India – Monetary Policy Review

National Australia Bank

- **At its Quarterly Monetary policy review on the 20 of July, the Reserve Bank of India (RBI) cut the MSF rate by 75bps, whilst raising the Repo and Reverse Repo rates by 25basis points.**
- **The Cash Reserve Ratio was held at 4%, but the minimum daily balance was reduced from 99% to 95%.**
- **The decision reflects an increasing focus on anchoring inflationary expectations while easing liquidity, amid an improved external backdrop.**
- **Another key objective was to increase household financial savings. This is an astute measure as it will lessen current account vulnerabilities.**
- **The Indian economy remains weak, although there have been positive developments on the trade front.**
- **Inflationary pressures have risen, with the Wholesale Price Index reflecting the pass through of a lower exchange rate. The RBI is attaching increasing importance to the Consumer Price Index, and is uncomfortable with its current high level.**
- **The Indian Rupee has been assisted by RBI measures to provide concessional swap rates to banks to attract NRI deposits, a measure expected to draw in USD 10 billion. Foreign Institutional Investors have become net buyers of Indian securities during September, reversing the net selling trend over June-August.**
- **NAB Economics has altered its interest rate outlook. We now expect one to two more rate hikes, which would push up the Repo rate between 7.75-8% (previously 6.75-7%) to reflect the anti-inflationary focus of the new RBI Governor, Raghuram Rajan. The MSF rate is expected to fall, and the gap between the Repo rate and MSF rate is forecast to narrow to 100bp.**

RBI's Decision

In its Mid-Quarter review of monetary policy on the 20th of September, the RBI (Reserve Bank of India) made the following decisions:

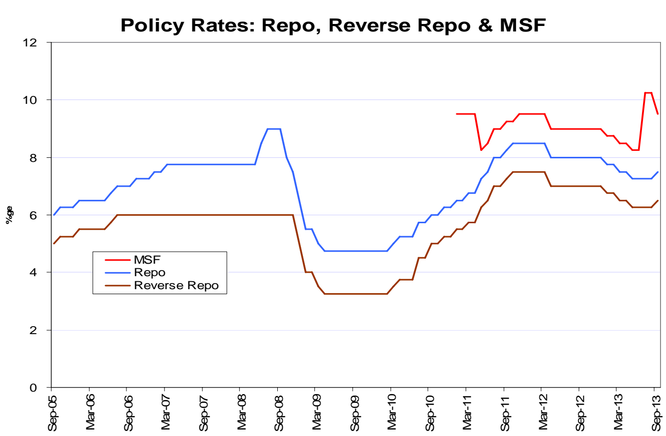
- Reduced the Marginal Standing Facility (MSF) rate by 75basis points from 10.25% to 9.5%.
- Increased the policy Repo rate under the Liquidity Adjustment Facility by 25bp, from 7.25% to 7.5%.
- Reduced the minimum daily maintenance of the Cash Reserve Ratio (CRR) from 99% to 95%, whilst keeping the CRR unchanged at 4%.

This is the first Monetary policy review since the newly appointed Governor Raghuram Rajan took over the helm at the RBI. The release of the monetary policy statement was postponed in light of the Fed's FOMC (Federal Open Market Committee) meeting on the 18th of September, in which the Federal Reserve decided to continue with its US85bn/month bond-buying (QE) program.

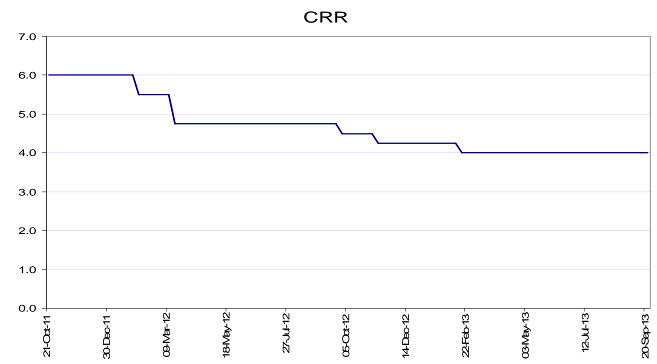
The MSF rate is the overnight rate at which banks borrow from the RBI when there is an acute cash shortage or an asset-liability mismatch. Banks usually provide approved Government securities as collateral. The Repo rate is the rate at which the RBI lends to commercial banks for a short period in return for securities, and the Reverse Repo rate is the rate at which the RBI borrows from them.

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 (Statutory Liquidity Ratio) was also maintained at 23%. The SLR is typically used to expand or contract the rate of credit growth in the economy.

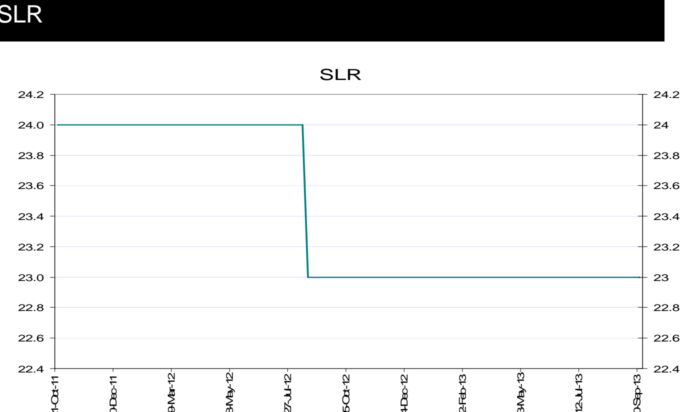
Policy Rates



CRR



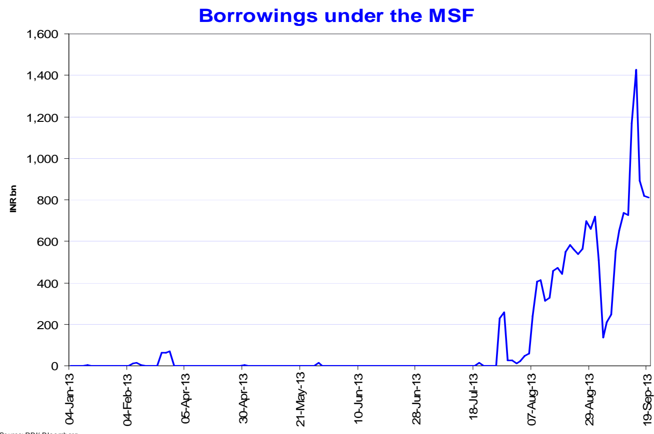
SLR



This is the first rate rise since the RBI cut by a cumulative 125bps, commencing in April 2012. The decision to cut the MSF rate whilst simultaneously raising the Repo rate reflects the *RBI's focus turning away from an external focus towards anchoring domestic inflation expectations*, reflecting an improvement in the external situation (see also External and Financial section). The gap between the Repo rate and the MSF rate has been reduced to 200 bps (previously 300 bps).

The prior rise in the MSF was meant to make it expensive for financial market participants to short the rupee. Besides, the limit for individual bank borrowings under the Liquidity Adjustment Facility (a mechanism whereby banks can borrow from the RBI through repos) had been restricted to 0.5% of their Net Demand and Time Liabilities so as to drain liquidity from the banking system, and raise the cost of short term funds. *Banks have increasingly resorted to borrowing from the RBI under the MSF facility (see chart): as a result, the MSF rate has become a sort of de facto policy rate.*

Borrowing under MSF

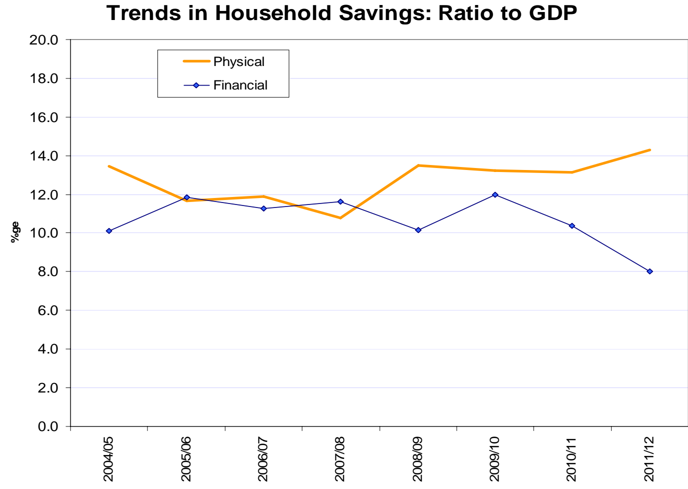


Another key objective that the *Statement highlighted was that household financial saving was 'lower than desirable'*. The aim of the policy hike was to dissuade consumers from investing in physical assets (e.g. gold and real estate) and bolster financial savings. The rate hike should be seen as part of the process to boost financial savings by lowering inflationary expectations; this process will get a further fillip when CPI linked bonds will be introduced towards the end of the year.

The focus on enhancing financial savings is a very smart move. *By funding a greater proportion of investment from domestic savings, there will be less of a reliance on foreign capital, reducing the strains on the Current account balance.*

India's recent woes related to its high CAD (Current Account Deficit) underscores the importance of raising the level of domestic savings.

Household Savings: Financial & Physical assets

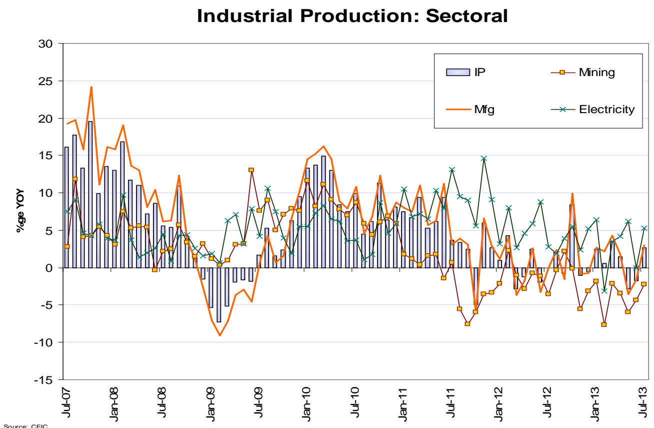


Growth and Production

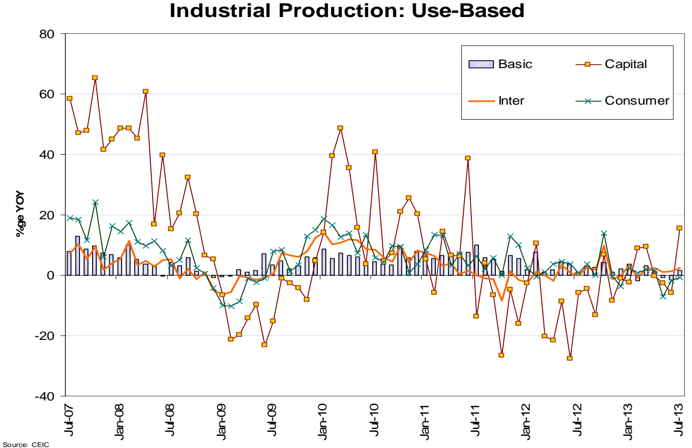
The Indian economy continues to remain weak, with growth expanding by 4.4% over the year to June quarter 2013, the slowest pace since March 2009.

Other activity indicators remain weak, although it is all not downbeat. Industrial production expanded by a modest, but positive, 2.6% over the year to July 2013. This is the strongest result since March 2013, and the first positive number following 2 prior months of contraction. Electricity production was the standout (5.25%), whilst there was a welcome return to growth in manufacturing (3%), with Electrical machinery and apparel manufacturing the standout sectors. Legislative problems continue to plague the mining sector, which contracted by -2.3%.

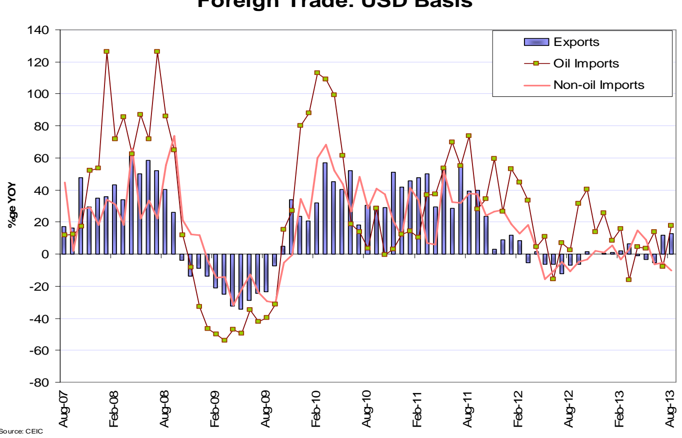
Industrial Production: Sectoral



Industrial Production: Use Based



Trade



By use, intermediate goods – a measure of downstream demand – increased by 2.4%, a welcome development. The most encouraging development has been the 15.6% increase in the capital goods sector. However, given the volatility of this sector, it is too early to call a commencement in the investment cycle.

Trends in international trade reveal that exports increased by 13% over the year to August 2013. Non-oil imports contracted by -10.4%, although worryingly, oil imports surged by 17.9%. Overall, the trade deficit is 23% lower than August 2012's level, and close to 30% lower than August 2011's level.

Overall, India's activity indicators remain weak, suggesting some measure of support is needed.

Prices

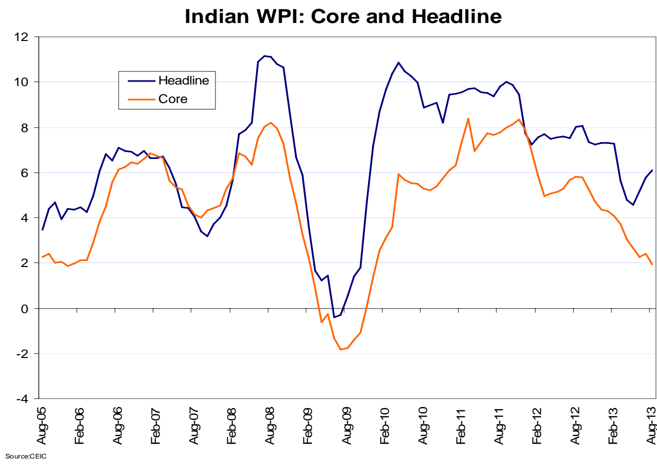
The weakness in the Indian Rupee during August led to a resurgence of price pressures. The Wholesale price index (WPI) rose by 6.1% over the year to August 2013 (5.8% in July). This is the third consecutive month in which the WPI has risen. Core inflation, however, as measured by non food manufactured inflation fell to a low of 1.9%, reflecting limited pricing power among corporates.

Examining the drivers of WPI, one can clearly see a spike in food inflation (18.2% vs. 11.9% in July), driven largely by a 244.6% increase in the price of onions, a staple in the Indian diet. There was a deceleration in the price of cereals, notably wheat. Protein prices too rose, notably fish and chicken.

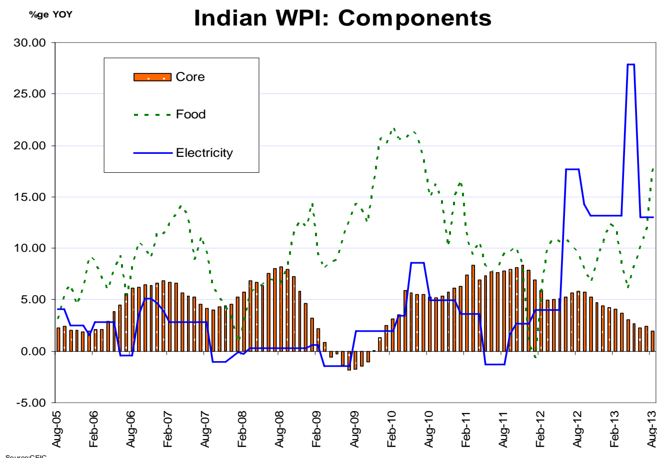
Fuel and power inflation remained steady at an elevated 11.3%, and could rise further due to anticipated increases in diesel prices. Consumer inflation eased a touch to 9.5% (9.6% in July), but still remains high.

The RBI highlighted the recent rise in the WPI as well as noted that inflation remained high at the 'retail level, measured by the CPI, and has been high for a number of years, entrenching inflation expectations at elevated levels'.

Headline and Core Inflation

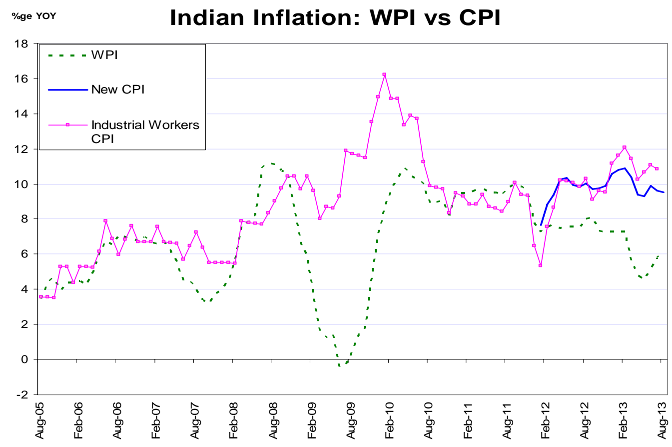


WPI Components

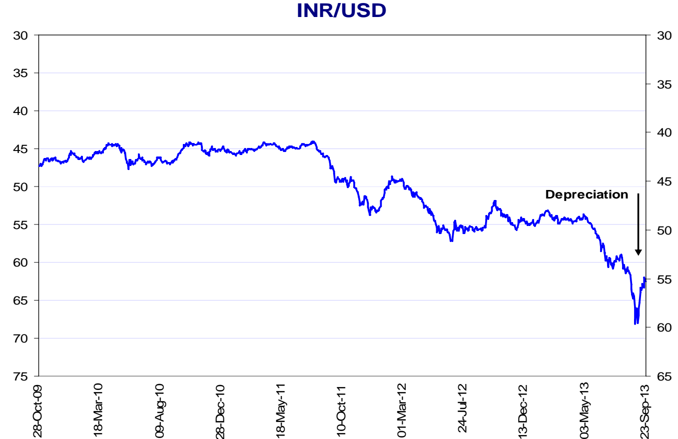


The declined in the core WPI measure did not seem to matter much in the RBI's decision making, as it was more worried about the recent upsurge in the headline WPI price measure. Moreover, it has also hinted that it is concerned about the high CPI, suggesting increasing weight will be attached to this indicator going forward: an indication of a more hawkish monetary policy stance.

WPI and CPI



Indian Rupee to US Dollar



External and Financial

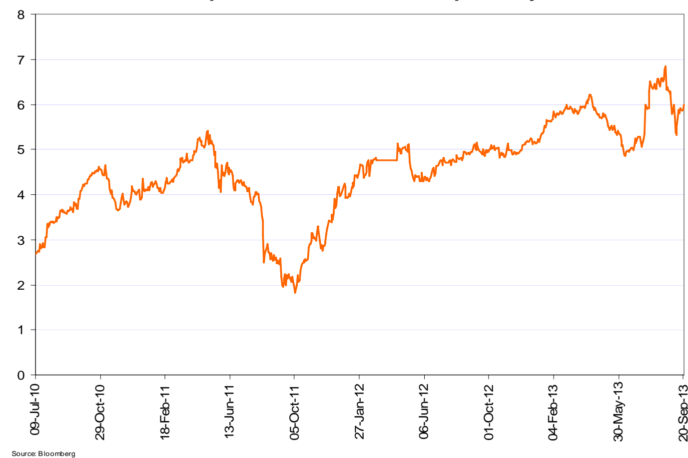
Following the ructions in currency markets stemming from the Fed's announcement on QE tapering (a decision now put on hold), the Indian Rupee fell sharply, reaching a low of INR 68.2/USD on the 28th of August. However, some measure of calm has been achieved in currency markets. At the time of writing, the Rupee was trading at 62.5/USD, an improvement of almost 10% compared to its recent lows.

In addition to the creation of the swap window for oil marketing companies, the Reserve Bank has generated additional measures which would help alleviate stresses in the Current Account and augment bank funding. It has opened a Concessional swap window for banks to swap fresh FCNR (B) (Foreign Currency Non Resident) deposits for a minimum tenor of 3 years; the window will be open till the 30th of November. What this means is that banks can swap their dollar deposits with the RBI for Rupees, and at the end of the period, they can swap the rupees back for dollars, whilst paying the 3.5% pa. swap cost. This is considerably lower than the 6% rate prevailing in the market (see Chart). *This allows banks to boost their profits and/or offer more attractive terms to customers. It is estimated that this facility could raise up to USD10bn*, which would help in financing the Current Account. Note that the swap facility only covers the principal payment and not the interest payment.

Moreover, banks can now borrow up to 100% of their unimpaired Tier 1 Capital (previously 50%) from overseas, and swap the foreign currency with the RBI at a rate 100bp below the prevailing market rate – another positive for bank funding and the rupee. This measure is expected to further attract USD5 billion in foreign capital.

Finally, the decision by the Fed not to taper has offered some breathing space to Indian authorities. However, the Monetary Policy Review noted that it was more of a postponement, and tapering was 'inevitable' in the future.

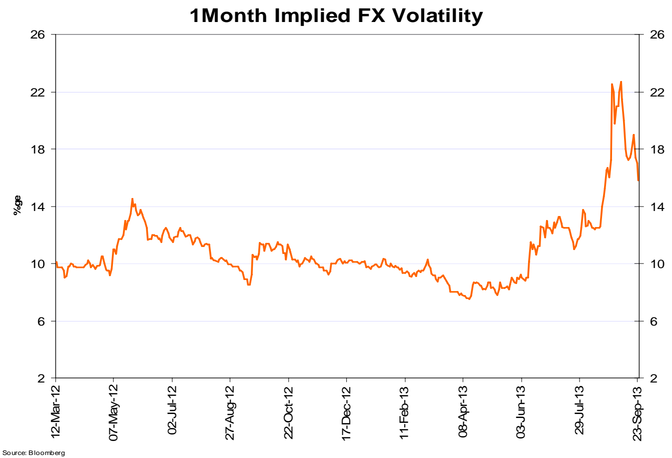
FX Swap Rate: 3 Years Ahead



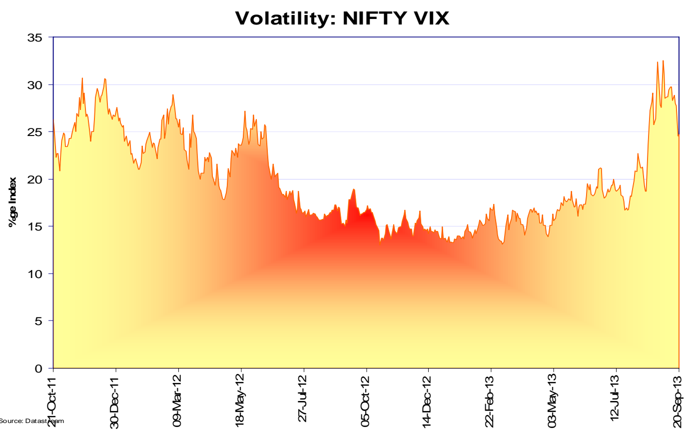
Reflecting the improved external situation, volatility measures for both currency and equity markets have eased. The 1-month implied volatility, a measure of expected moves in the exchange rate used to price options, has eased considerably since the peaks at the end of August and early September. Moreover, the Nifty VIX (Volatility Index) used to measure equity market volatility over the ensuing 30 days has also fallen from its peak in early September.

There was renewed FII (Foreign Institutional Investor) interest in Indian securities in September. Whilst they were net sellers during the June-August period, FIIs purchased net USD1.75bn of Indian securities, primarily equities (USD1.95bn), whilst they sold modest amounts of debt (USD0.2bn).

FX Volatility – 1 month ahead



VIX Index - Nifty



In summary, the RBI noted the improvement in the external environment, which prompted it to reduce the MSF rate. However, it will be monitoring external market decisions and stands ready to act in either direction should the situation warrant.

Concluding Remarks

Group Economics has altered its interest outlook following the Monetary policy review and the change in emphasis by the new RBI Governor, Raghuram Rajan. We are forecasting one to two more rate rises, which will lift the repo rate between 7.75-8% (previously 6.75-7%), a level we expect to persist till the end of the 2013-14 financial year. The increase in the Repo rate will be compensated by further cuts in the MSF rate, and the gap between the Repo rate and the MSF rate will be reduced to 100 basis points (previously 200 bp).

Our forecasts are underpinned by the anti-inflationary stance of the Monetary Authorities, with a specific objective in anchoring inflation expectations. The pass through from a weaker exchange rate and suppressed infaltionary pressure are expected to offset some of the disinflationary impacts from a favourable monsoon (kharif) harvest and a negative output gap, due to below trend growth.

The weak Indian economy will limit the scope and magnitude of future rate rises. However, rate cuts are not envisaged till well into 2014, when the RBI feels more comfortable with the inflation trajectory in the overall economy.

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