India – Monetary Policy Review

National Australia Bank

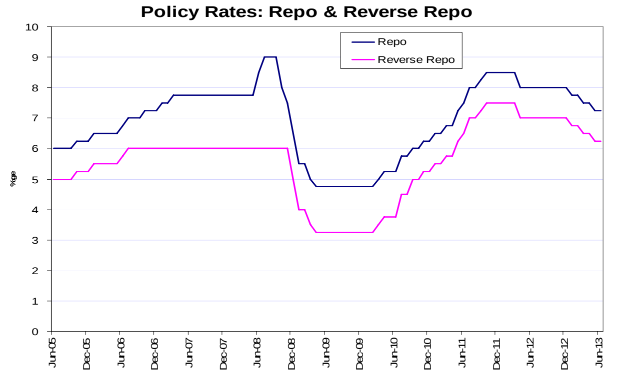
- **At its Mid Quarter Monetary policy review on the 17th of June, the Reserve Bank of India (RBI) maintained the benchmark repo rate at 7.25%, and the reverse repo rate at 6.25%.**
- **The Cash Reserve Ratio (CRR) was held at 4%, and the Statutory Liquidity Ratio (SLR) was maintained at 23%.**
- **The RBI expressed concern at the sudden, steep depreciation in the Rupee amid a high Current account deficit: key factors impacting its interest rate decision.**
- **It also highlighted high food and administered price rises, which when combined with a weaker rupee, could generate second-round inflation effects.**
- **This is against a backdrop of falling wholesale and core inflation, as well as soft activity indicators.**
- **On a more positive note, ratings agency Fitch has upgraded India's outlook to stable on an improved fiscal outcome and some progress on tackling structural problems in the economy.**
- **Further cuts to the repo rate will depend on a more sustained decline in inflation: a more stable rupee, a contained current account deficit and a moderation in food price inflation.**

RBI's Decision

In its Mid quarter Monetary policy review, the RBI (Reserve Bank of India) held its benchmark Repo rate at 7.25%, and the Reverse Repo rate at 6.25%. The Repo rate is the rate at which the RBI lends to commercial banks for a short period in return for securities, and the Reverse Repo rate is the rate at which the RBI borrows from them. Moreover, it maintained the Cash Reserve Ratio (CRR) at 4% and the SLR (Statutory Liquidity Ratio) at 23%. The CRR represents the proportion of net demand (e.g. current deposits) and time liabilities (e.g. fixed deposits) the scheduled commercial banks are required to maintain with the RBI. They don't earn any interest on these reserves; the purpose is to ensure solvency and liquidity of the banking system. The SLR is typically used to expand or contract the rate of credit growth in the economy.

The RBI has cut the Repo rate by a cumulative 125bps since March 2012. The most recent was a 25bps cut on the 3rd of May, 2013. The sharp decline in the Indian Rupee, concerns about financing the large Current Account Deficit as well as upward pressures on food prices outweighed considerations about a soft economic situation at its most recent meeting.

Policy Rates



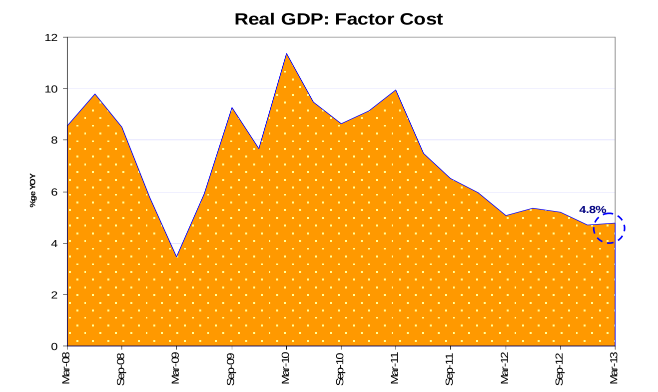
CRR

SLR

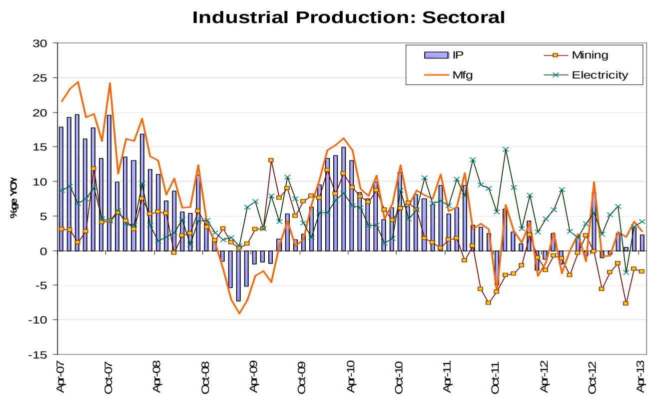
Growth and Production

The Indian economy grew by 4.8% over the year to March quarter 2013. For the 2012-13 financial year, it expanded by 5%: the lowest in a decade. Higher frequency indicators such as monthly partial indicators also remain soft. (Newly revised) Industrial production data revealed that Industrial production increased by a modest 2.3% over the year to April 2013, somewhat weaker than the 3.4% over the year to March 2013. Mining was particularly weak once again, contracting by -3%; manufacturing was also muted, rising by 2.8%. One somewhat bright spot was the 4.2% rise in electricity production, the highest since January 2013. By use, the volatile capital goods production showed a marked slowdown: increasing by 1% c.f. the 9% expansion in March. The RBI highlighted these figures as evidence of 'damped investment demand'. Intermediate goods, a sort of leading indicator of downstream production, rose by 2.4%, in line with the overall average. Consumer goods production rose to 2.8% (from 1.8% in March), driven largely by an increase in production of non-durables. This could indicate a tentative improvement in consumer confidence, but it's still way too early to say much definite with passenger car sales falling by -6.6% over the year to May 2013.

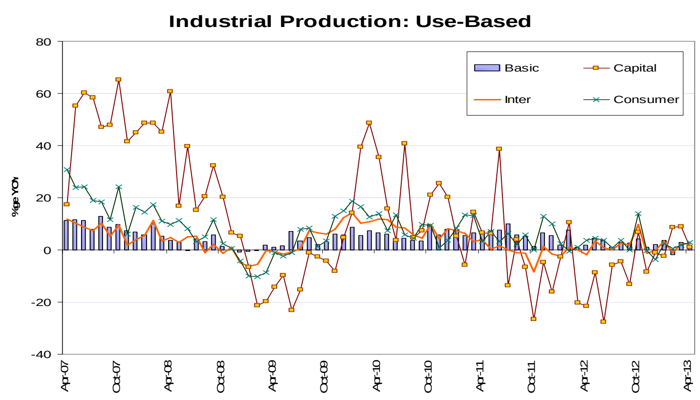
GDP



Industrial Production: Sectoral



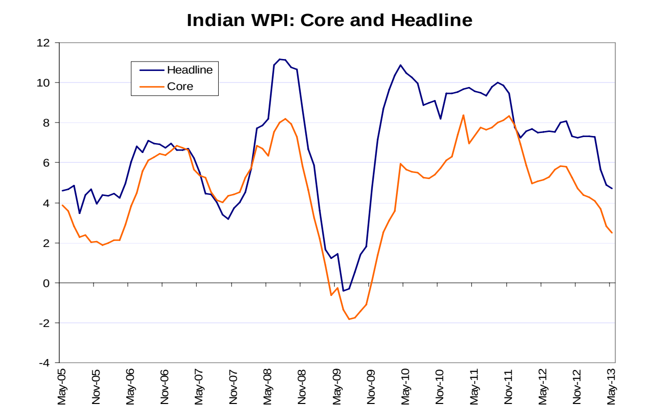
Industrial Production – Use Based



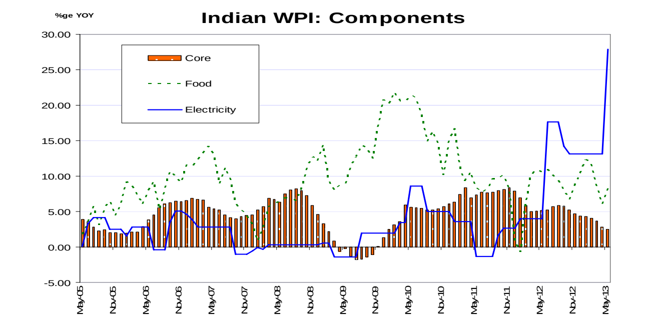
Prices

Wholesale price inflation continued its downtrend in May: it rose by 4.7% over the year to May 2013, below the 4.9% outcome recorded in April. Moreover, core inflation too trended lower: it increased by 2.5% over the year to May 2013, well below recent outcomes. These results could indicate a lack of pricing power among Indian businesses. However, prices remain elevated with respect to food (13.9%) and electricity (27.9%) as the Government allows an increase in cost recovery from electric utilities. In the food category, prices for cereals (rice, bajra and wheat) and protein based foods (fish and meat) remain particularly high.

Headline and Core Inflation

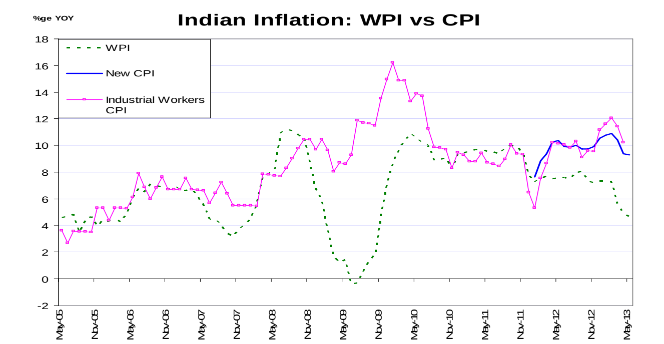


WPI Components



Retail inflation (measured by the CPI) edged lower to 9.3%, the second successive month it has remained below 10%. The relatively higher weight for food in the CPI basket helps account for the differential between the WPI and CPI measures more broadly.

WPI and CPI

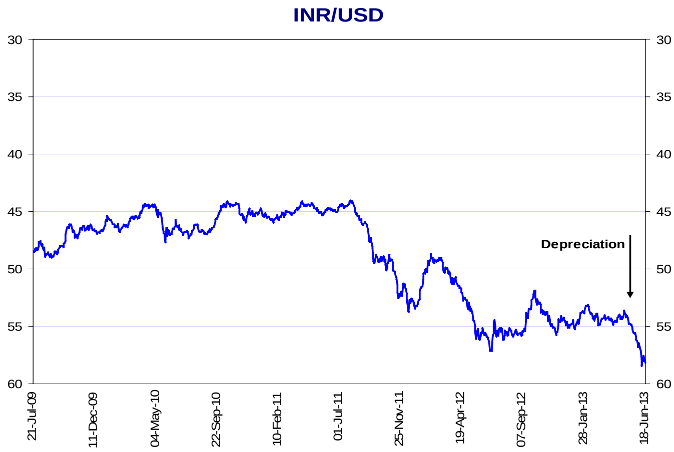


Whilst the RBI would be encouraged by the moderation in wholesale and core inflation, it would like to see further downward pressure on food prices as well as consumer prices.

External Situation

The RBI's hand has been stayed primarily due to external events, the most notable being the sharp fall in the Rupee. Between 22nd of May and the 11th of June the rupee depreciated by 6%. It is currently trading around INR58/USD. Comments by the Federal Reserve Chairman, Ben Bernanke, about possibly 'tapering' the USD85 billion/month Quantitative Easing program has set off alarm bells in financial markets, triggering a sharp sell-off in emerging market currencies, including the Indian Rupee.

Indian Rupee to US Dollar

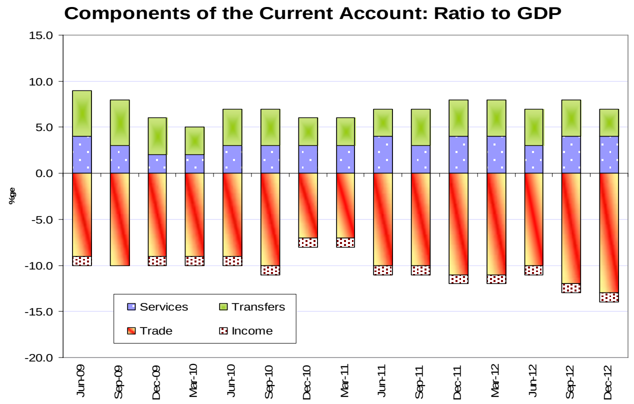


A weakening rupee could generate import price inflation. Moreover, it could also weaken the allure of holding Indian assets among overseas investors, as the Rupee depreciates and becomes more volatile. Foreign Institutional Investors have pulled out nearly USD3.8bn from the Indian debt market during June 3-June 17. Were this trend to be sustained over a longer period, it could generate some problems as India has a high Current Account Deficit (CAD). The CAD came in at 6.7% of GDP during the December quarter, 2012. For the 2012-13 financial year, it is anticipated to be in excess of 5% of GDP.

More recent trade data too hasn't been very encouraging: India's trade deficit in the month of May rose to USD20.1bn, up from USD17.8bn in April. It is expected that the trade and Current account position will gradually improve over the course of the 2013-14 financial year. The main reason is the expected decline in gold imports due to policy changes by the Government and the RBI: import duties on gold have risen to 8%; it is more difficult for banks and trading houses to import gold; and there are restrictions on bank lending against gold.

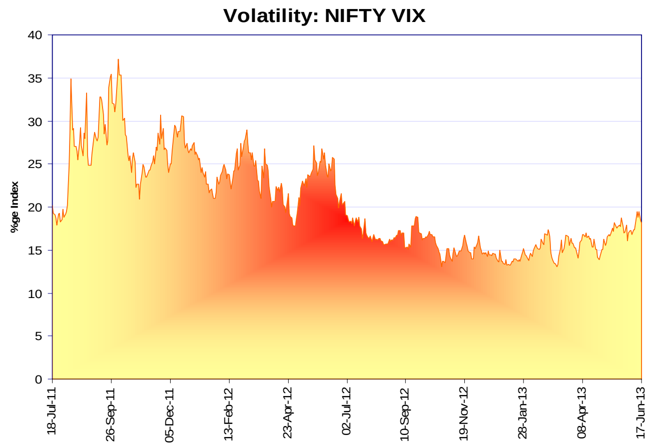
The significance of the high CAD and weakening rupee in determining the RBI's decision can be summarised by the following comment by Duvvuri Subbarao, RBI's Governor: 'Shifts in global market sentiment can trigger sudden stop and reversal of capital from a broad swath of emerging markets, swiftly amplifying risks to the outlook. India is not an exception'.

Current Account Deficit



A significant development has been the decision by ratings agency, Fitch to upgrade India's outlook to Stable from Negative. The contained fiscal deficit, as well as progress made in removing structural bottlenecks had been cited as Fitch as factors supporting the upgrade. Moreover, the Finance Minister, P Chidambaram is expected to announce measures around the end of June to spur foreign investor interest including relaxing limits on FDI participation in various sectors.

Volatility Index



The India VIX (Volatility Index), an indicator of expected market volatility over the ensuring 30 days, rose in the aftermath of tensions in currency markets. It appears that some of the volatility has spilled over into equity markets. The index reached a high of 19.49% on the 11th of June, the day the Indian rupee plunged to its lowest level. The index has since eased somewhat, but remains high relative to levels in the early part of 2013.

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Important Notices