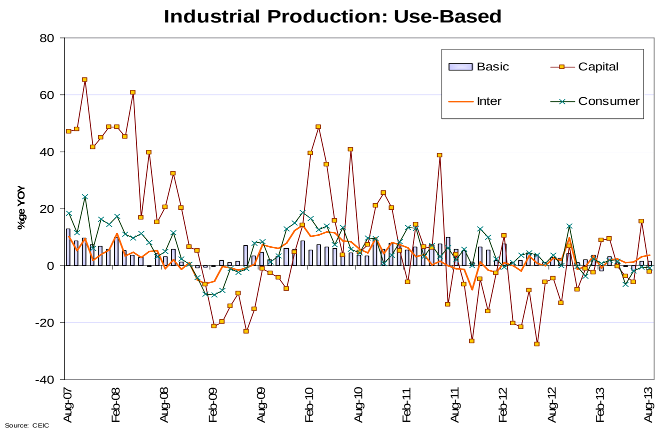
By use, the volatile capital goods sector contracted by -2%, after rising by over 15% in July, indicating weakness in investment continues to persist. Consumer durables (-0.8%), also contracted, suggesting that consumer demand is waning with weak growth and rising cost of credit. Intermediate goods production – a measure of downstream demand – increased by 3.6%, and was the only bright spot in this category.

There remains some optimism that September's industrial production data would be somewhat better than the previous month. The *8 Core industries* (Infrastructure sector) recorded a sizeable 8% expansion over the year to September. This is the fastest pace of annual growth recorded in calendar year 2013, and compares favourably with the 8.3% expansion over the year to September 2012. Coal, Refinery products, Cement and Fertilizers were the best performing segments.

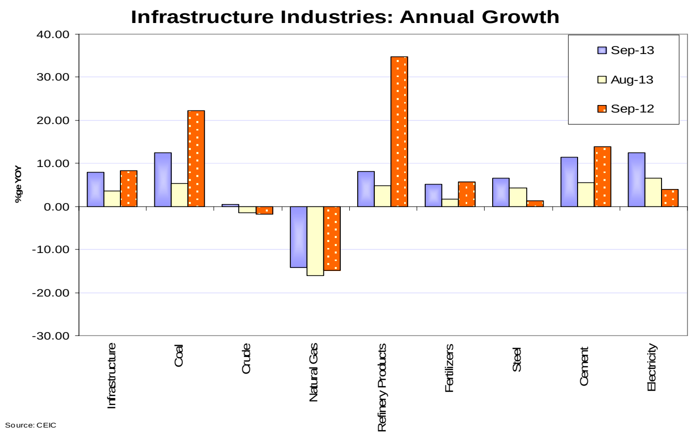
Industrial Production: Sectoral



Industrial Production: Use Based



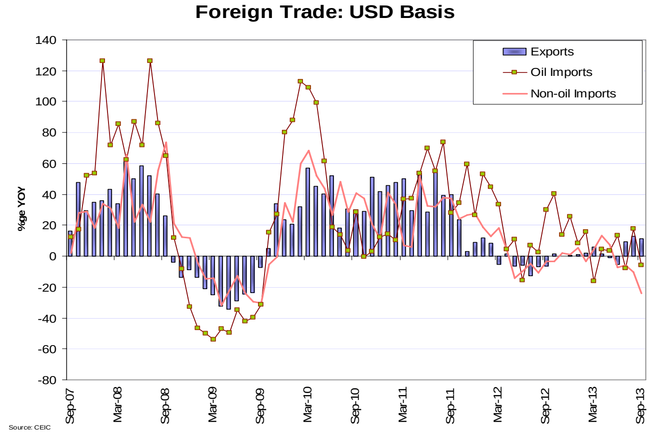
Infrastructure Sector



Trends in international trade reveal that exports increased by 11.2% over the year to September 2013. Non-oil imports contracted by a substantial -24.2% (reflecting weak domestic demand), and oil imports too fell by -6%. Taken together, the trade deficit of USD 6.76bn is now almost 61% *below* year-ago levels.

The upshot of these favourable trade numbers is that the Current Account Deficit is now forecast to be around 3.7%, possibly lower – and well below the 4.8% recorded in the 2012-13 financial year.

Trade



Overall, despite some signs of improvement, India's activity indicators remain weak, suggesting some measure of support is needed.

Prices

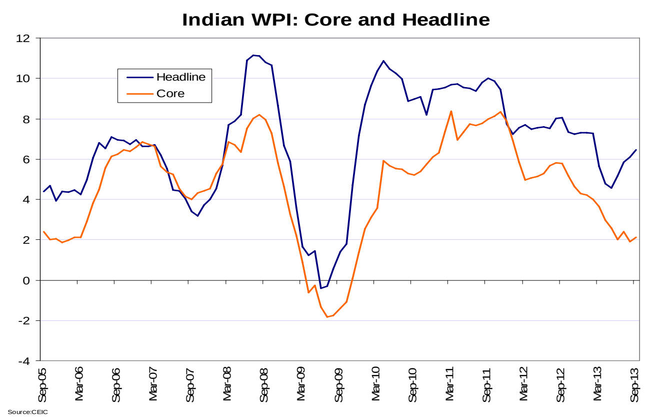
The weakness in the Indian Rupee during August and, to a lesser extent September, led to a resurgence of price pressures. The Wholesale price index (WPI) rose by 6.5% over the year to September 2013 (6.1% in August). This is the 4th consecutive month in which the WPI has risen. Core inflation, however, as measured by non food manufactured inflation rose to a well-contained 2.1%, reflecting limited pricing power among corporates and weak global metal prices.

Examining the drivers of WPI, one can clearly see a spike in food inflation (18.4% vs. 18.2% in August), driven largely by a 322.9% increase in the price of onions, a staple in the Indian diet. There were also notable price rises in ginger, sweet potatoes, garlic and tomatoes.

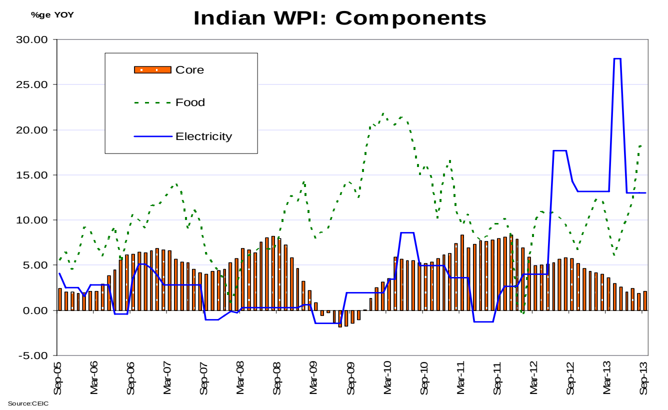
Fuel and power inflation remain elevated at 10.1%, and could rise further due to anticipated increases in diesel prices. Consumer inflation rose to 9.8% (9.5% in August), and remains uncomfortably high.

The higher CPI is partly accounted for the higher weight of food relative to the WPI. However, this is only part of the story. NAB Economics has started to calculate a Core CPI measure, by excluding food and energy prices. Core CPI remains very high, rising by 8.6% over the year to September (2.1% for Core WPI). This is driven largely by the cost of housing, transport, education and health services. Governor Rajan highlighted this point succinctly by indicating:"Core CPI has also been growing very strongly and that has us worried".

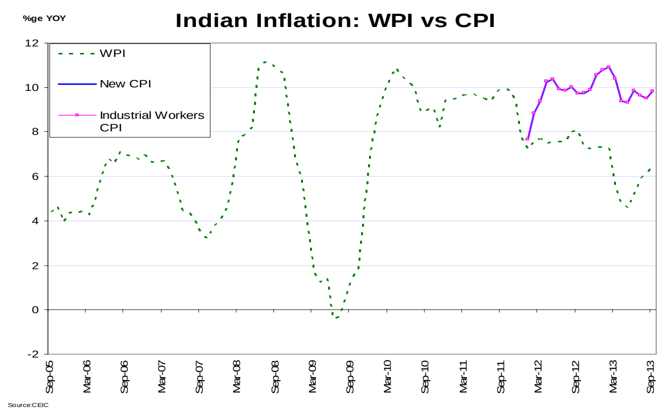
Headline and Core Inflation



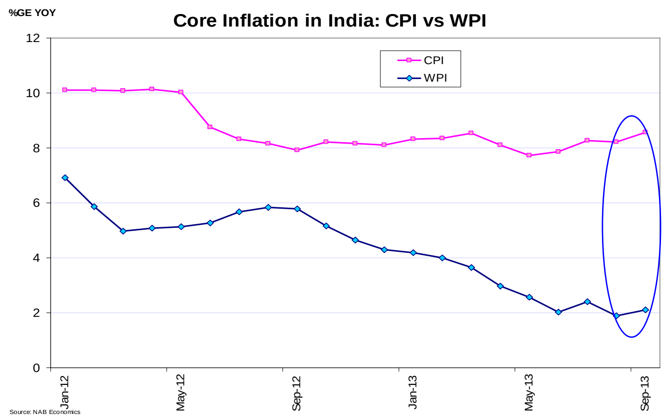
WPI Components



WPI and CPI



Core Inflation: CPI vs. WPI

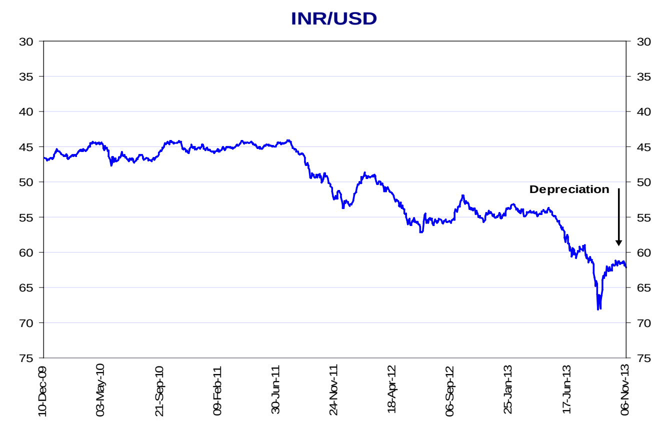


While India's low Core WPI is only one criterion in setting monetary policy, the Monetary Authorities are clearly concerned about the high prices businesses and consumers face in their daily lives, and would like to see it ease from these elevated levels. Monetary policy will thus be calibrated accordingly.

External and Financial

Following the ructions in currency markets stemming from the Fed's announcement on QE tapering (a decision now put on hold), the Indian Rupee fell sharply, reaching a low of INR 68.2/USD on the 28th of August. However, some measure of calm has been achieved in currency markets. At the time of writing, the Rupee was trading at 62.5/USD. There has been some slight weakness in the value of Rupee towards the end of October, which typically results from month-end demand for foreign exchange from importers and banks.

Indian Rupee to US Dollar

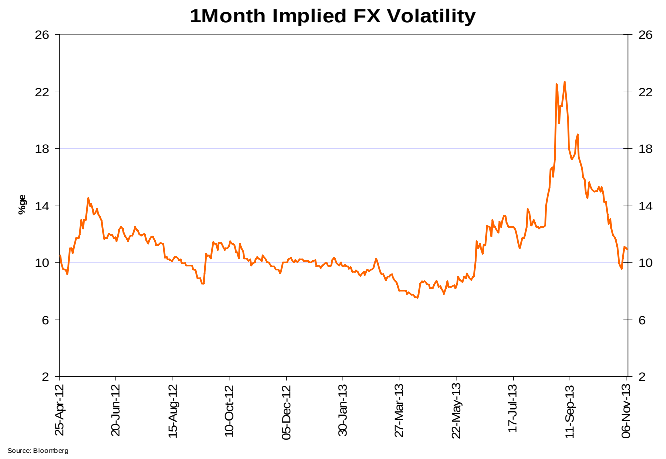


The 1-month implied FX volatility, a measure of expected moves in the exchange rate used to price options, has eased considerably: from a high of around 23% around late August, early September, it has retreated to around 10.9%, reflecting an improvement in conditions in the foreign exchange market.

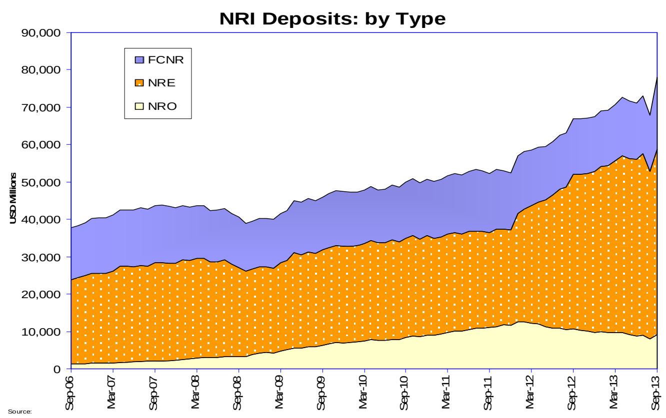
This improvement reflects a number of measures by both the RBI and the Government. The Foreign exchange Swap window offered to oil marketing companies has helped in bringing some measure of stability to the foreign exchange market and is said to have withdrawn around USD400 million of demand from the daily foreign exchange market.

Besides this, the RBI has offered banks a Concessional swap facility to attract FCNR (B) NRI deposits and allowed banks to borrow up to 100% of their unimpaired Tier 1 Capital from overseas. The latter *2 measures have been are said to have generated in excess of USD12.1bn of foreign exchange*, according to estimates from the Reserve Bank. Besides, Foreign Institutional Investors, particularly Equity Investors, remain optimistic about the India growth story, and have been net buyers of securities in September and October. Debt investors, however, still remain somewhat sceptical overall.

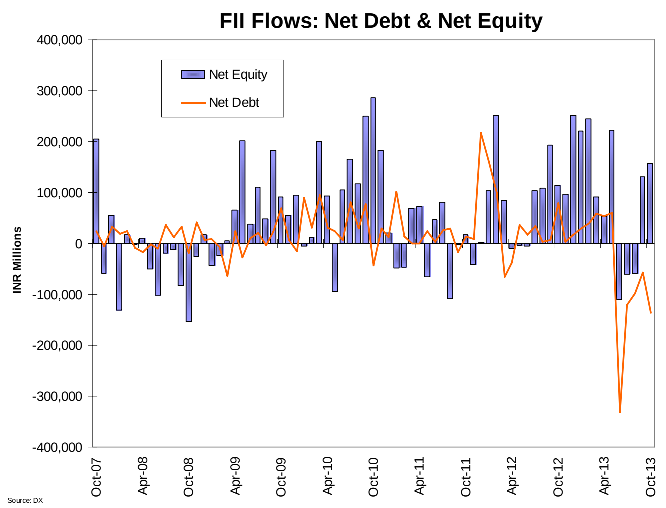
FX Volatility: 1-Month Implied



NRI Deposit Flows



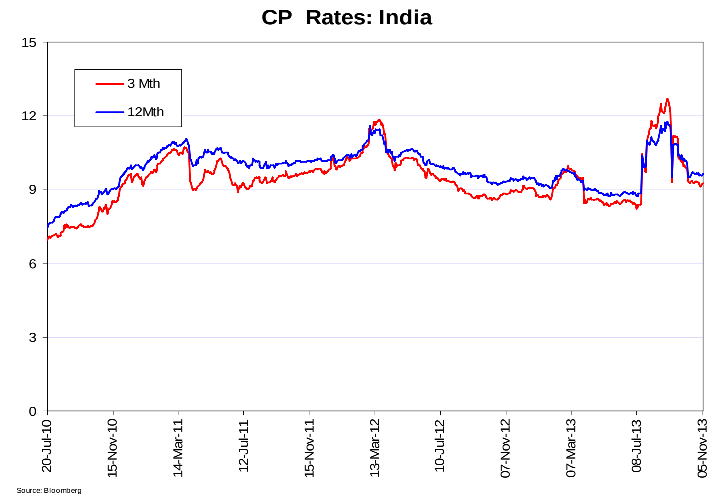
FII Flow: Debt and Equity



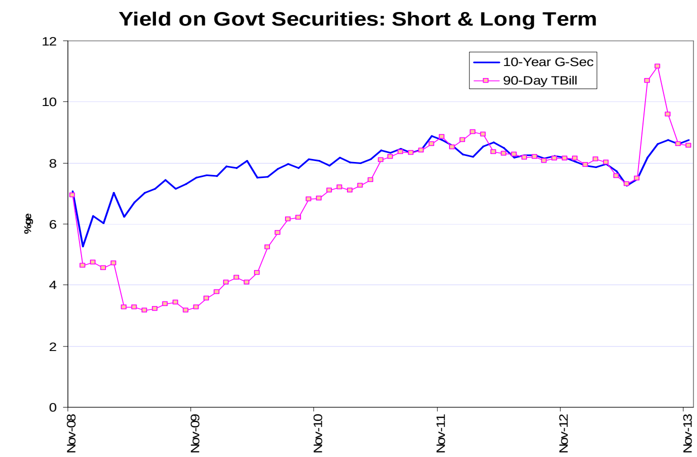
Another significant point is the easing in *Commercial Paper* rates, particularly at the short end. The exceptional measures to defend the Rupee led to a significant jump in the MSF rate, which translated into significantly higher short rates. These exceptional measures were instituted, in part, to make shorting the rupee an unattractive proposition to speculators. However, with the narrowing of the band between the Repo Rate and the MSF rate to 100bp, there has been a concomitant decline in Commercial paper rates. As a result, we are likely to see increasing use of short term Commercial paper from Corporates and somewhat less reliance on bank Credit.

Furthermore, the yield curve has become 'normal', with the 10-year G-Sec (Government Security) yield higher than the 90-day Bill rate. The yield curve was highly inverted during most of the July-October period.

Commercial Paper Rates



Yield on Government Securities



In summary, conditions in the external sector have stabilised considerably, from a couple of months ago. Concerns about funding the Current Account Deficit have receded considerably, and the yield curve has become upward sloping. However, normal conditions would only be said to have *returned to the foreign exchange market when the support to oil marketing companies is withdrawn completely.*

Concluding Remarks

Following the October 29th decision, we are forecasting one more rate rise, which will push the Repo rate to 8% by the end of the 2013-14 financial year.

Despite an expected improvement in the 'kharif' (monsoon) crop, and the disinflationary impact of a weak economy, the second round effects of high food and energy prices, as well as the elevated level of Core CPI, will warrant an extra rate rise. However, the weak economy, and the long lead times in monetary policy will limit the scope of further tightening. As mentined by Governor Rajan, "*If we tighten signficantly more now given the long lead times in monetary policy acting, we may find ourselves having overtightened and we do not want to go there with a weak econom*y".

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