more give, less take

National Australia Bank

India Monetary Policy

by Group Economics

October 2014

Summary & Overview

- The RBI held the policy Repo rate at 8% in its latest meeting – as broadly anticipated.
- The focus on meeting the 6% headline CPI outcome in January 2016 was reiterated.
- The RBI adopted a number of measures, including allowing banks to access additional liquidity, provided they meet their 22% SLR holding requirements.
- Core CPI inflation has declined markedly since September last year. However, high Food price inflation due to the drought has limited the decline in Headline CPI.
- Inflation expectations remain high, and have edged higher this quarter, limiting any prospect for a rate cut.
- India continues to remain an attractive investment destination, particularly for Foreign Debt investors. The recent upgrade in India's outlook from negative to stable by S&P will help improve India's risk perception.
- We forecast the RBI to remain on hold at 8% during the remainder of 2014 and 2015. A 25bp rate cut is anticipated to bring the Repo rate down to 7.75% in the March quarter, 2016.

RBI's Decision

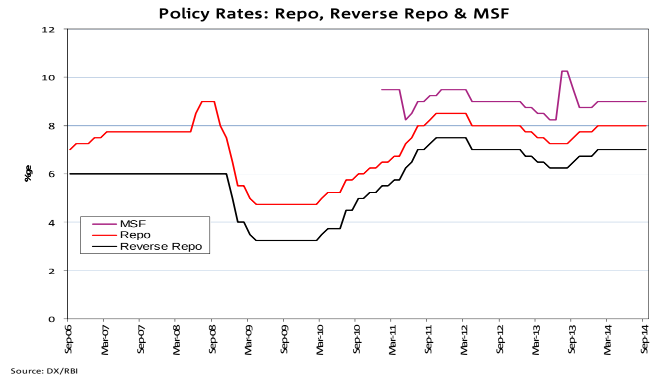
At its meeting on the 30th of September, the RBI made the following Monetary Policy decisions:

- ❖ Maintained the policy Repo rate unchanged at 8%;
- ❖ Maintained the Reverse Repo rate at 7%, and the MSF (Marginal Standing facility) rate at 9%;
- ❖ Provide liquidity through overnight and term repos, the latter consisting of 7-day and 14-day duration
- ❖ The CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio) were held at 4%, 22%, respectively.

As per our and the market projections, the RBI maintained the policy rate at 8%. It restated 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.

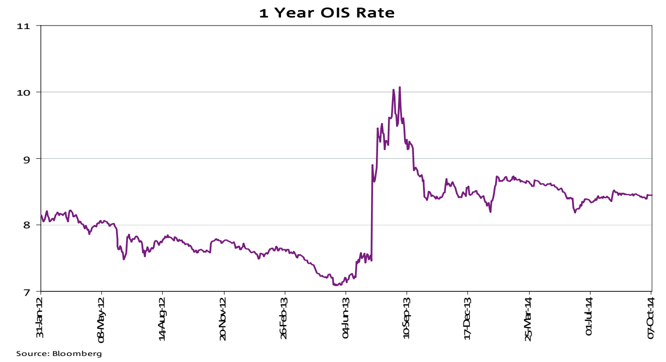
Further it indicated that the 8% target is likely to be achieved, with a downward bias (i.e. likely to be below 8%). However, there were upside risks to meeting the 6% 2016 target, albeit a bit less so than in the previous monetary policy statement.

RBI Decision



As the decision was in line with market expectations, 1-Year interest rate swaps (derivate contracts to guard against 1 year borrowings) remained stable post announcement and haven't altered much since then.

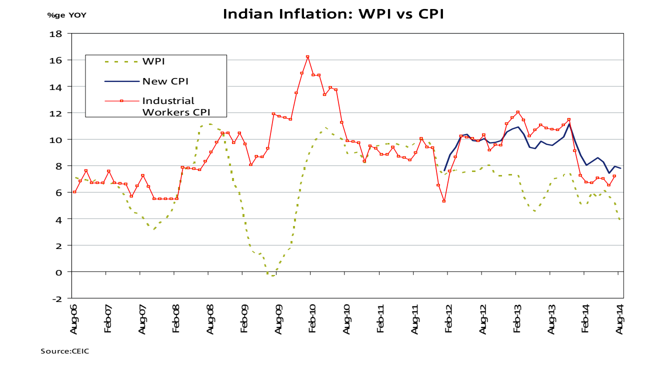
1-Year Interest Rate Swap



Inflation & Growth Drivers

Inflationary pressures abated in August, according to headline inflation. Consumer prices – RBI's preferred gauge – rose 7.8% during the year to August 2014, below the 7.96% in July, and close to recent lows. Wholesale prices expanded by 3.74%, the slowest pace since October, 2009.

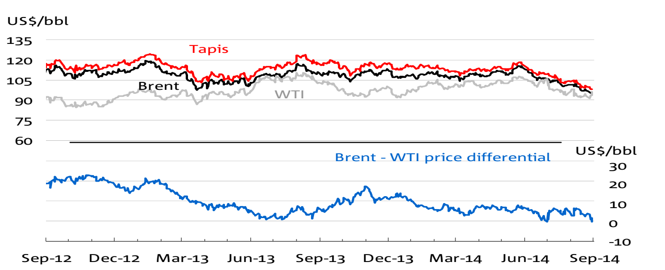
Headline Inflation



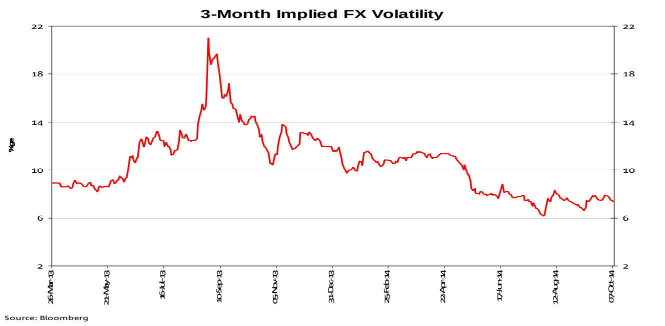
Some of the factors underpinning weaker price pressures include: easing in fuel prices, as well as relative stability in exchange rates, limiting the impact of imported inflation.

The benchmark WTI (West Texas Indicator) price was trading around USD90/bl. Further, 3-mth implied FX volatility, a measure of exchange rate swings used to price options, was at 7.4%, close to recent lows – according to Bloomberg data.

Crude Oil Prices

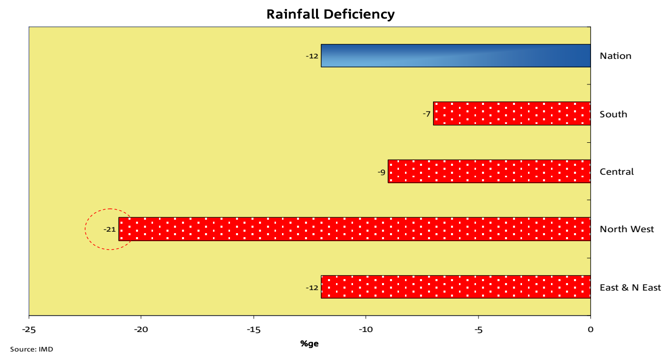


Exchange rate volatility



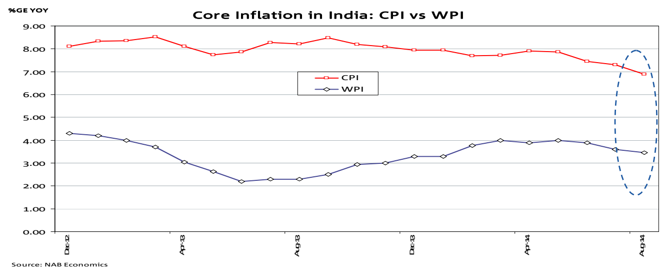
Food prices, which comprise close to 50% of the CPI basket, expanded by 9.2% over the year to August, well above the overall CPI increase. Within food, fruits (24.3%) and vegetable (15.2%) prices increased rapidly, suggesting measures to improve storage, distribution and limit waste could assist in assuaging food price pressures. Besides, the weaker monsoon is likely to have contributed to rising food prices. According to the Indian Meteorological Department (IMD) the monsoon deficiency is estimated at 12%, and is most pronounced in North West India in states such as Punjab, UP and Rajasthan.

Monsoon Outcomes

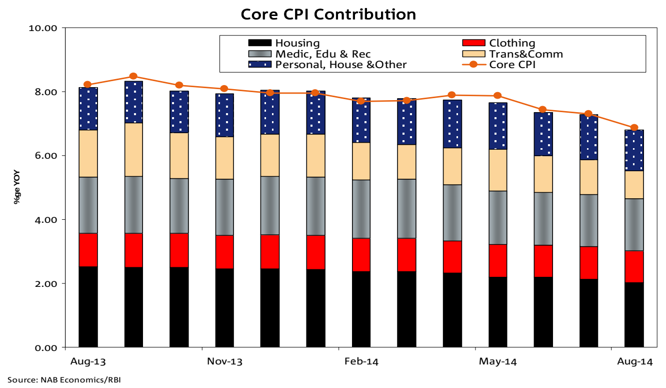


The RBI was visibly pleased with the improvement in Core CPI (CPI excluding food and fuel). It has fallen 160bp since September 2013 to a low of 6.9% in August 2014. Within the components of Core CPI, the contribution of housing has eased, reflecting softer rental growth. Lower global fuel prices have lessened the impact of transport costs. Clothing, medical and health have broadly remained stable. There has also been an easing in household requisites, although 'others', reflecting personal non-tradeable services, has recorded strong price growth.

Core Inflation Indicators

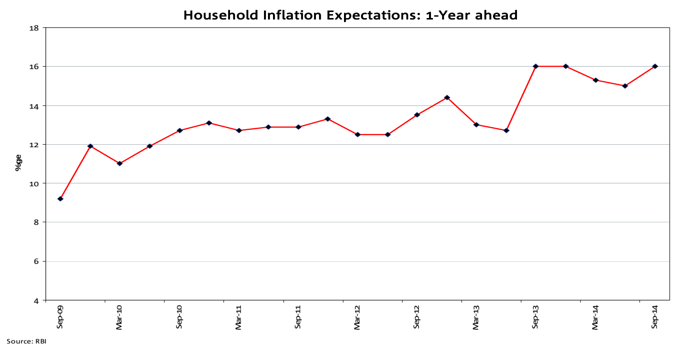


Contribution to Core CPI Inflation



Household *inflation expectations* for the year ahead reveal that households are expecting the retail inflation rate at 16% over the year to September, 2015. This is higher than the previous survey, and may reflect the impact of higher food prices due to the weaker monsoon. The survey measures expectations of urban households based on their individual consumption baskets and provides useful *directional* information as to the likely path of future inflation. These results will make a cut very difficult to justify.

Inflation Expectations Survey

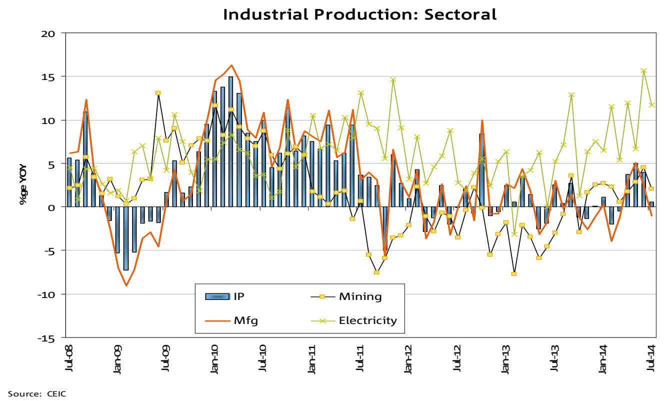


Following the robust 5.7% GDP outcome in the June quarter, economic conditions have moderated somewhat.

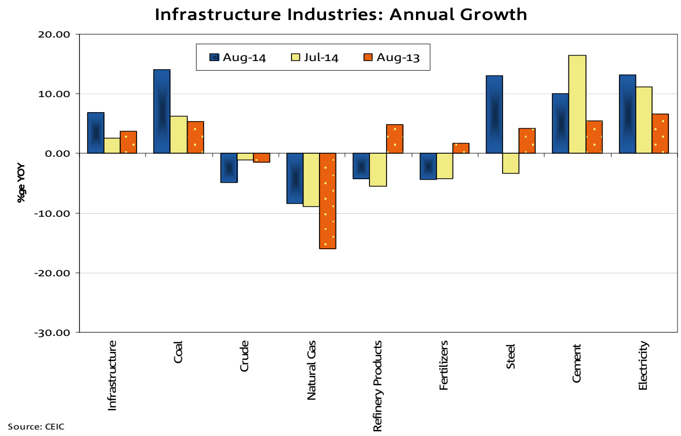
Industrial production has eased to 0.5% in July, from 3.9% in June – partly impacted by a high base in July, 2013. By sector, manufacturing, moved into negative territory, whilst electricity was the strongest, in line with recent trends. By use, the consumer sector was the weakest, and the volatile capital goods category also turned negative.

On a somewhat more positive note, the performance of the Infrastructure sector improved strongly in August, rising by 6.9%, well above the 2.6% outcome in July. This raises hope of an improvement in Industrial production in August. By sector, steel, cement, electricity and coal were better performing. The performance of the coal sector could slacken though, given ongoing uncertainty regarding the Supreme Court's decision to cancel all but 4 captive coalfields allocated since 1993.

Industrial Production



Infrastructure Industries

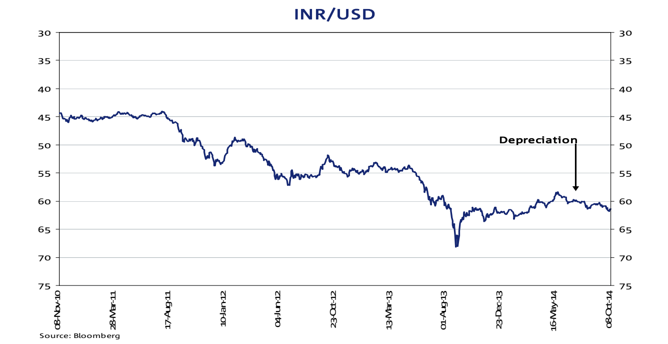


External and Financial

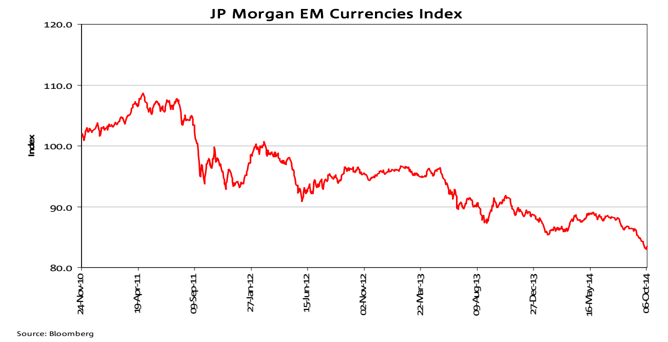
The Indian Rupee has pared back some of its recent weakness against the greenback, buoyed by a narrowing in Augusts' trade deficit (USD 10.8bn vs. USD12.2bn in July), lower Crude oil prices and Dollar selling by nationalised banks. It was last trading around 61.39/USD, compared with a recent low of 61.82/USD on the 2nd of October.

It should be remembered that the recent Dollar strength has been broad based, against a number of other currencies, not just the Indian Rupee. According to data from the RBI, over the month to 1st October, 2014, the Indian Rupee *depreciated* by 2.1% against the USD, but *appreciated* by 3.1% and 1.8% against the Japanese Yen and Euro, respectively. Further, the INR has fared somewhat better when compared to the basket of Emerging market Currencies, based on the JP Morgan EM Currencies Index.

Indian Rupee to the USD

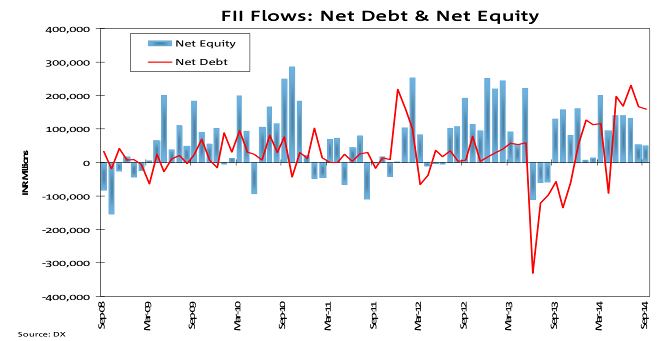


JP Morgan Emerging Currencies Index



India continues to remain a popular investment destination for Foreign Portfolio investors. This is particularly the case for Foreign debt investors, who are likely to be attracted to the inflation-fighting objective of India's Central Bank. Further, recent measures on extended settlement times will add to the appeal of Indian debt securities. Interest in India's Equity offerings still remains, but the data for August, September are considerably less bullish.

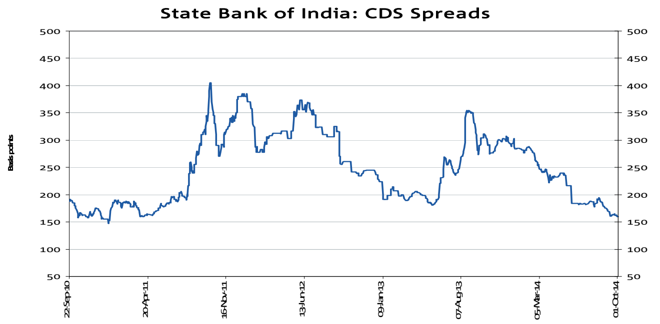
FII Inflows



Ratings agency, S&P recently upgraded its outlook on India from negative to stable. It highlighted that the current political landscape is more amenable to economic and fiscal reforms. The decision by S&P will further improve India's standing. There has been a continued, gradual easing in the State Bank of India's CDS spreads, a proxy for India's

Sovereign risk. This pattern in CDS spreads is aligned with the improved S&P rating.

Sovereign Risk Perception



Source: DataStream

Outlook

With regard to the Monetary policy outlook, we are forecasting the RBI (Reserve Bank of India) to remain on hold for an extended period. The Repo rate is forecast to remain at 8% for the remainder of 2014 and 2015, before the RBI cuts by 25bp, leaving the Repo rate at 7.75% by March quarter, 2016.

In its Monetary Policy report issued on the 30th of September, the RBI indicated that it expected to meet the critical 6% medium term target, although the latter faced upside risks. Some of the risks stem from RBI's internal modelling on the path of Headline CPI, which indicated a 7% outcome in March quarter, 2016. It reconciled these diverging trends by suggesting that their judgement reflected a 6% outcome, but the model results indicate upside risks to the forecasts.

An improvement in the food supply chain would be the main factor ensuring a lower path for prices going forward. Weaker commodity prices would also help. Conversely, a weaker exchange rate, higher commodity prices, a sub-par monsoon in 2015-16 and stronger than expected growth could generate upside risks to inflation. The evolution of these factors, and the attendant inflationary impact will likely influence the RBI's decision going forward.

RBI's Other Measures

The RBI mentioned it would reduce the liquidity provided under the Export Refinance facility (ECR) from 32% to 15% to reduce dependence on sector-specific liquidity measures. Instead, it wanted to focus on providing liquidity across the board through both overnight Repos (0.25% of Net Demand and Time Liabilities) as well as term Repos of 7-day and 14-day duration (0.75% of Net Demand and Time Liabilities).

Additionally, the RBI highlighted a number of measures to improve India's banking and financial architecture. They include:

- **Developing Government Securities market:** As part of measures to improve the Government securities market, the ceiling on SLR securities in the Held to Maturity category (i.e. without marking to market) is to be reduced from 24% to 22% in a staggered manner, over January-September, 2015. Further, more liberal measures were adopted regarding short selling Government securities.
- **Boosting Banks' Liquidity:** To provide flexibility to the banks in meeting the Basel 3 LCR (Liquidity Coverage ratio) mandate, Banks which meet their 22% SLR requirement can now access a further 5% liquidity of their Net Demand and Time Liabilities (NDTL) from the RBI at a rate higher than the MSF rate. This is in addition to 2% (of NDTL) that Banks can access through the MSF facility.
- **Early Warning System:** To provide forewarning of potential banking problems, banks' critical financial metrics are to be closely monitored by the RBI. Deviations from pre-defined benchmarks could result in more invasive supervision.
- **Central Fraud Registry:** To assist banks by providing a central database of fraudulent customer.
- **Foreign Investors:** To address operational issues faced by Foreign Portfolio investors in different time zones, an option for T+2 settlements for secondary market OTC trade in Government securities.
- **Hedging for Importers:** Importers can now hedge up to 100% of imports (previously 50%) based on the higher of the past 3 years or the previous year imports, subject to other conditions being met.

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