India – Monetary Policy Review

National Australia Bank

- **At its Quarterly Monetary policy review on the 30th of July, the Reserve Bank of India (RBI) maintained the benchmark repo rate at 7.25%, and the reverse repo rate at 6.25%.**
- **The weak rupee, high current account deficit and concerns about outflows from Foreign Institutional Investors have influenced the decision.**
- **The Cash Reserve Ratio (CRR) was held at 4%, and the Statutory Liquidity Ratio (SLR) was maintained at 23%.**
- **This comes against a backdrop of much tighter liquidity conditions, including raising the Marginal Standing Facility rate to 10.25% (from 8.25%).**
- **These tightened measures will remain in place till stability is restored in the foreign exchange market.**
- **Growth indicators, in terms of both production and services remain weak. Food price inflation has risen, whilst core inflation has moderated further.**
- **The government has instituted measures to boost inflows such as boosting FDI in retail and telecoms; however, supply-side bottlenecks need to be urgently addressed.**
- **Group Economics is forecasting the repo rate to fall between 6.75-7% by March 2014. Any rate cut, however, will be deferred until end 2013 or early 2014 – given the unsettled external situation.**
- **Raghuram Rajan will become the new Governor of the RBI in early September, replacing the incumbent, Duvvuri Subbarao.**

RBI's Decision

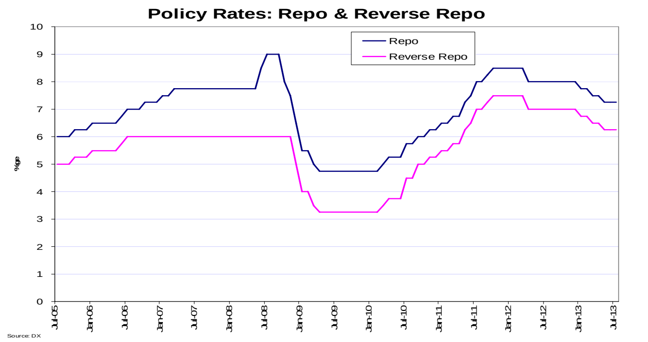
In its Quarterly Monetary policy review on the 30th of July, the RBI (Reserve Bank of India) held its benchmark Repo rate at 7.25%, and the Reverse Repo rate at 6.25%. The Repo rate is the rate at which the RBI lends to commercial banks for a short period in return for securities, and the Reverse Repo 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.

Prior to the Monetary policy announcement, the RBI had initiated a number of liquidity tightening measures with the eventual aim of reducing demand for US Dollars to stem the highly volatility in the Indian Rupee. It raised the Marginal Standing Facility (used by banks to borrow from the RBI during acute cash shortages) rate to 10.25%, previously 8.25%. The daily minimum requirement for the Cash Reserve Ratio was raised to 99% from 70%. Finally, the limit for individual bank borrowings under the Liquidity Adjustment Facility (a mechanism whereby banks can borrow from the RBI through repos) has been restricted to 0.5% of their Net Demand and Time Liabilities. For the banking system as whole, overall access by way of repos under Liquidity Adjustment facility has been restricted to INR 750 billion.

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 and heightened volatility in the Indian Rupee, concerns about financing the large Current Account Deficit, and sharp outflows by Institutional investors have been instrumental in the policy decision by the RBI. Activity has remained sluggish, and inflation, as measured by the Wholesale Price Index, remained contained although food prices were somewhat elevated. The situation can be aptly summarised the following statement by the RBI: "*India is caught in a classic 'impossible trinity' trilemma whereby we are having to forfeit some monetary policy discretion to address external sector concerns*".

Raghuram Rajan will become the new Governor of the RBI in early September, when the term of Duvvuri Subbarao comes to an end.

Policy Rates



CRR

SLR

Growth and Production

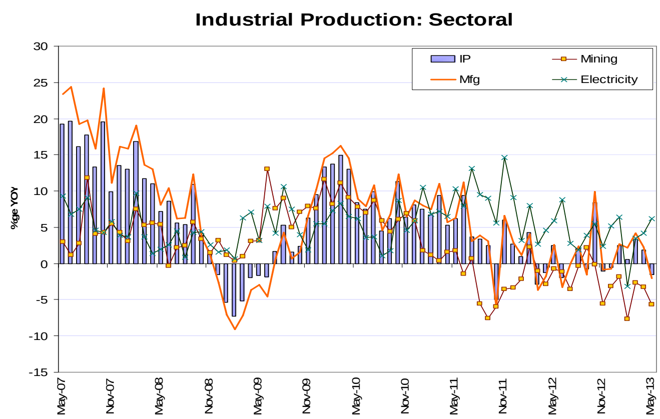
The Indian economy grew by 4.8% over the year to March quarter 2013. For the 2012-13 financial year, it expanded by 5%: the lowest in a decade.

Industrial production remains weak, and contracted by -1.6% over the year to May 2013, the first negative reading since December 2012. Mining continues to remain poor (-5.7%), whilst manufacturing too declined (-2%). The one bright spot has been the improvement in electricity production (6.2%). By use, the contraction in capital goods (-2.7%) reflects soft near term investment outcomes, and is somewhat of a concern. The output of the 8 core sectors also remains muted, with output in 8 core infrastructure sectors growing by a mere 1.8% over the year to June 2013: the corresponding figure for the 3 months to June 2012 was a much stronger 7%.

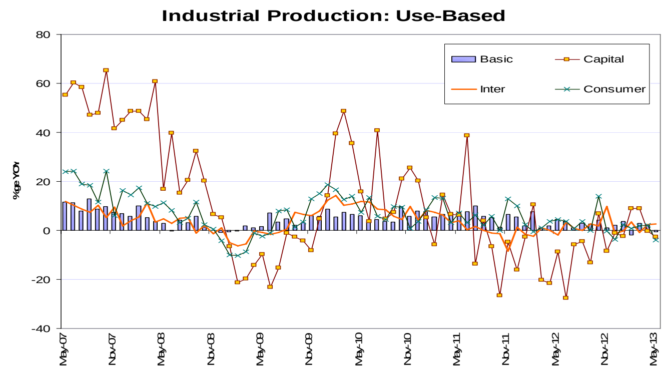
Other surveys such as the RBI's OBICUS and Industrial Outlook Surveys reveal only a sluggish improvement among manufacturing companies is expected over the June quarter. Besides, the RBI's Services Sector Composite revealed a slight easing over April-May 2013. The most recent HSBC Services PMI reading came in at 47.9 for July, implying a contraction in the services sector, driven largely by falls in the new business component. With services accounting for 60% of the Indian economy, these readings further confirm India's tentative economic situation.

Taken together, activity indicators would suggest that the Indian economy would benefit from a rate cut.

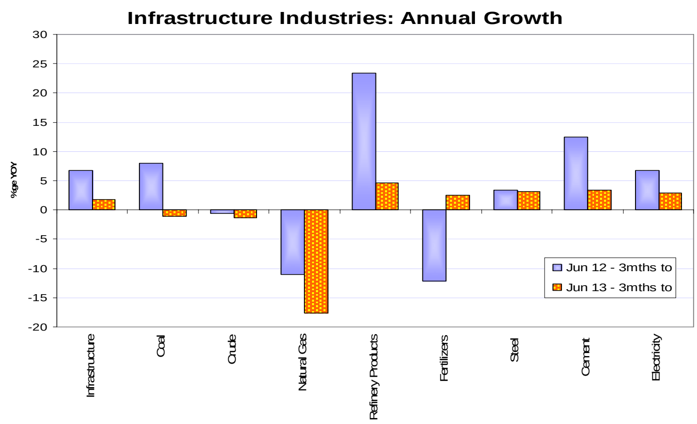
Industrial Production: Sectoral



Industrial Production: Use Based



8 Core Sectors

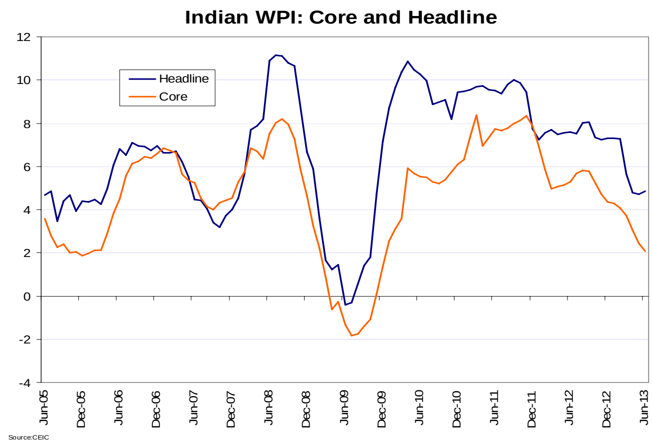


Prices

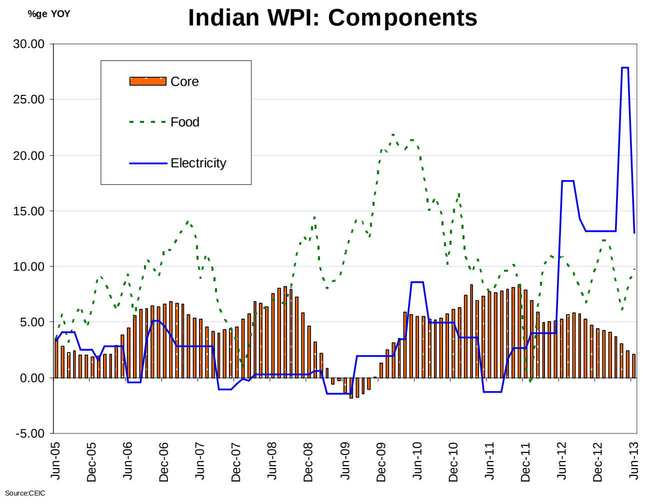
The downtrend in Wholesale prices reversed somewhat in June, with the Wholesale price index rising by 4.85% over the year to June, slightly higher than the 4.7% recorded in May. – driven mainly by higher food prices. However, core inflation continues to edge lower, expanding by 2.1% over the year to June 2013, driven by easing in metals and chemical prices. These results could indicate a lack of pricing power among Indian businesses.

However, food prices (9.7%) remain high, driven primarily by prices for vegetables (primarily onions and ginger) as well as cereals (rice, wheat and bajra). Fuel prices have eased somewhat due to lower coal prices in March, and electricity prices had eased due to base effects.

Headline and Core Inflation

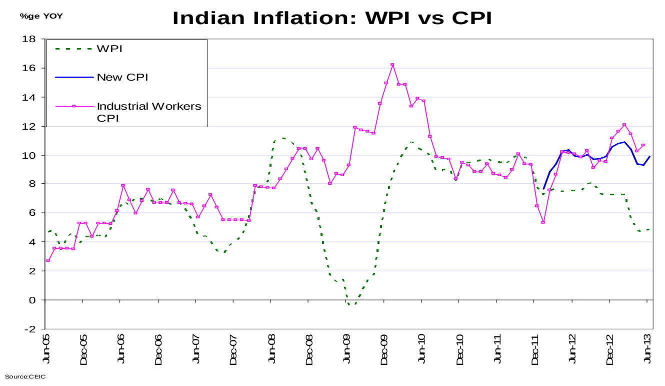


WPI Components



Retail inflation (measured by the CPI) accelerated to 9.9% in May, driven by higher food prices. The relatively higher weight for food in the CPI basket helps account for the differential between the WPI and CPI measures more broadly. The RBI has been encouraged by the recent monsoons, which augurs well for the production of the *kharif* (monsoon) crop. This should be beneficial to both growth and inflation, provided issues relating to food distribution are adequately addressed.

WPI and CPI



Taken together, the inflation figures have provided mixed signals to the RBI, although it would like to see a further moderation in food prices.

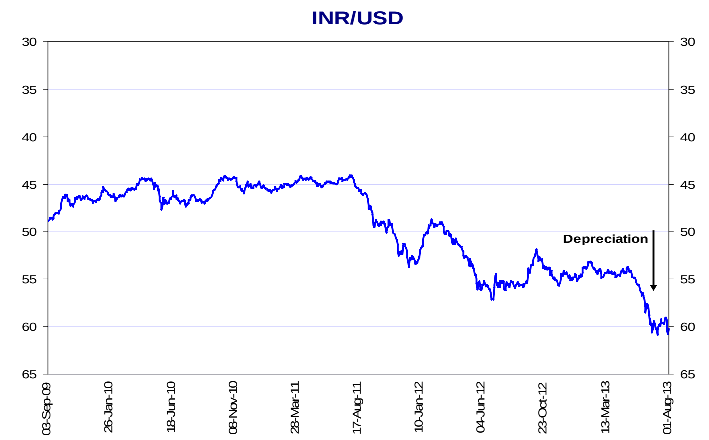
External and Financial

The RBI's hand has been stayed primarily due to external events, the most notable being the depreciation and volatility in the Indian Rupee. The Indian Rupee has depreciated over 13% between the beginning of May to early August, with the bulk of the depreciation having commenced since May 22nd when the Federal Reserve Chairman Ben Bernanke discussed the possibility of 'tapering' the USD85 billion/month QE program. This triggered a sharp sell-off among Emerging Market currencies, including the Indian Rupee. At the time of writing, the Rupee was trading at INR 60.90/USD.

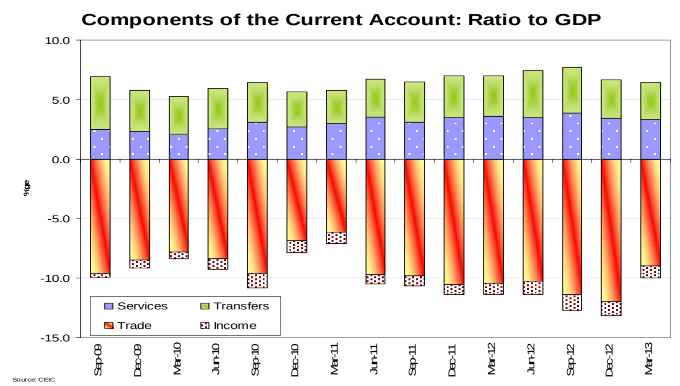
The Indian rupee has been particularly impacted due to the high Current Account Deficit, which amounted to 4.8% of GDP over 2012-13 financial year. Recent trade data hasn't been encouraging, with exports falling by -4.6% over the year to June 2013, in USD terms. Imports too also fell (-0.4%), driven largely by falls in non-oil imports (-6.7%), which was largely offset by a surge in oil imports (13.7%).

The RBI adopted liquidity tightening measures to support the Rupee. In its conference call, the RBI stated that it was not targeting a specific level for the Rupee, but was more concerned about Rupee volatility. It also strived to limit speculation by increasing restrictions on Foreign Institutional investors in dealing with currency risk. *The RBI highlighted that it will not rollback its measures till such time that stability is restored in the foreign exchange market.*

Indian Rupee to US Dollar



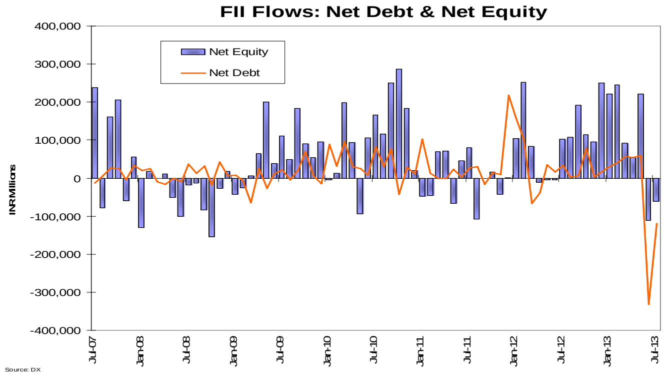
Current Account Deficit



A weakening rupee could generate import price inflation, with RBI suggesting that a 10% depreciation leads to a 1.2% pass through to higher prices. Moreover, it could also weaken the allure of holding Indian assets among overseas investors, as the Rupee depreciates and becomes more volatile, leading to rising hedging costs.

Foreign Institutional Investors pulled out nearly USD 10.5 billion in June-July 2013. June was the worst month, with an estimated USD 7.5 billion in withdrawals; July saw an outflow of USD 3 billion. Debt outflows were by far the worst impacted, with an estimated USD 7.7 billion withdrawn from debt funds, and the remainder from equity funds. Whilst disconcerting, a continued outflow in equity funds would be more of a risk to the Indian economy and could precipitate conditions leading to a capital stop. Factors such as a further slump in the growth outlook, along with continued volatility in the Indian Rupee could further weaken India's allure among Foreign Institutional Investors.

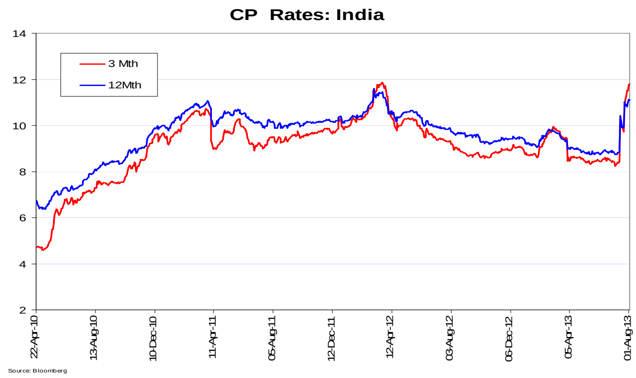
FII Flows



In response, the government has eased some restrictions on multi brand retailing, as well as those relating to FDI in the telecoms sector as well as increased export subsidies (from 2 to 3%) in industries such as textiles, engineering and allied sectors. Further, it has moved to speed up approval of mega projects. Moreover, unofficial estimates suggest that gold imports, estimated at 141 tonnes and 162 tonnes in April and May respectively, are expected at a considerably lower 31 tonnes in June and around 40 tonnes in July, largely driven by government and RBI restrictions. Such measures will indeed assuage pressure on the Current Account Deficit. However, structural improvements are sorely needed to boost the supply-side and lift investor sentiment. One example can be seen in the fall in domestic coal production and the attendant higher coal import bill: coal imports in the June quarter led to an FX outflow of USD1.9billion, 44% worse than the corresponding amount in the previous period. India's foreign exchange reserves currently stand at USD 280bn, 6¾ months' worth of import cover.

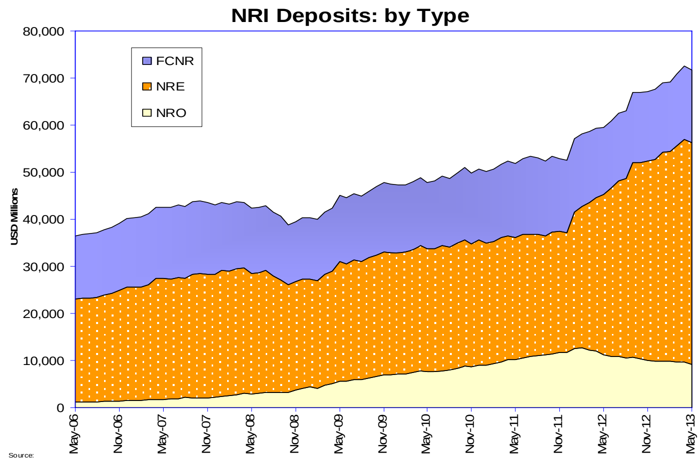
The RBIs liquidity tightening measures have led to an increase in the cost of short term finance, with the cost of issuing short term commercial paper around 11%. As at the March quarter, Gross NPAs (Non performing assets) were around 3.4% in the Indian banking system, with Public sector banks somewhat worse impacted at 3.8%. A slowing economy and higher rates could lead to a rise in non-performing loans. According to rating agency Crisil, gross non performing loans in the Indian banking sector could rise to 4% by March 2014. Analysis by the RBI reveals that Agriculture, Construction, Iron & Steel and Engineering would be among the worse impacted sectors. The RBI's stress tests also reveal that Indian banks should be able to withstand shocks, given their relatively strong capitalisation.

Commercial Paper Rates



One segment that could prove beneficial is the NRI segment. There continues to be strong inflows into NRE (Non-Resident External Rupee) accounts, in particular. These accounts offer the dual benefits of higher rates as well as have the repatriability option – attractive to NRI investors. Anecdotal evidence suggests that NRIs have shown increased interest in both depositing funds as well as purchasing real estate in India following the depreciation of the rupee. This is particularly the case with NRIs based in West Asia, with a number of currencies such as the UAE Dinar pegged to the USD.

NRI Inflows



Concluding Remarks

The Indian Economy faces challenges on multiple fronts: a slowing economy, mixed signals on inflation, and more worryingly a difficult external situation, with a volatile, depreciatiing rupee and a wide current account deficit. In the absence of external headwinds, the RBI might actually have cut rates this time around. However, they are likely to seek further evidence of external stability before they embark on any further easing measures.

Given the soft economic backdrop, NAB Economics is forecasting the benchmark repo rate between 6.75- 7% by March 2014, a 25-50.bp cut in comparison with the current 7.25%. Any reduction, however, will be delayed until the end of 2013 or early 2014 till such time as the RBI feel reassured about the external situation.

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