more give, less take

India Monetary Policy

by Group Economics

September 2015

Summary & Overview

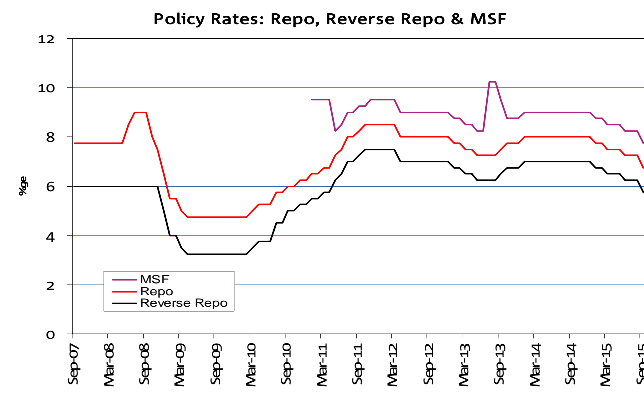
- The RBI cut the benchmark Repo rate by an outsized 50bp on the 29th of September to 6.75%.
- In addition to muted inflationary pressures and limited evidence of a pickup in growth, global factors (particularly around Emerging markets) influenced this decision.
- The RBI will work with the Government to exert pressure on banks to pass on most of the 125bps of rate cuts this year.
- Looking forward, NAB Economics is forecasting the RBI to remain on hold for the rest of 2015, with the Repo rate to remain at 6.75%.
- Further ahead, NAB Economics is forecasting 2 more cuts to the Repo rate in 2016, with the Repo rate expected to end 2016 at 6.25%.
- The risks to the forecasts are evenly balanced.
- In addition, the RBI announced a number of important regulatory measures, including greater overseas participation in Government bonds, and steps to boost the depth of the foreign currency market.

RBI Decision

At its 29th September Monetary Policy meeting, the RBI:

- Cut the benchmark Repo rate by 50bps to 6.75%;
- Kept the Cash Reserve Ratio (proportion of funds to be kept at the RBI) of scheduled banks stable at 4% of net demand and time liabilities (NDTL);
- Continued providing liquidity using both overnight (0.25% of NDTL) and 14-day term repos (0.75% of NDTL).

Policy Rates



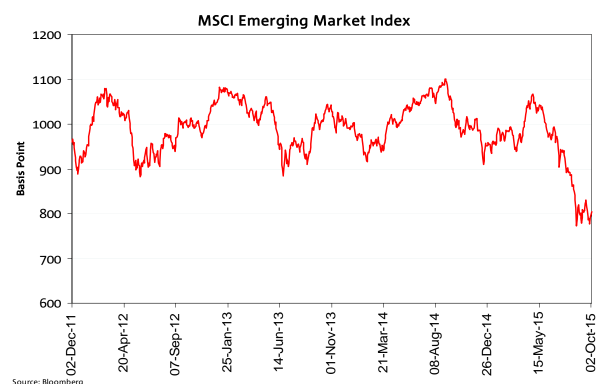
The magnitude of the cut (50bps) surprised both the markets, as well as NAB Economics. The general consensus was for a 25bps cut following favourable inflation outcomes.

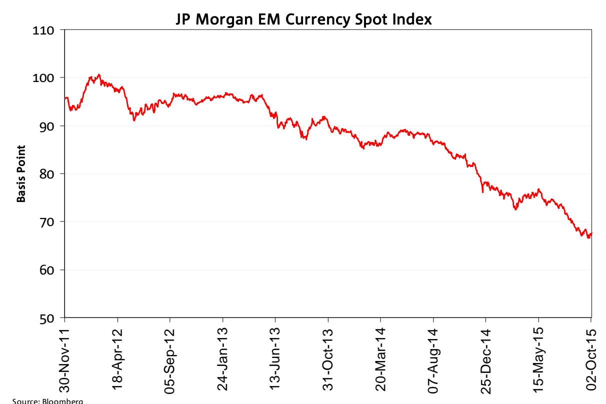
The sharp cut in activity can be pinned down to 3 key factors:

1. Well contained inflation outcomes;
2. Lack of growth momentum in the Indian economy. Governor Rajan highlighted the outsized cut would provide greater certainty to businesses to proceed with their capital expenditure plans;
3. Concerns that global growth has moderated, particularly in Emerging market economies due to issues surrounding China, and the expected rise in the US Fed Funds rate.

It is interesting that this time around global factors have been highlighted. According to the *Institute of International Finance*, there was USD40bn worth of outflows from EM debt and equities combined during the September quarter. This has contributed to deterioration in both EM equities and currencies. The *MSCI EM* Equities index – a gauge of EM equities – fell 20% during the September quarter. Further, the *JP Morgan EM Currency* index – a basket of select EM currencies against the US dollar – also declined by a similar margin.

EM Equities and Currencies



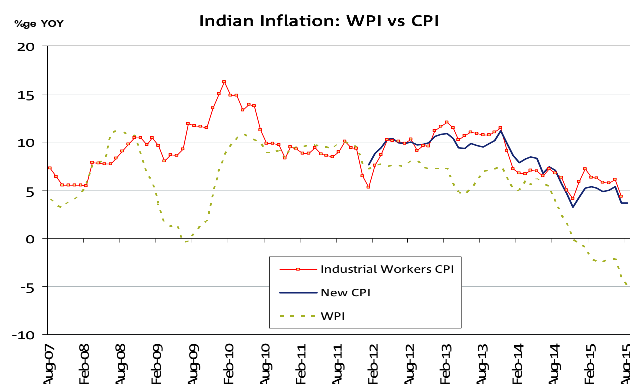


Prices and Activity

Inflationary pressure abated in August, with the Headline CPI (the target for monetary policy) declining to 3.66% over the year. This was the lowest outcome since November 2014, and has been partly impacted by supportive base effects. Despite a 14% monsoon deficiency, food prices rose by a modest 2.2%. The latter reflects, in part, efforts by the Government to improve food supply, including taking measures against hoarding, as well as incentivising imports of select commodities. In the food category, pulses (25.8%), spices (8.4%) and protein-rich products such as meat and fish (5.8%) rose higher than the average. Conversely, cereals (1.2%) and fruit (1%) recorded below average price rises. Advance estimates from the Ministry of Agriculture point to increased food grain production this year, assisted by timely advisories and ongoing efforts at monitoring seed and fertiliser availability.

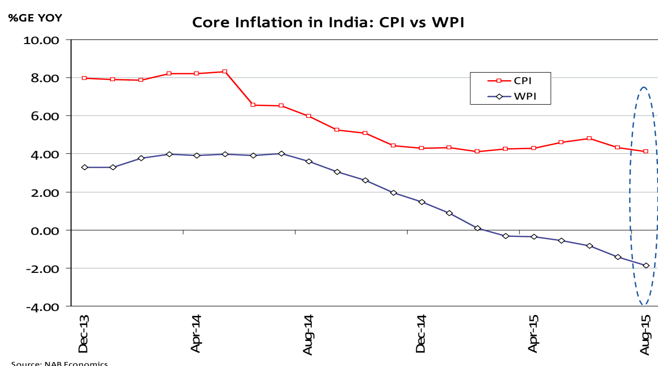
Finally, wholesale prices declined by -5% over the year to August, and largely reflect weak fuel and commodity prices.

Headline Inflation indicators



Core inflation (ex food and fuel) is another important metric watched closely by the RBI. It can be thought of as a measure of inflation persistence. Core CPI also fell, to 4.1% over the year to August, 2015. Lower fuel prices have led to a negative contribution from the transport component. There was also a slight easing in the personal care, education and health categories. Housing remained firm.

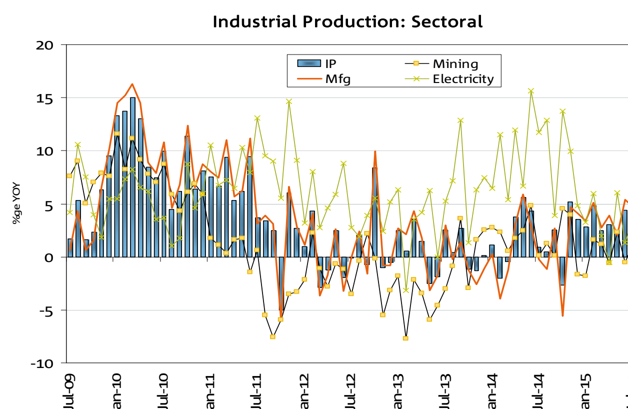
Core Inflation

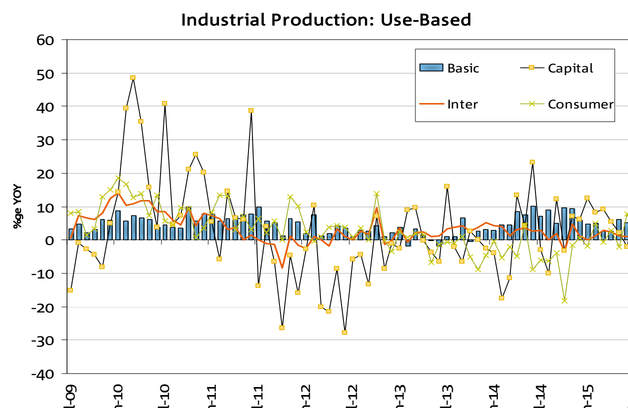


Activity indicators remain muted in India. The Index of industrial production expanded by 4.2% over the year to July, 2015. This is similar to June's outcome, and higher than the March-May period. However, it still indicates that production is yet to gain traction. By sector, manufacturing rose by 4.7%, with an acceleration apparent in sectors such as apparel, furniture and motor vehicles. Electricity rose by a measured 3.5%; there remain some issues regarding the financial situation of electricity distribution companies. Mining rose by a meagre 1.3%. By use, capital goods production surged by 10.6%, but continues to remain volatile.

The 1.3% expansion in consumer goods follows a 7.7% rise in June. The aggregate masks the performance of the individual constituents: consumer durables have recorded double-digit growth over the past couple of months, whilst consumer non-durables have remained weak. The rise in consumer durables indicates a tentative improvement in urban consumer demand, but we will need to watch the progress going forward to see if this is sustained.

Industrial Production: Sources & Uses





Manufacturing capacity utilisation eased to 71.5%, indicating continued spare capacity in the Indian economy. Higher levels of capacity utilisation remain one of the key triggers for higher capital expenditure. As a result, investment is yet to show a consistent upturn. One of the constraining factors remains the weak global environment. Exports have declined continuously, on a yoy basis, since December, 2014. The performance in August has been dismal, declining by 20.7% in yoy terms. *With weak global*

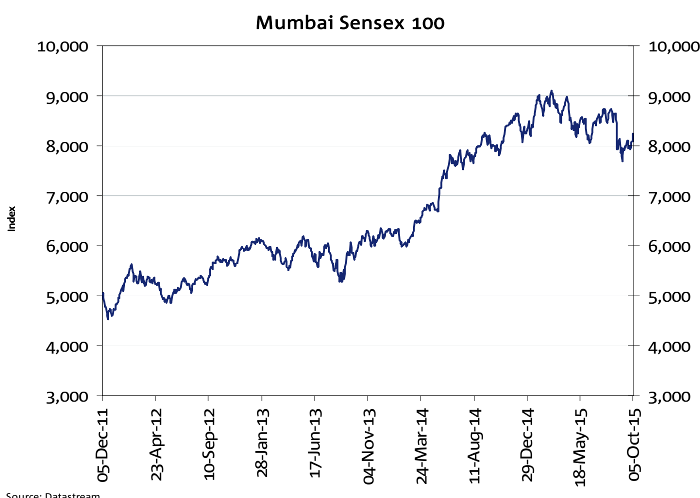
demand contributing to lower capacity utilisation, the RBI is hoping to boost domestic demand through these rate cuts.

External and Financial

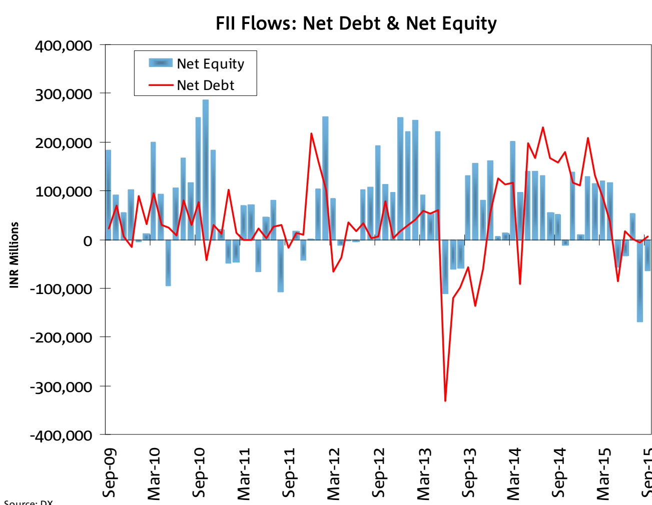
The devaluation of the Renminbi in August triggered falls in Indian and other EM equity markets. However, conditions have since improved, and have received a fillip post the RBI rate cut (see below). Further, the rate cut has also boosted bonds, with the 10-year benchmark Government bond yield falling by around 20bp in the subsequent days following the rate cut. Such a move is likely to ease the Government's borrowing costs: it is estimated that Government is scheduled to borrow around INR2.3 trillion in securities during the second half of the 2016-17 financial year.

Indian equities have witnessed sharp outflows – as with other EMs – during August and September. The impact on debt securities has been relatively mild, by comparison. According to data from the NSE (National Stock Exchange) the impact of portfolio outflows on equities has been mitigated somewhat by demand from domestic institutional investors, including insurance companies.

Equities and Portfolio Inflows



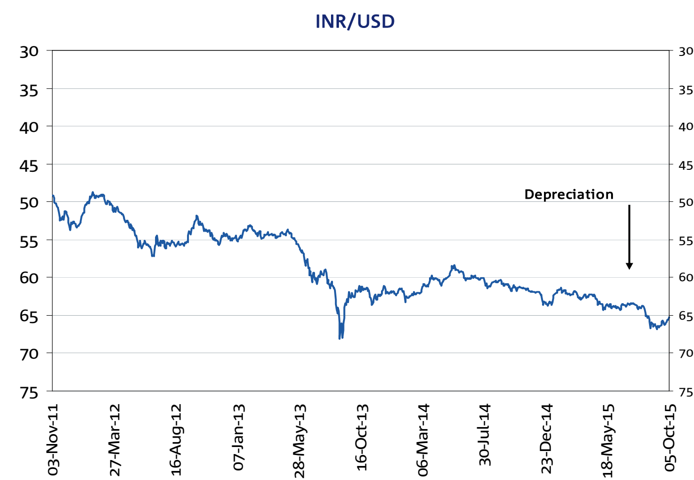
Source: Datastream



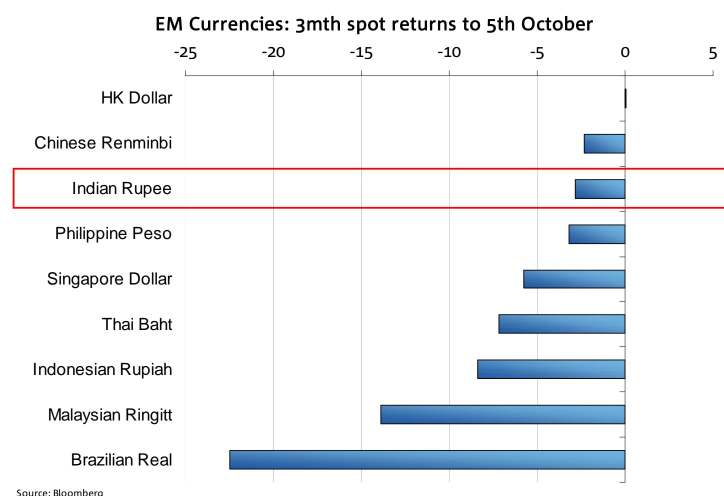
Source: DX

The Indian Rupee was last trading around INR65.3 to the USD. Near term FX volatility had risen somewhat during August, but has since settled down. The Indian rupee is among the better performing of the EM currencies over the past 3 months. In the Asian region, the Chinese Renminbi and the Hong Kong dollar have delivered slightly better returns; however, the Indian rupee has fared considerably better than the Indonesian Rupiah, Malaysian Ringitt, and, to a lesser extent, the Thai baht. Other EM currencies to have suffered sharp declines include: the South African Rand, the Turkish lira, Russian rouble and the Brazilian Real.

INR-USD



Source: Bloomberg



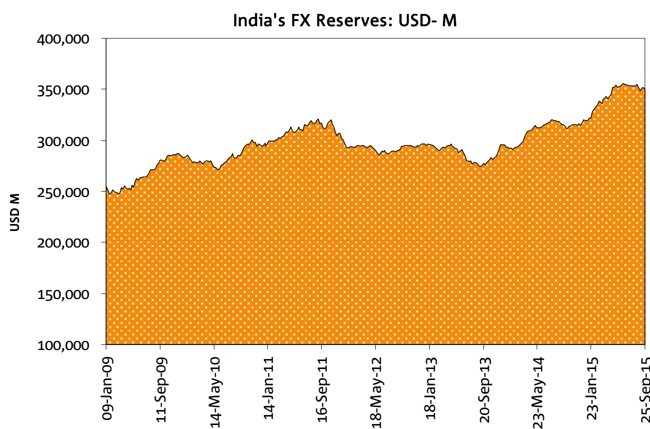
Source: Bloomberg

India's current account deficit for the June quarter came in at a modest 1.2% of GDP. The weak export performance is likely to see a modest deterioration in the September quarter. However, falling oil and commodity prices, and still weak imports will likely see only a modest deterioration.

More significantly, India's FX reserves remain strong, around USD350bn. Despite sharp equity outflows from portfolio investors, strong FDI inflows, as well as robust growth in NRI deposits (particularly NRE and FCNR) have helped maintain FX inflows.

India's modest current account deficit and high level of reserves act as external shock absorbers, and thereby offer a measure of protection in the present economic conjuncture.

FX Reserves

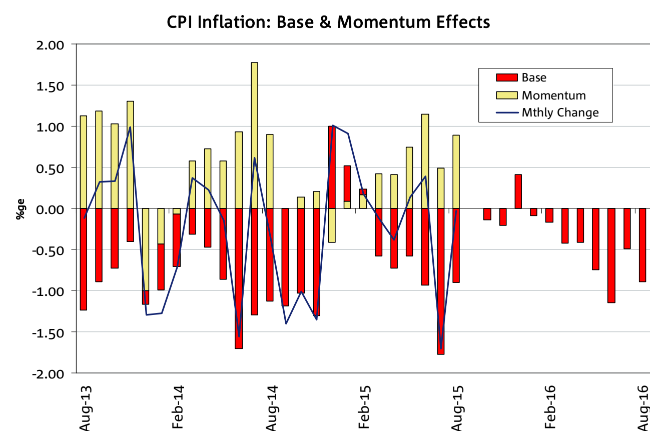


Outlook

NAB Economics is forecasting the RBI to remain on hold at 6.75% for the remainder of 2015. During 2016, a further 50bp of rate cuts is anticipated (post the Budget), yielding a Repo rate of 6.25% by the end of 2016. The RBI will likely work with Government to pressure the banks to pass on most of the 125bp of rate cuts. So far, banks have only passed on between 50- 70bps.

In the near term, the favourable base effects are likely to dissipate and turn somewhat unfavourable, particularly in December. However, more supportive base effects are likely to re-emerge in early 2016, and remain particularly pronounced towards the middle of the year.

CPI Inflation: Base & Momentum Effects



Our projections remain broadly consistent with the RBI's inflation outlook. The RBI is forecasting inflation to average around 5.5% during the 2016-17 period, before moderating to around 4.8% by March 2017. Further, it also indicated a real interest rate of 1.5-2% as appropriate, based on the 1-year T Bill rate. The latter, typically, remains 25-50bp higher than the policy (Repo) rate.

The risks to our interest rate forecasts remain evenly balanced. Higher commodity prices, poor monsoon outcomes in 2016, limited progress on fiscal management and supply side pressures could lead to higher than expected inflation outcomes, and thereby prevent any future rate cuts. Conversely, an escalation in global deflationary forces might prompt a more aggressive response from the RBI.

Other Measures

In addition, the Monetary policy review covered a number of regulatory developments. Some of the key measures include:

- The limits for Foreign portfolio investments in debt securities are to be specified in Rupee terms.
- Further, the limits in Central Government securities are to be increased in phases to 5% of outstanding stock by March 2018. This will ensure an additional INR 1,200bn increase in the limit. The requirement that investment will only be permitted in Government securities with a residual maturity of at least 3 years would still apply. In the current financial year, additional limits are to be increased on the 12th of October, and the 1st of January, 2016.
- To facilitate enhanced cross-currency hedging strategies, exchange traded currency futures and options will be introduced in 3 cross-currency pairs; EUR-USD, GBP-USD and USD-JPY. Guidelines are to be issued by the end of November, 2015.
- Resident entities will be able to increase their hedging limits in the OTC market from USD 250,000 to USD1 million. Further, to provide additional depth to the currency market, the RBI has proposed allowing financially sophisticated investors to participate (possibly as speculators), without access to an underlying asset. Related guidelines are expected to be released by end-December.

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