India Monetary Policy

By NAB Group Economics

12 April 2016

Summary & Overview

- **The RBI cut the policy Repo rate by 25bps at its April meeting. It also tightened the policy corridor to better align policy rates with the call rate (interbank overnight borrowing rate).**
- **Subdued inflation outcomes (due to lower food prices), the Government's commitment to fiscal consolidation and weak capital spending led to the rate cut.**
- **The most significant changes, however, were the additional liquidity measures announced to facilitate more effective monetary transmission.**
- **Foreign portfolio investors have turned to net purchasers of Indian equity markets since March, following 3 months of outflows.**
- **Volatility in the foreign exchange market remains muted, assisted by record high FX reserves.**
- **NAB Economics is forecasting another rate cut in the September quarter to 6.5%.**
- **Uncertainties regarding the Seventh Pay Commission's recommendations, the upcoming monsoon season and a possible re-emergence of commodity price pressures could limit the scope for further cuts.**

Monetary policy decision

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

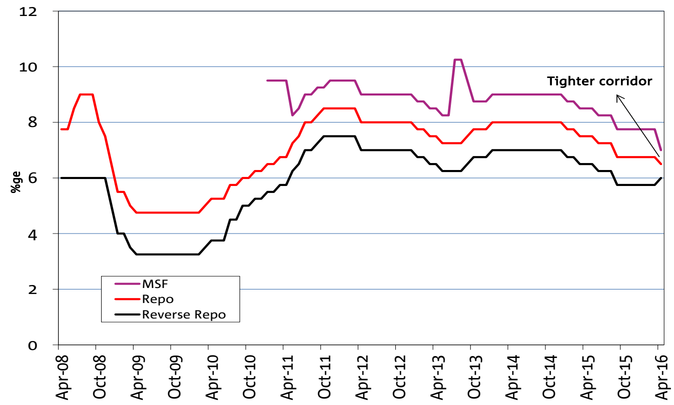
- Cut the policy repo rate by 25pb to 6.5% (from 6.75%);
- Maintained the CRR (Cash Reserve ratio) at 4%, but reduced the daily maintenance of the CRR from 95% to 90%;
- Continued to provide liquidity, but indicated a progressive move from a 1% liquidity deficit (based on demand and time deposits) to a liquidity neutral position;
- Raised the reverse repo rate (at which banks lend to the RBI) by 25bp to 6% and cut the MSF (marginal standing facility rate) by 75bp to 7%. This would lower the policy corridor from +/- 100bps to +/- 50bps.

The April 5th Monetary policy meeting was a landmark in terms of the policy measures announced. The 25bp cut in the policy rate was accompanied by a raft of measures to boost liquidity and ensure more effective monetary transmission by banks.

With regard to the policy rate, the 25bp cut was largely anticipated by the markets as well as by NAB Economics. Some of the reasons for the cut include: favourable inflation readings in February; a commitment to fiscal consolidation by the Finance Ministry in its annual budget; lingering weakness in the investment cycle, and modest levels of capacity utilisation.

The RBI did not just cut the policy rate by 25bp. It also raised the reverse repo rate (at which banks lend to the RBI) by 25bp to 6%, and lowered the MSF rate by 75bp to 7%. The aim was to tighten the policy rate band to +/-50bps (from +/-100bps), so as to ensure the call money rate (at which banks borrow from each other for short-term funding gaps) is better aligned with the Repo rate. Such a move would help reduce volatility in short term rates, and help banks in their Treasury operations.

Policy Rates: Repo, Reverse Repo & MSF

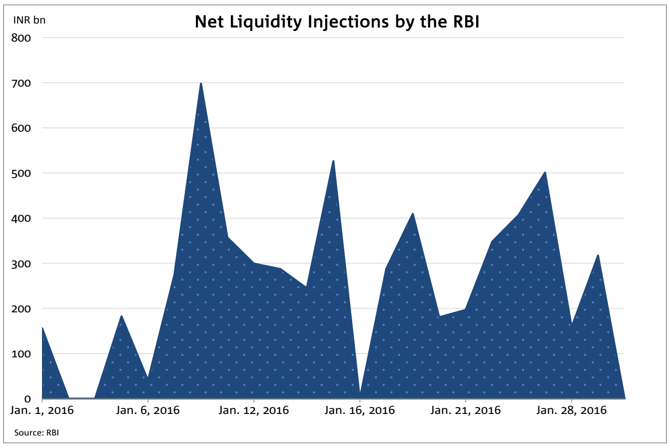


Source: DX/RBI

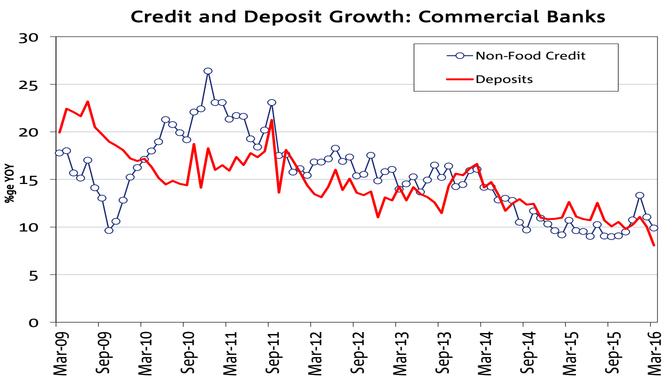
The main thrust of this policy, however, has been the structural changes to liquidity management. From 1st of April, banks have had to adjust their lending rates using the MCLR (marginal cost lending rates) framework. This implies banks will need to adjust their lending rates each month based on what they offer for new fixed deposits - which broadly track short-term rates such as treasury bills and certificates of deposit. The RBI indicated at the post-announcement press conference that the median overnight MCLR had fallen between 25-50bps since the end of March.

To ensure better pass through of prior rate cuts, and avoid any spikes in lending rates, the authorities indicated that it would move from a liquidity deficit to one of neutral liquidity. In other words, they would gradually infuse an extra INR2-2.5 trillion of liquidity. The additional liquidity would be of a more 'durable' nature, consisting of purchases of both foreign and domestic assets. RBI Governor Rajan indicated that the RBI would have less discretion with regard to purchase of foreign assets, as these could be dictated by global factors. Hence the purchase of domestic assets should be seen as a 'residual' purchase. Further, the RBI indicated it would continue to provide short-term liquidity to address temporary liquidity mismatches.

The RBI backed up its statement post-announcement with concrete action, injecting INR15billion into the system through open market purchases of bonds. In fact, the RBI has generally been adopting an accommodative liquidity stance, largely through repo operations and open market purchases.



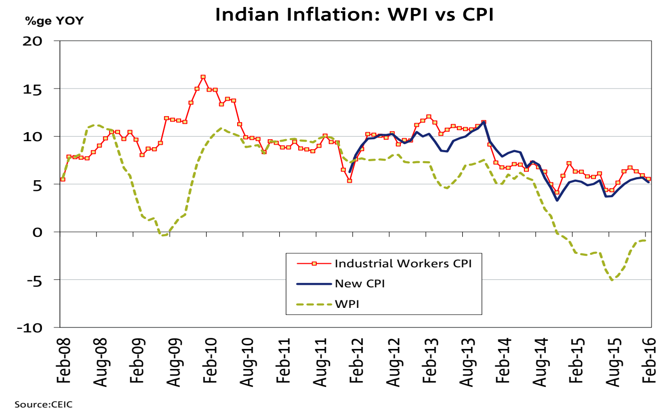
Another liquidity enhancing measure relates to reducing the daily maintenance of the Cash Reserve Ratio (the proportion of deposits that banks need to park with the RBI) from 95% to 90%, thereby freeing up funds for additional lending. Finally, the Government has also assisted by bringing down the rates on small savings schemes (which compete with deposits), and linking them to market rates. Banks have generally complained that the competitive rates on offer by such schemes have prevented them from lowering their deposit and, hence, lending rates. Banking system deposit growth has been slower than that of credit, pushing up the credit to deposit ratio.



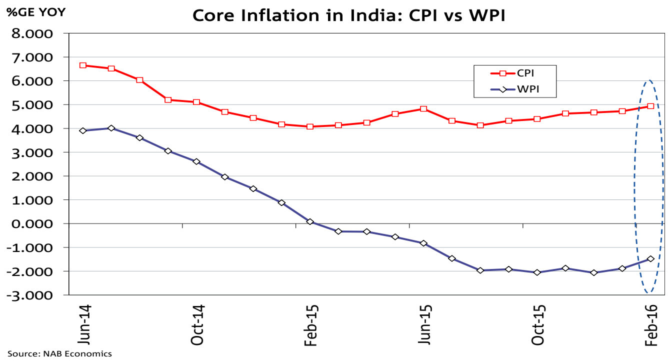
The aforementioned discussion is quite technical, but crucial, as it impacts monetary policy transmission, and thereby has flow-on effects on the real economy. The main takeaway from the liquidity enhancing measures, and tighter policy corridor is that the RBI is, in effect, creating a more favourable policy transmission environment through adequate liquidity provision.

Prices & Activity

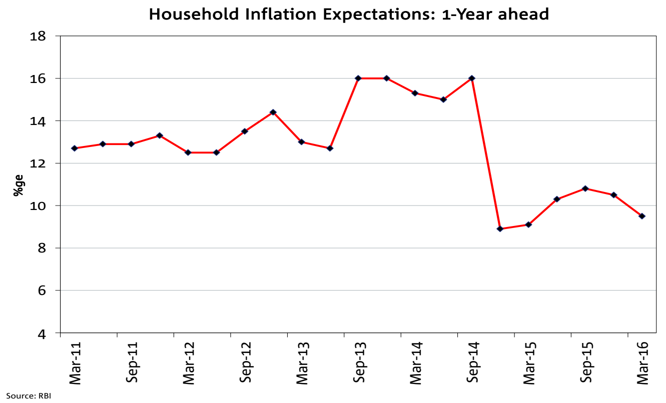
The rate cut has been set against a backdrop of moderate economic activity and prices. The headline CPI – which is the target of the RBI – decelerated to 5.2% in February, the lowest since October 2015. This was assisted by lower food prices, in particular a sharp fall in vegetable prices (0.7% in February vs. 6.4% in January) as food production increased. Further, there was some modest easing in the prices of pulses (from 43.3% to 38.3%) – a major contributor to food inflation. Effective supply management, and lower minimum support prices helped restrain the prices of cereals (2.2%). Fruits (-0.7%) contracted, but prices remained somewhat higher in the meat and fish proteins category (7.3%), where supply has failed to match demand.



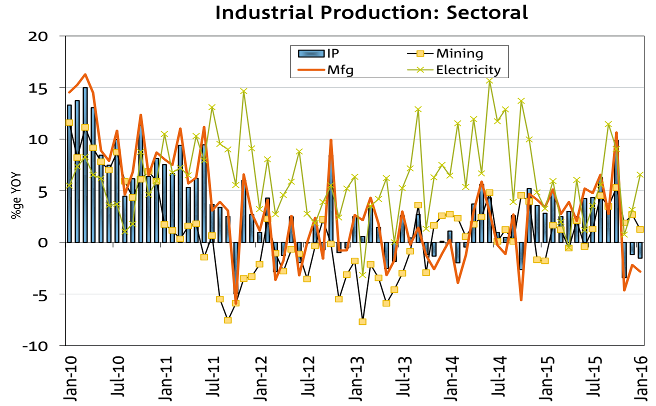
Core inflation (excluding food and fuel) edged up higher to 5%, suggesting a floor for any possible future declines in headline inflation. This broadly reflects capacity constraints in the services sector. In February, there were price rises in housing, education, personal care and transport segments.



The decline in household inflation expectations will likely be a source of comfort for the RBI. Median household expectations for the year ahead have fallen back to single digits. Following a recent peak of 10.8% in September, 2015, they have eased to 9.5% in the March quarter, 2016.

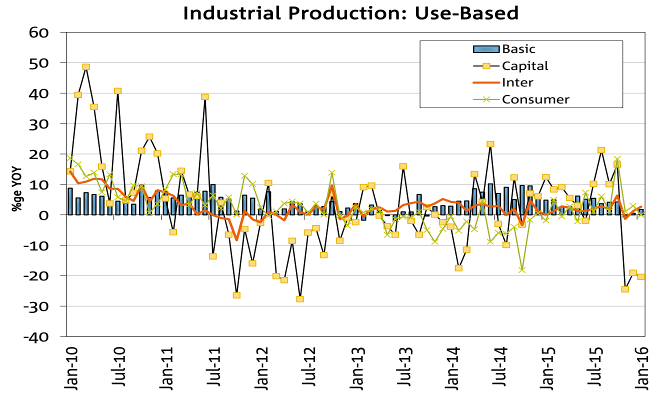


Activity remains restrained, as measured by the Index of Industrial production, which contracted by -1.5% over the year to January, 2016. In fact, it has contracted by 3 consecutive months following the strong outcome in October, 2015. By sector, manufacturing was by far the weakest, with mining and electricity recording positive growth. These weak outcomes contrast with the stronger results for manufacturing in the National Accounts. The latter measures valued added in manufacturing, and benefits from lower input costs (e.g. fuel).



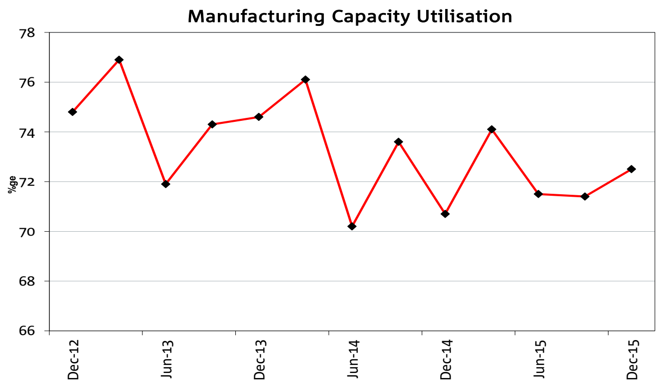
Source: CEIC

In terms of production by use, the weakness in capital investment is most apparent. This reflects weak demand, combined with import competition. One of the aims of the monetary policy announcement was to kick-start investment by ensuring that cuts are passed on to businesses. Further, there appears to be an urban-rural divide with consumer durables (driven largely by urban demand) rising 5.8%, and consumer non-durables (more rural influenced) contracting -3.1%.



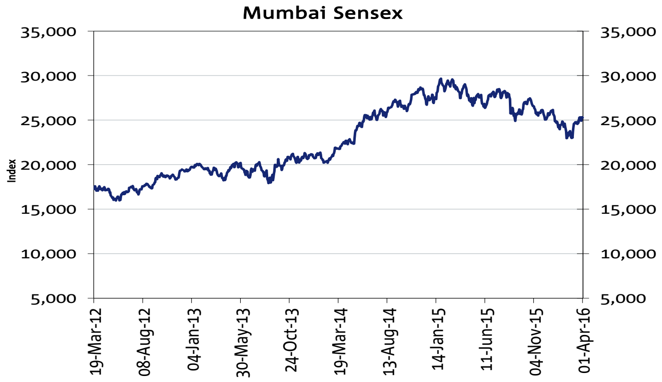
Source: CEIC

Finally, capacity utilisation in the manufacturing sector – which was explicitly referenced in the monetary policy statement – remains modest, despite showing a recent pickup in the March 2016 quarter. Companies operating at lower capacity levels have a reduced incentive to undertake further capital spending.



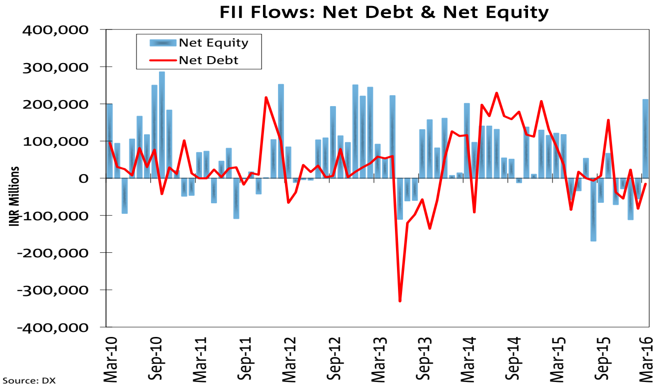
Financial Market Developments

The Indian equity market has regained ground, since falling to a recent low in February, 2016. It fell 12% over the 2 months to February 2016. This broadly reflects global – and particularly, emerging market – weakness. Since then, sentiment has improved and equities have largely retraced their losses, rising 10% since the recent nadir in February. Pharmaceuticals, IT and automobiles were among the better performers; the steel sector has been negatively impacted by global oversupply.



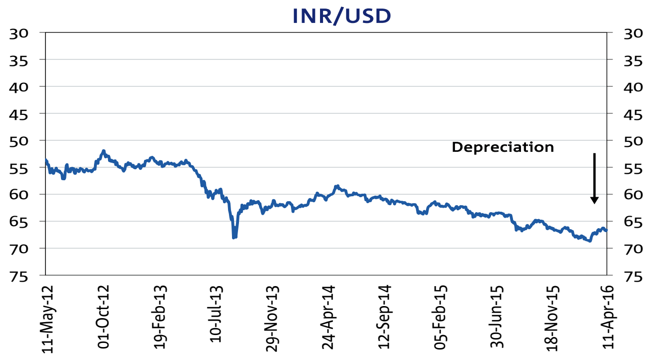
Source: Bloomberg

The rise in the Sensex has also been accompanied by a concomitant rise in foreign portfolio investor (FPI) equity inflows. After declining for 3 consecutive months, net foreign equity inflows rebounded sharply in March. More recent data till April 7th suggests continued FPI interest in Indian equities. Net debt inflows have remained negative over the past 2 months. However, the recent rate cut has improved sentiment among FPI debt investors, with inflows till the 7thof April.



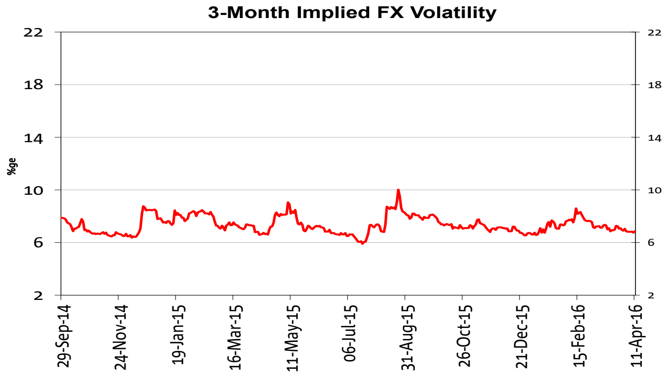
Source: DX

As with the case of the Sensex, the Indian rupee has reversed its earlier weakness against the USD, and was last trading around 66.5INR/USD. It fell to a low of 68.5 INR/USD. However, a more dovish stance from the US Federal Reserve, and positive sentiment towards emerging markets has led to an appreciation in the INR.



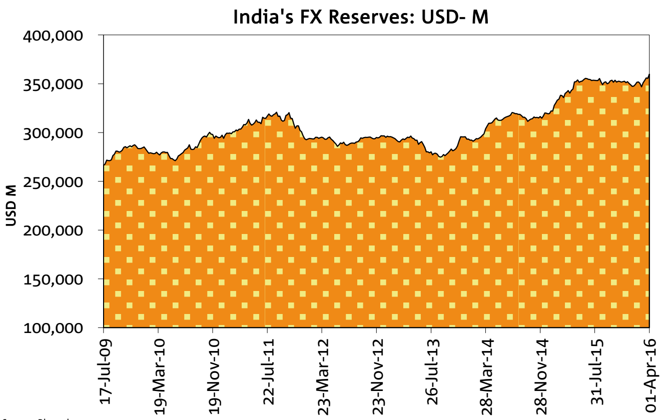
Source: Bloomberg

Despite the depreciation in the rupee in the first two months of the year, volatility in the Indian rupee has remained relatively subdued. Whilst 3-month FX volatility did rise somewhat during February, it remained well below levels during the Renminbi depreciation episode in August last year.



Source: Bloomberg

Volatility in the foreign exchange has been partly supported by India's strong external fundaments. The current account deficit stood at -1.3% of GDP, based on December quarter, 2015 data. Further, India's foreign exchange reserves remain solid, and are currently near USD360bn, a record high.



Source: Bloomberg

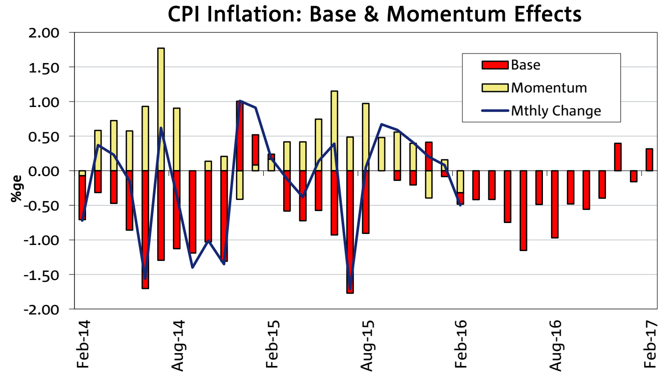
Outlook

At the RBI press conference, Governor Rajan indicated that monetary policy stance would 'remain accommodative', and would respond to economic and financial development as they arise.

Looking ahead, NAB Economics is forecasting another rate cut in the September quarter. This will push down the policy Repo rate to 6.5%, where it is expected to persist for the remainder of 2016. Looking at the future trajectory for inflation, base effects are expected to remain supportive during the September quarter, which should reverse somewhat by the end of 2016, and in early 2017.

There are risks surrounding our interest rate projections. The impact of the Seventh Pay Commission (timing details of which are yet to be finalised by the Government), might create upward pressure on prices, and limit the scope for rate cuts. Further, uncertainty about the monsoon, and a possible re-emergence of commodity (particularly energy) price pressures might also limit the scope for further cuts.

Conversely, a more favourable monsoon, weaker global activity and hence commodity prices, and a restrained pay increase (based on the 7th Commission recommendations) might generate more than one rate cut.



Source:NAB Economics

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