# India Monetary Policy
by Group Economics

August 2014

National Australia Bank

## Summary & Overview


- The RBI held the policy Repo rate at 8% in its latest meeting – as broadly anticipated.
- The Statutory Liquidity Rate was cut by 50bp to 22% to enable banks to free up capital for lending, and to boost their liquidity coverage.
- This time around, there was a clear emphasis on moderating the medium term inflation outlook, with a special emphasis on a 6% CPI target for January 2016.
- Headline and Core retail inflation have eased markedly in June, partly driven by 'base effects'.
- Inflation expectations, though, remain high, despite easing moderately.
- The uncertainty regarding the monsoon remains a key risk for the inflation (and thereby monetary policy) outlook.
- India's foreign exchange reserves have expanded to USD320.6bn, driven by international inflows and a restrained current account deficit.
- We are forecasting the RBI to remain on hold at 8% over the course of the 2014-15 Financial year, with risks evenly balanced.

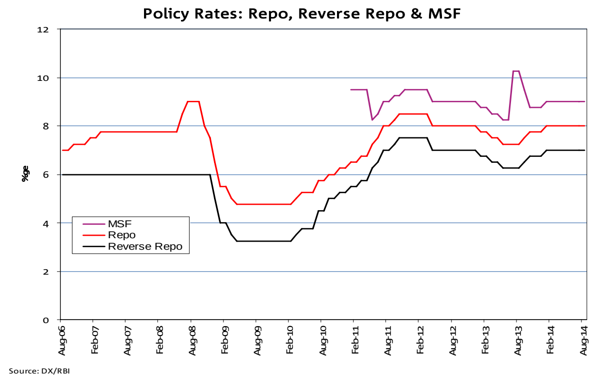

## RBI's Decision

At its Monetary policy meeting on the 5th of August the RBI:

- ❖ Maintained the policy Repo rate unchanged at 8%;
- ❖ Maintained the Reverse Repo rate at 7%, and the MSF (Marginal Standing facility) rate at 9%;
- ❖ Cut the Statutory Liquidity ratio (SLR) of Scheduled Commercial banks by 50bps to 22%, effective August 14;
- ❖ Maintained the Cash Reserve Ratio at 4%;
- ❖ Reduced the proportion of debt banks can hold without marking to market from 24.5% to 24%.

As per our and the market projections, the RBI maintained the policy rate at 8%. It reiterated its commitment to a disinflationary path, wherein growth in the Consumer price index falls to 8% by January 2015, and further to 6% by January 2016.

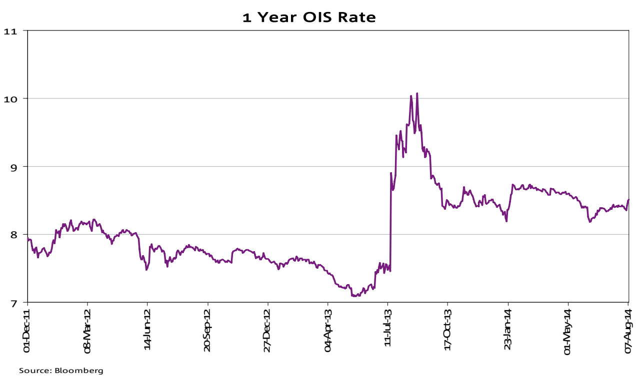
### RBI Decision




The interesting feature this time around has been the increased focus on achieving the more challenging 6% CPI outcome by January, 2016. Whilst the RBI Governor Rajan was somewhat relaxed about achieving the 8% outcome in January, 2015, he was not as sanguine with regard to achieving the 6% outcome in January, 2016. He noted there were upside risks to the 2016 inflation forecast, and believed that curbing inflation was the best strategy for achieving sustainable growth outcomes. In his words, 'Let's fight the anti-inflation fight once, and let's win. That will create the best conditions for sustainable growth'.

Markets interpreted the Governor's Comments as somewhat hawkish, in contrast to the June Meeting. As a result, 1- Year interest rate swaps (derivate contracts to guard against 1 year borrowings) jumped about 10bp since the announcement, and have risen further since.

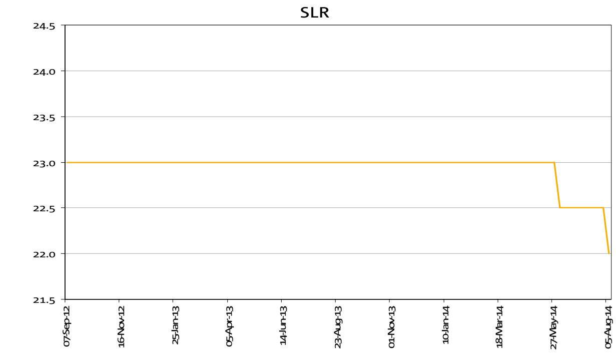
### 1-Year Interest Rate Swap




Other interesting measures adopted at this meeting centred on boosting bank lending capacity. The RBI cut the Statutory Liquidity Ratio (the portion of deposits that must be invested in Government bonds) to 22%, down from 22.5%. The aim was to free up bank lending to productive sectors of the economy, when credit growth picks up. Another objective was to offer banks the opportunity to meet the higher liquidity requirements as part of Basel 3.

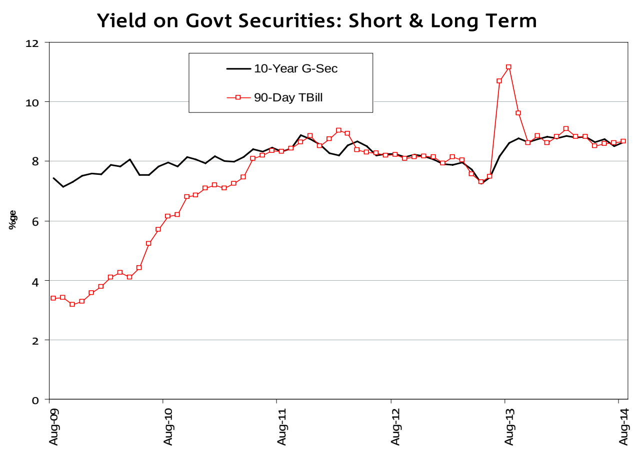
According to the *Mint* publication, the SLR cut could potentially free up INR40bn for lending in the Indian banking system. Further, it lowered the cap on the amount of debt that banks can hold without marking to market to 24% from 24.5%. This would encourage banks to increase their financial market participation to avoid potential risks from marking to market.

## Statutory Liquidity Ratio




The cut in the SLR, pushed up bond yields by around 10bp, and are expected to be broadly negative for Government bonds. That said, bond yields are expected to trade in the 8.4-8.7% range, according to estimates from ING Vysya Bank.

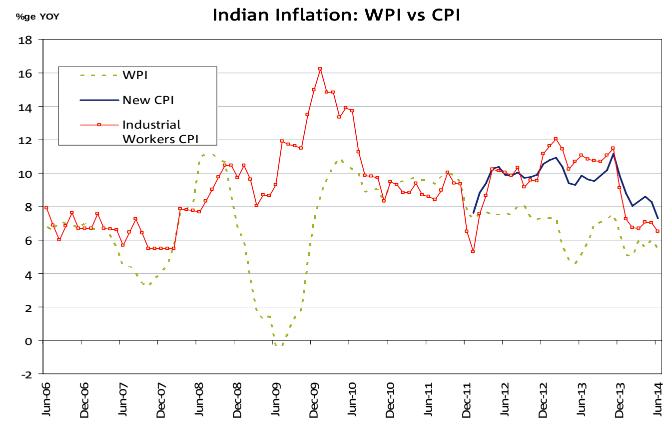
## Yields on Government Papers




# Inflation & Growth Drivers

Inflationary pressures have moderated in June, according to headline Consumer and Wholesale price data. Consumer prices – RBI's preferred gauge – rose 7.3% during the year to June 2014 – the lowest since the series commenced in January 2012. Wholesale prices expanded by 5.4%, the lowest in 4 months.

## Headline Inflation

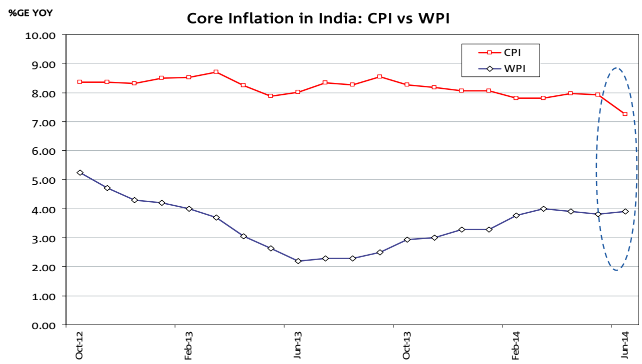



Source:CEIC

The easing in inflationary pressures was partly due to base effects, impacted by the stronger price increase in the previous corresponding period. In the food category, there was an easing in vegetables and cereal prices at the retail level. Fruit prices, though remained very high.

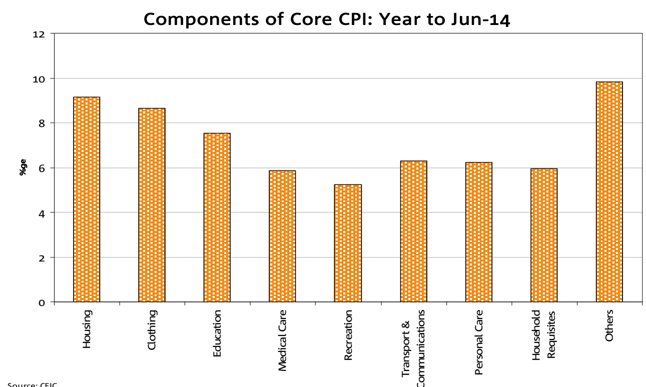
More significantly, Core CPI also moderated to 7.3% in June: the lowest on record. In the core category, there has been some visible easing in medical, transport and household requisites categories. Housing, clothing and 'others' remained elevated.

## Core Inflation measures




Source: NAB Economics

## Core Inflation indicators

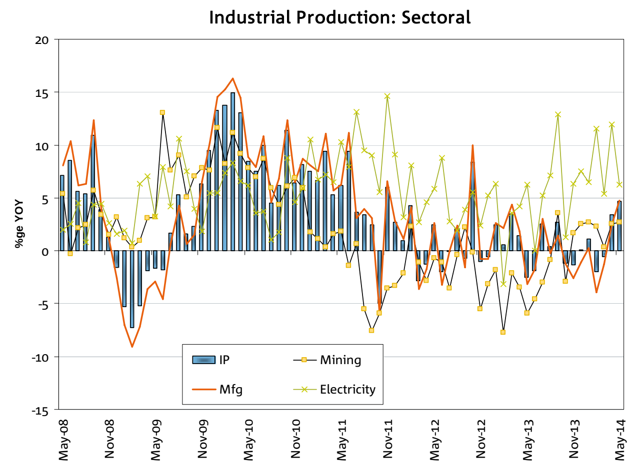



Source: CEIC

There was a slight rise in the rate of Core Wholesale (non food manufactured) inflation, from 3.8% to 3.9%. This could indicate improved economic conditions, with the Index of

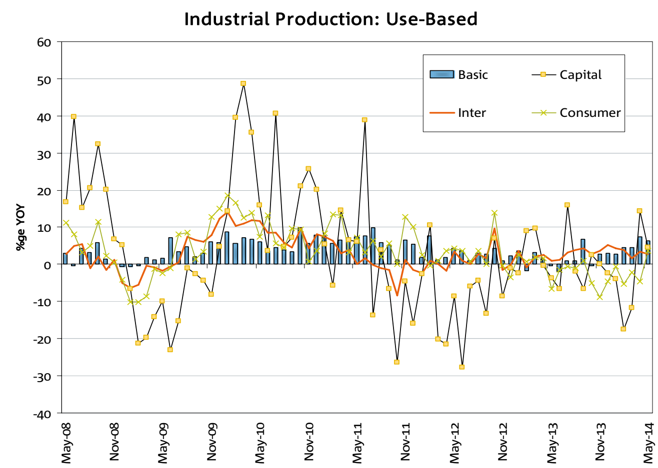
Industrial production rising 4.7% over the year to May, 14. This is the strongest outcome since October 2012. By sector, electricity was the strongest performing, although both mining and manufacturing – previously laggards – performed quite well. By use, all segments contributed to the positive outcome. Encouragingly, the volatile capital goods segment has shown a positive outcome for 2 consecutive months, although it remains to be seen if this is the start of a more durable improvement in investment.

## Industrial production: Sectoral




Source: CEIC

## Industrial Production: Use Based




Source: CEIC

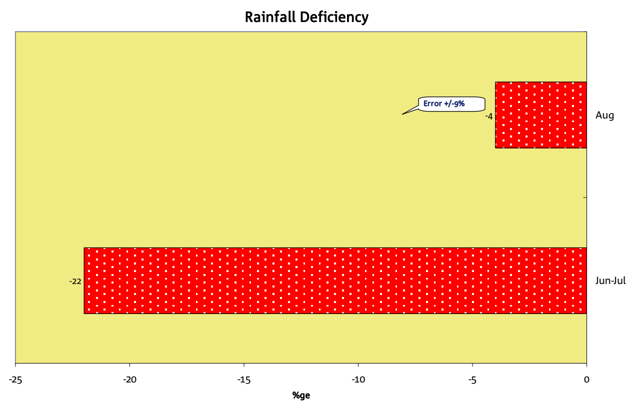
Household *inflation expectations* for the year ahead reveal that households are expecting the retail inflation rate at 15% over the year to June 2015. Whilst lower than the previous 3 quarters, inflationary expectations still remain high. The survey measures expectations of urban households based on their individual consumption baskets. Whilst not directly comparable to official measures, the survey provides useful *directional* information as to the likely path of future inflation.

## Inflation Expectations Survey


Source: RBI

The all-important monsoon rains (which accounts for 70% of India's annual rainfall) have started to show signs of improvement, after a very weak start. The monsoon period is from June to September, and is critical for summer crops such as rice, soybean, cane and cotton. .

## Indian Monsoon Projections



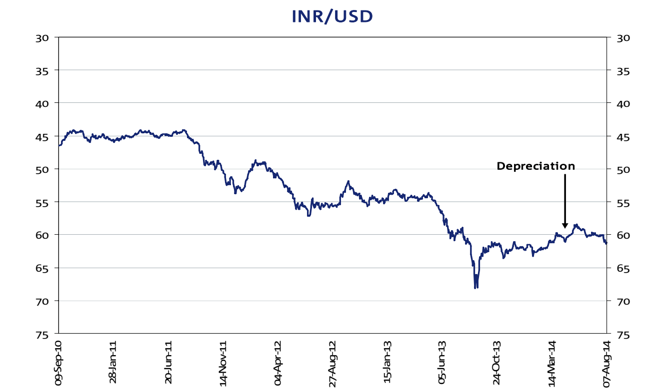

According to the *Indian Meteorological Department (IMD)*, the rainfall deficiency in June was 43% (below normal); conditions improved in July, with a deficiency of 10% recorded for the month. The deficiency for the June-July period was 10%. The IMD is forecasting a 4% deficiency, with an error of +/-9% in the crucial sowing month of August. Data updated to the 7th of August by the IMD reflected a 17% shortfall.

The Government has undertaken risk mitigation measures such as ordering a crackdown on hoarders, setting minimum export prices for onions and potatoes to limit exports of these products, as well as selling 25% of its rice and wheat stocks in the domestic markets since June. Whilst useful in themselves, the volume and spatial distribution of rainfall will have an impact on crop production, and potentially food inflation, which accounts for close to 50% of India's CPI basket.

## External and Financial

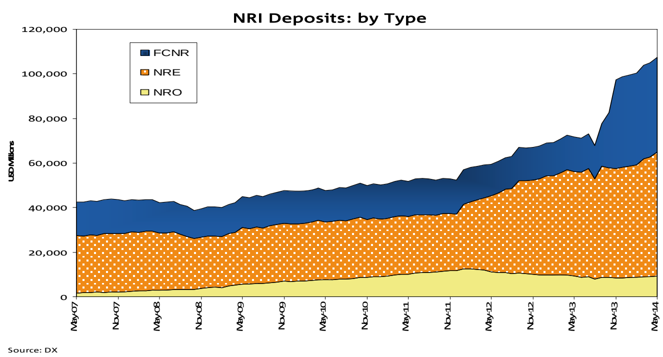
The Indian Rupee has been impacted by global economic factors, and has been trading around 61.3/USD. The INR has depreciated in consonance with a rising USD, with heightened geopolitical risks, prompting a flight to safety to safe-have currencies like the USD.

### FX rate

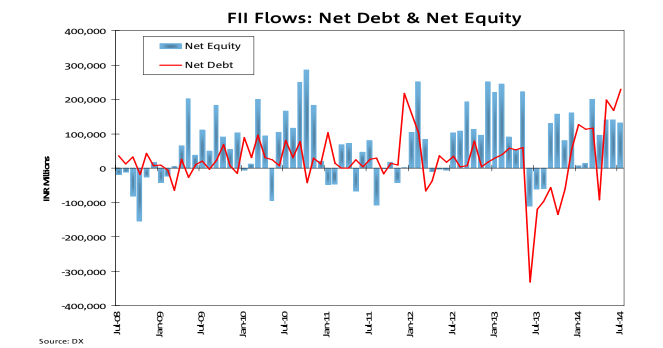



India continues to remain a popular investment destination, both for overseas Indians as well as Foreign Institutional Investors. NRI deposits have continued to remain strong, particularly in the NRE (Non Resident External) and FCNR (Foreign Currency Non resident) categories. Further, Net debt investments by overseas international investors have taken off quite sharply since May, 2014. They have surpassed Foreign equity inflows, although the latter too remain substantial.

### NRI Deposits




### FII Inflows

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India's foreign exchange reserves have swelled through a combination of a much contained Current account deficit, and rising inflows. India's FX reserves currently stand at USD320.6bn, around USD45bn higher than August-September 2013. The accumulation in reserves, focus on maintaining a credible policy to stave off inflation, as well as a focus on containing the fiscal and current account deficits are part of the policy mix by Indian authorities to help immunise the economy from external shocks.

The possibility of external shocks was specifically mentioned in the Monetary policy report: 'EME's remain vulnerable to changes in investor risk appetite driven by any reassessment of the future path of US monetary policy or possible escalation of geopolitical tensions'.

## Outlook

**With regard to the Monetary policy outlook, we are forecasting the RBI (Reserve Bank of India) to remain on hold at 8% over the 2014-15 financial year, with risks evenly balanced.**

Favourable 'base' effects for the retail price outlook are likely in October, November 2014 before dissipating in the final quarter of the 2014-15 financial year (the January-March period). Moreover, the RBI mentioned that the 8% target for the CPI in January 2015 seemed 'likely'; however, there were upside risks with regard to meeting the 6% target in January 2016. The RBI cited that it was crucial for the disinflation process to be 'sustained over the medium term', to ensure a viable medium term growth profile. It is also keen to see inflation expectations fall from the current elevated levels.

Some of the risk factors include: uncertainty over the monsoon and the impact on food production; the pass through of administered price increases (in fuel); and potential for geopolitical tensions leading to rising oil prices.

Risks are evenly balanced around our central projection. A faster, more pronounced disinflationary path could see a rate before the end of the financial year. Conversely, pressures from a weak monsoon along with rising geopolitical tensions could prompt a rate rise.

John Sharma

Economist – Sovereign Risk

john.sharma@nab.com.au

Tom Taylor

Head of International Economics

Tom_Taylor@national.com.au

# Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

## Australian Economics and Commodities

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

## Industry Analysis

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

## International Economics

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

# Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

## Australia

**Economics**
Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

**FX Strategy**
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

**Interest Rate Strategy**
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

**Credit Research**
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

**Equities**
Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

**Distribution**
Barbara Leong
Research Production Manager
+61 2 9237 8151

## Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

## New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

## UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Head of Credit Strategy
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532