India Monetary Policy

by Group Economics

April 2015

Summary & Overview

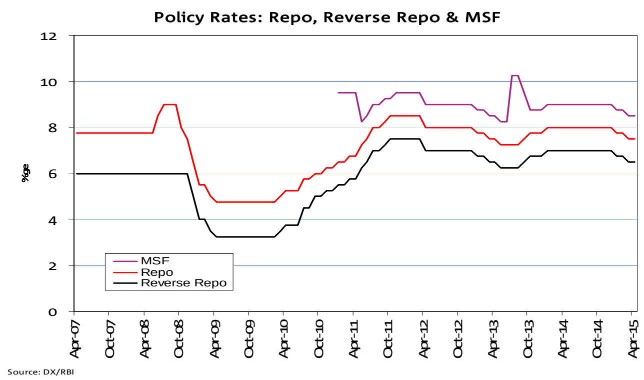
- The RBI held the benchmark Repo rate at 7.5% in its April 7 Meeting.
- Governor Rajan also chided banks for not passing prior rate cuts. Following his remarks, a number of banks reduced their base rates.
- Headline consumer inflation rose to 5.4% in February. However, inflationary pressures remained contained, with Core CPI falling to 4.1% in February.
- India's external position is much more secure than before, with FX reserves at USD343bn.
- Reflecting increasing confidence in India's economic prospects, Moody's upgraded India's outlook from stable to positive.
- The RBI announced a number of regulatory changes, including measures to allow Indian Corporations to issue Rupee-denominated bonds overseas.
- NAB Economics is forecasting another 25bp cut to the Repo rate in 2015– most likely in the June quarter, with the year-end Repo rate expected at 7.25%.
- Further rate cuts are possible but depend on : path of food prices and the monsoon rains; the supply response (land, power, etc) and possible external uncertainty.

RBI's Decision

At its April, 7th meeting, the RBI:

- Maintained the policy Repo rate at 7.5%; the MSF (Marginal Standing Facility) and Reverse Repo Rate were held at 8.5% and 6.5% respectively;
- Kept the Cash Reserve ratio at 4%
- Continued providing liquidity under overnight repos at 0.25% of banks' NDTL (Net Demand & Time Liabilites), and 7-day and 14-day term repos at 0.75% of banks' NDTL.

Indian Policy Rates

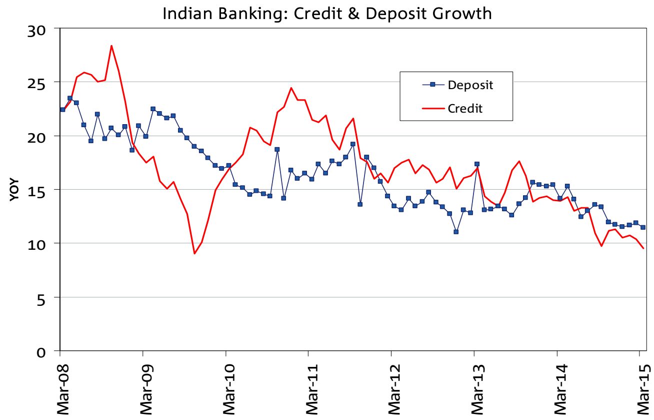


The RBI's decision was largely anticipated, given the previously 'front-loaded' rate cuts in January and March. **In its Statement, the RBI highlighted that recent unseasonal rains had generated some uncertainty and that banks had not passed on the previous rate cuts.**

With regard to weather disturbances, the Farm Ministry indicated that there could be a 4-5% decline in the wheat crop. Recognising the potential negative impact on affected farmers, Prime Minister Modi indicated an increase in the compensation package to be provided to distressed farmers.

On interest rates, Governor Rajan chided the banks for not passing on the previous rated cuts. He also highlighted the 'tepid' pace of credit growth (9.5% over the year to March) and easing liquidity as factors enabling banks to cut rates. More specifically, he suggested that banks should compute their lending rate based on the *marginal cost of funds* (which are more sensitive to the policy rates), instead of average costs.

Credit & Deposit growth



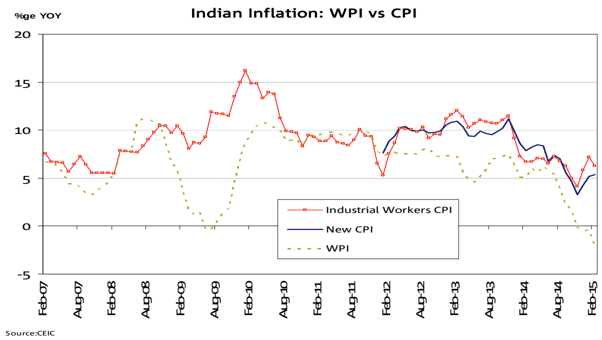
Following the remarks by the Governor, a number of banks announced a reduction in their base rate, the minimum lending rate. SBI indicated a 15bp cut in its base rate to 9.85%; ICICI 25bps to 9.75%; and HDFC 15bps to 9.85%.

Inflation and growth

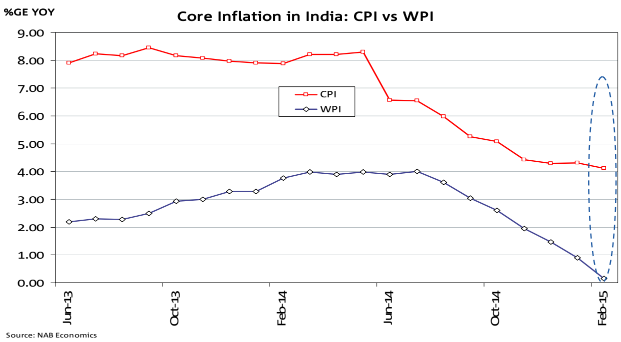
Headline consumer inflation increased a touch in February, rising by 5.4% over the year (5.2% in January). Food prices (6.8%) remained somewhat elevated, due largely to fruits (8.9%), vegetables (13%), dairy (9.2%) and pulses (10.6%). By contrast, the wholesale price measure turned negative, impacted by falling fuel prices.

Underlying inflationary pressures though, remain contained. This can be seen in the declining trend in Core CPI (ex fuel and food), which has fallen over the past 9 months to a low of 4.1% in February. This is partly due to the impact of lower fuel prices on transport costs. Besides, housing costs have eased partly due to revisions in the coverage of the new CPI measure; and muted demand for health, education and services has restrained price increases in these categories. Further, rural wage growth has eased substantially, rising by 5.5% in January 2015, c.f. 15% during 2007-13, according to the *Labour Bureau*.

Headline inflation

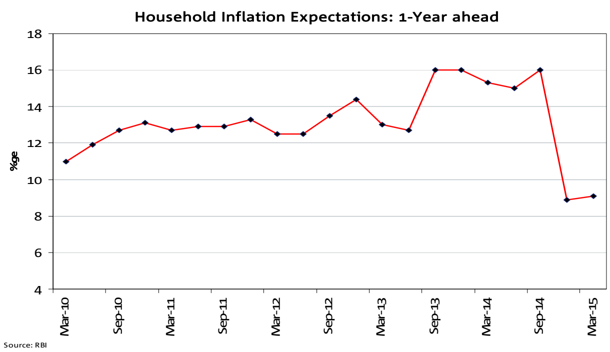


Core inflation



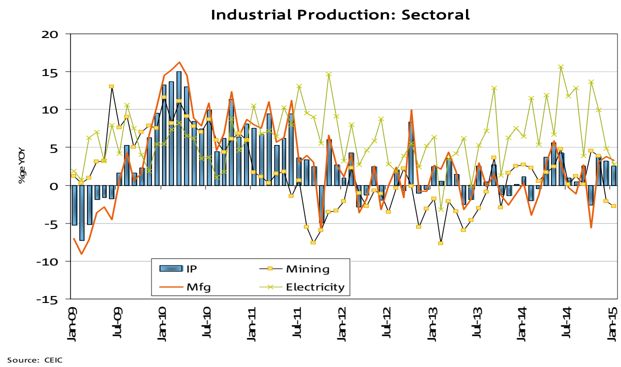
The RBI's survey of *household inflationary expectations* is a useful forward-looking price indicator, and provides an insight into future behaviour of prices, and hence interest rates. In the most recent (March 2015) survey, household inflation expectations for the year head rose slightly (from 8.9% to 9.1%). However, they remain in single digits, and well below levels since September, 2014. This does give some confidence that the RBI will cut rates again.

Inflation Expectations

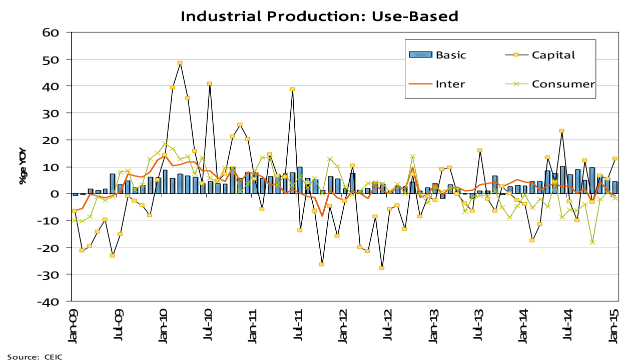


Industrial production has shown positive growth over the 3 months to January, 2015. Mining has still been in the doldrums, although electricity, and more importantly given its relatively larger share, manufacturing has shown positive growth. By use, consumer goods (particularly durables) has been weak, but capital goods has shown strong growth. That said, it is still too early to call this the start of a new capital investment cycle, although progress on clearing stalled projects will help.

Industrial Production - Sectoral



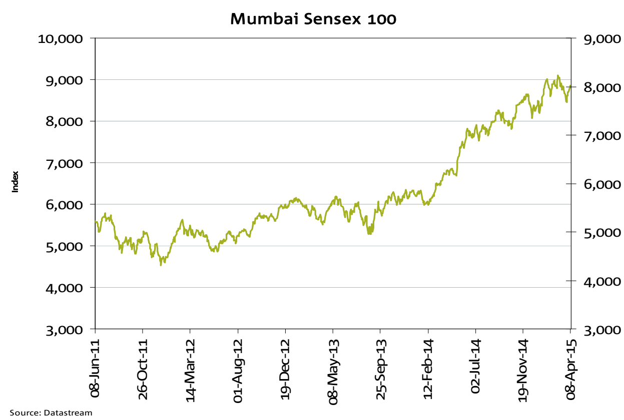
Industrial Production - Use



External and Financial

The equity market seems to have shrugged off the rate decision, and continues to gain strength. Data from SEBI revealed that foreigners continue to have a strong appetite for Indian shares, buying a net USD41.4 million of shares, taking the year's inflows at USD6.3bn, the highest in Asia. Coal India, Reliance Industries and Tata Consultancy have been among the stronger performers.

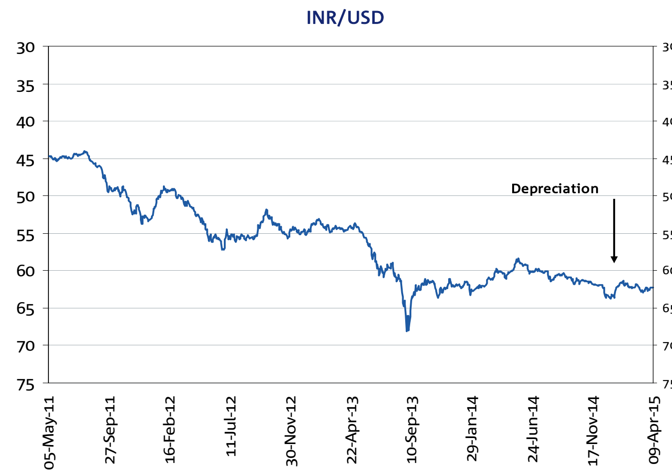
EQUITIES



India's rupee has been trading around the USD62-63 range, and FX volatility remains broadly muted. However, India's

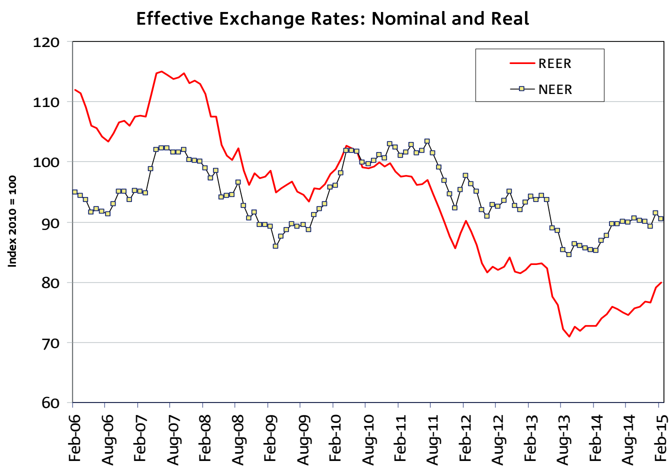
REER (Real Effective Exchange rate) has risen noticeably over the past few quarters. The RBI noted this in its review and suggested that it maybe a factor constraining export growth – although it also made the point that it did not target any particular level for the exchange rate.

FX Rate:



Source: Bloomberg

Effective Exchange rates

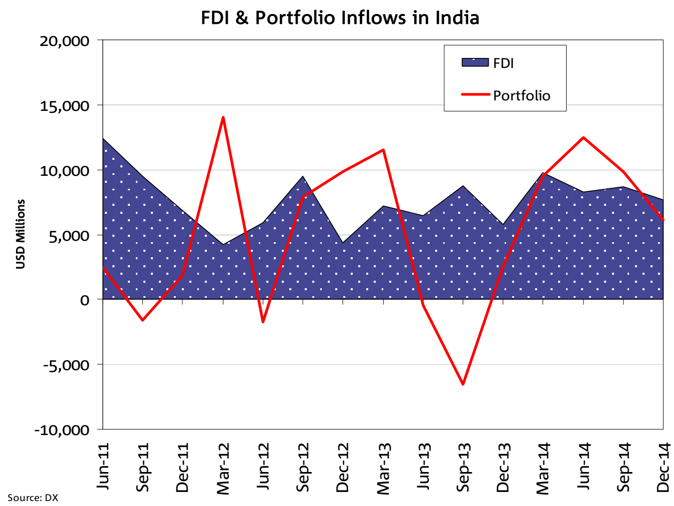


Source: BIS

Whilst exports have been constricted by the higher exchange rate, imports too have fallen in nominal terms due to lower crude oil prices. Besides, gold purchases remained broadly contained. The RBI also indicated that service exports have held up, particularly for software and tourism, ensuring limited pressure on the Current Account (the deficit for the December quarter was at -1.6%.

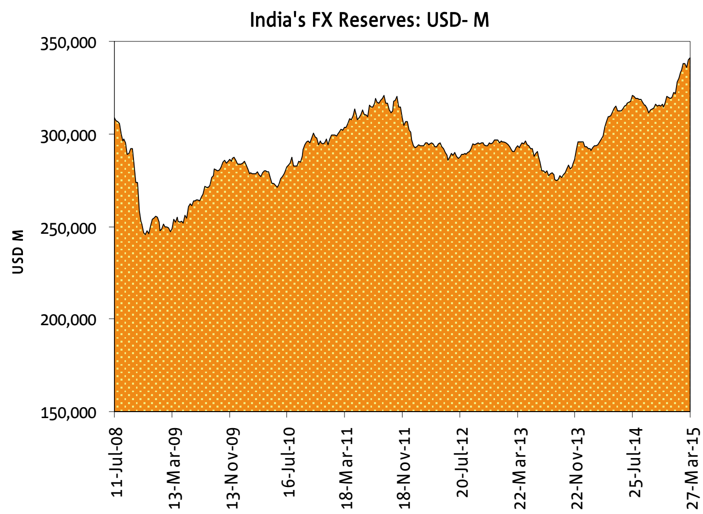
Strong capital inflows from both foreign direct investments as well as strong debt and equity portfolio inflows from overseas investors have more than covered India's deficit shortfall and have swelled India's foreign exchange reserves. The latest RBI data reveal that they have increased to USD 343billion, and provide a meaningful buffer against any volatility which may arise from anticipated US Federal Reserve rate hikes later in the year.

FDI and Portfolio Inflows



Source: DX

FX Reserves



Source: Bloomberg

Moody's has upgraded India's outlook to positive, from stable. This reflects a number of favourable developments: increased confidence in the economic outlook, improvements in its institutional profile and confidence in measures to boost infrastructure and ease business regulations.

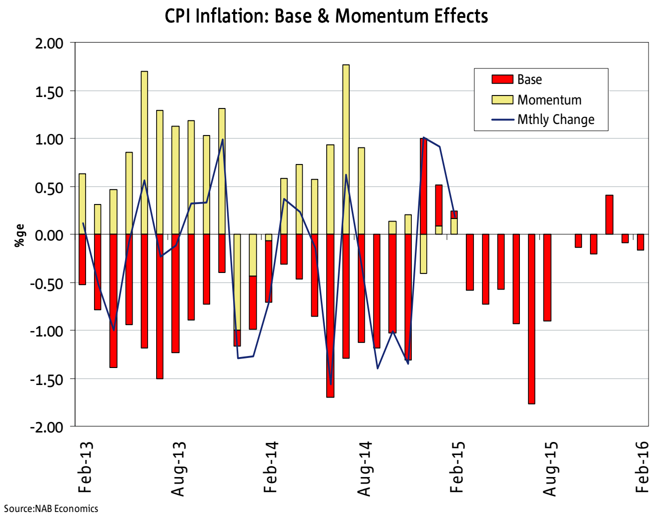
Outlook

The RBI indicated that 'Going forward, the accommodative stance of monetary policy will be maintained, but monetary actions will be conditioned by incoming data'.

Its aim was to achieve a below 6% inflation target by January 2016, followed by a 4% target (the mid-point of the proposed 4+/-2% target band) by March 2018.

Over the coming year, it expected inflation to evolve around the current level (5.4%) till June 2016, moderate to 4% by August, and rise to 5.8% by the end of the year. This pattern can be seen in the chart below, showing the projection of 'base effects' over the year head.

CPI Inflation: Base & Momentum Effects



NAB Economics is forecasting one more rate cut (during the June quarter), which will ensure a Repo rate of 7.25% by the end of 2015. Further rate cuts are possible, but depend on: the outlook for food prices and the coming monsoon rains; progress on improving the supply side of the economy; potential external uncertainty (e.g. from expected rate hikes from the Fed).

Financial and Regulatory measures

The monetary policy announcement was accompanied by a number of regulatory developments. Some of the key elements include:

- Allowing trading of Government bonds by retail investors. This could potentially lessen demand for certain types of bank deposits.
- Facilitating the issue of rupee bonds overseas by Indian corporations. Overseas investors will be able to enjoy high yields, and at the same time Indian corporations will not be subject to currency risk. This could be akin to 'dimsum' bonds issued by Chinese corporations in Renminbi.
- Permit banks to invest in each other's bonds for trading purposes – subject to restrictions.
- Doing away with the 'Calendar of Reviews' to be deliberated by bank boards. Instead, bank boards are to focus on key issues: business strategy, risk, compliance, financial reporting integrity, financial inclusion and human resources.
- Increasing the cap on borrowing limits of clients in the Micro finance sector.

John Sharma

Economist – Sovereign Risk

john.sharma@nab.com.au

Tom Taylor

Head of International Economics

Tom_Taylor@national.com.au

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

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 2 9237 1076

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

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

Asia

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

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+44 207 710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 1588

Derek Allassani
Research Production Manager
+44 207 710 1532

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

James Glenn
Senior Economist – Australia
+61 3 9208 8129

Vyanne Lai
Economist – Australia
+61 3 8634 0198

Phin Ziebell
Economist – Agribusiness
+61 475 940 662

Amy Li
Economist – Australia
+61 3 8634 1563

Dean Pearson
Head of Industry Analysis
+61 3 8634 2331

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

Brien McDonald
Senior Economist – Industry Analysis
+61 3 8634 3837

Karla Bulauan
Economist – Industry Analysis
+61 3 8641 4028

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

Jacqui Brand
Personal Assistant
+61 3 8634 2181