India –Monetary Policy Review

National Australia Bank

- **At its Quarterly Monetary policy review on the 28th of January 2014, the Reserve Bank of India (RBI) raised the Repo rate by 25bp to 8%, and simultaneously raised both the MSF (Marginal Standing Facility Rate) and Reverse Repo Rate by 25bp to 9% and 7% respectively.**
- **Whilst headline CPI and WPI came down due to softer food prices, Core CPI remained elevated around 8%, reflecting underlying price stickiness. The high Core CPI compelled the RBI to act.**
- **The Urjit Patel Committee recommended that a Headline Inflation target of 4% +/- 2% should be the primary target of monetary policy within 2 years. Such a move would, however, require legislative approval.**
- **India's economy remains weak, with industrial production contracting by 2% over the year to November, driven largely by weakness in manufacturing.**
- **The trade figures are very encouraging and indicate that the trade deficit for the April-December 2013 period was 25% lower than a year ago. Further, the Current Account Deficit is expected to be well, contained within 2.5% of GDP for the 2013-14 period, almost half of what it was a year ago.**
- **India's external vulnerability is lower than countries such as Turkey and South Africa, which have high Current Account Deficits.**
- **India's external funding needs have significantly benefited from the USD 34bn of inflows due to special measures such as the Concessional Swap facility for FCNR(B) deposits.**
- **NAB Economics is forecasting the RBI to keep the Repo rate on hold at 8% till the end of the 2014-15 Financial Year, as the RBI observes the impact of recent rises.**

RBI's Decision

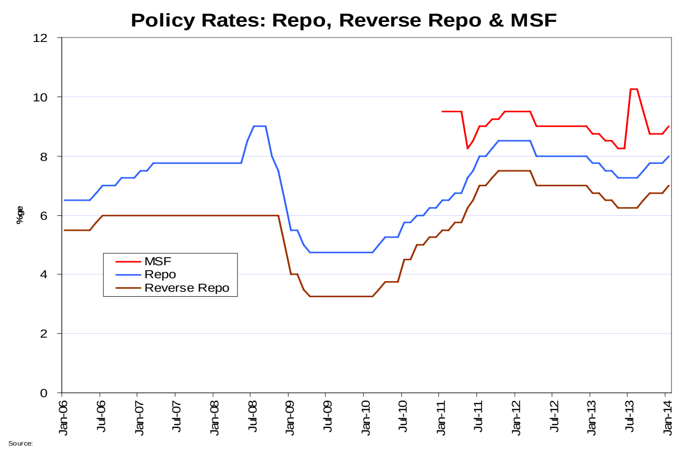
At its 3rd Quarter Review of Monetary policy for 2013-14, the RBI:

- Increased the policy Repo rate under the Liquidity Adjustment Facility by 25bp, from 7.75% to 8%.
- Raised the Marginal Standing Facility (MSF) rate and the Reverse Repo by 25bp to 9% and 7%, respectively.
- Maintained the Cash Reserve Ratio (CRR) at 4%.

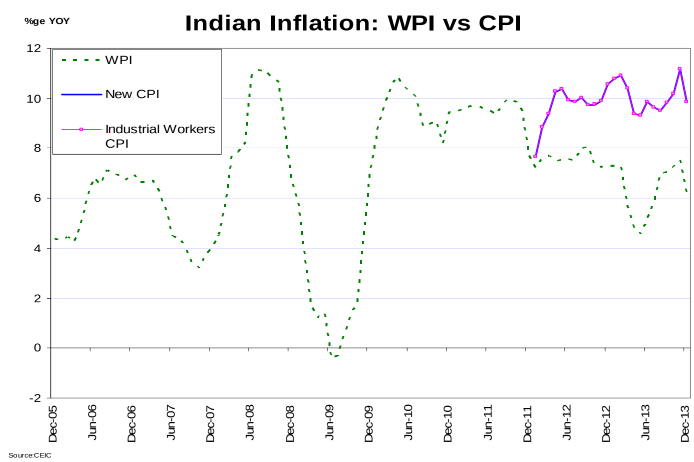
Since September, the Repo Rate has risen by a cumulative 75 basis points. This current increase in the Repo rate surprised market participants, but was not wholly unexpected. At the Mid-Quarter review of Monetary Policy on the 18th December, the RBI laid out the conditions for a rate rise: *the absence of a decline in food inflation, resulting in headline inflation remaining high, or a continuation of the high levels of Core CPI, i.e. excluding food and fuel*.

December 2013's inflation reading witnessed falls in both headline WPI (Wholesale Price Index) as well as CPI (Consumer Price Index). The WPI declined from 7.5% to 6.2%, whilst the CPI fell from 11.2% to 9.9%. However, Core WPI (non-food manufactured inflation) accelerated from 2.66% to 2.75%, whilst Core CPI (ex food and fuel) remained sticky at 8.1%. The high level of Core CPI indicated strong 'second-round' effects from elevated food and fuel prices. One of the aims of the RBI was to ensure that the Repo Rate was not below the Core CPI rate, as this would in effect result in negative real interest rates, creating a disincentive for savers, and provide an unbalanced environment for sustainable growth.

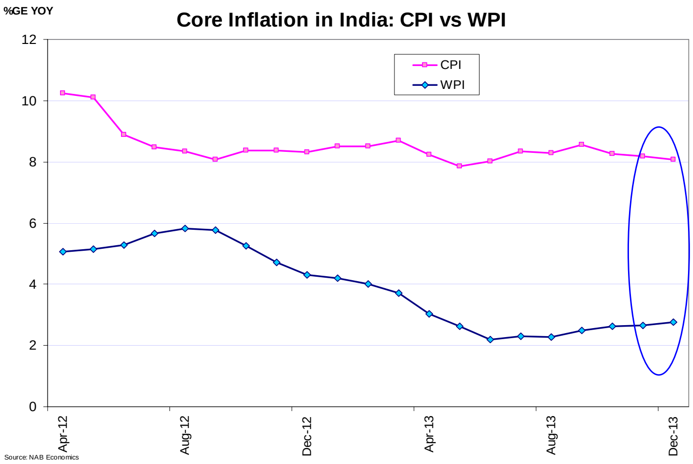
Policy Rates



WPI and CPI



Core Inflation: CPI vs. WPI



The fall in the headline numbers were driven largely by falls in food prices, notably fruits and vegetables. For example, food price inflation (in the WPI) slackened from 20% over the year to November 2013 to 13.7% in December. Prices for onions, a staple of the Indian diet, decelerated sharply from 190.3% (year to November) to 39.6% in December.

Core inflation, however, accelerated. Core WPI rose on account of higher prices for chemicals, non metallic minerals and paper products. More significantly, Core CPI remained elevated due to high prices for services such as education.

The implication of this decision is that Consumer Price Inflation (both Headline and Core) will be more closely monitored in setting monetary policy decisions, partly stemming from the recommendations of the Urjit Patel Committee on the Monetary Policy Framework (see section below). Furthermore, recent turbulence in Emerging Markets due to concerns about Fed tapering may have influenced the RBI (along with the Central Banks of Turkey and Brazil) to hike rates.

Urjit Patel Committee Recommendations

As part of a comprehensive review of India's Monetary Policy regime, a Committee chaired by Urjit Patel, Deputy Governor of the RBI, was tasked with delivering a Report on India's proposed monetary policy framework.

The Report highlighted that inflation-targetting as measured by the (Headline) New CPI should be predominant objective of monetary policy. This nominal anchor should be set at 4% +/- 2%, and should be adopted by 2016. Prior to incorporating this framework, the CPI needs to be brought down to 8% by 2015, and to 6% by 2016. The report also recommended that monetary policy decision-making should be vested in terms of a Committee, as opposed to solely with the RBI Governor.

In order to achieve these objectives, there needs to be close co-ordination between the fiscal and monetary authorities, with the Central Government aiming for a 3% Gross Fiscal Deficit Target by 2016-17.

Other noteworthy elements include the production of a bi-annual inflation review to provide forward guidance, as well as the scheduling of meetings every 2 months, with the flexibility to meet outside of the scheduled dates should circumstances warrant.

The RBI is currently examining these proposals. Legislative approval will be required in order to pass some of the measures such as the formal adoption of inflation-targeting and setting up of a Monetary Policy Committee. Whilst a move towards inflation targeting will provide policy certainty and help contain India' high inflation rate, food and fuel currently account for 57.1% of the CPI basket. Whilst these play an important part (as empirically demonstrated in the report) in forming inflation expectations, they largely depend on factors well outside the control of the RBI: weather, food storage & distribution, as well geopolitical tensions. T*here is a risk, therefore, that a rigid adherence to this measure could result in excessively high interest rates, damaging growth and employment*.

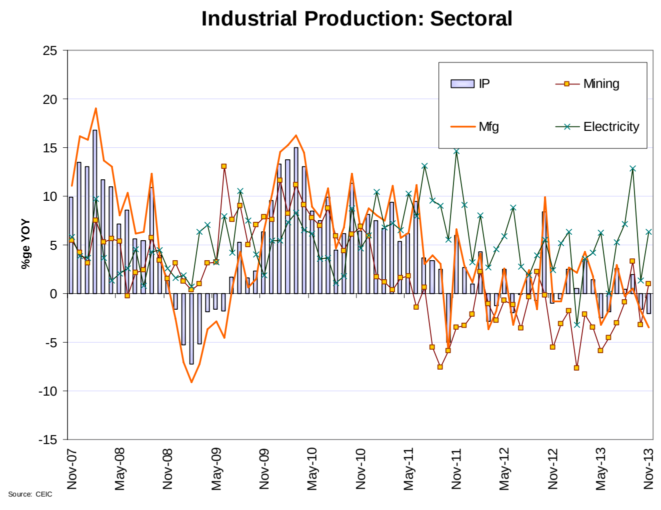
On *liquidity management,* the Committee would like to lessen the dependency on overnight repos, and enhance the importance of the *14-day term repo* facility. It highlighted the inherent superiority of the 14-day term repo facility as it allowed market participants to on lend/repo term money in the interbank market and develop segments and yields for term transactions.

Growth and Production

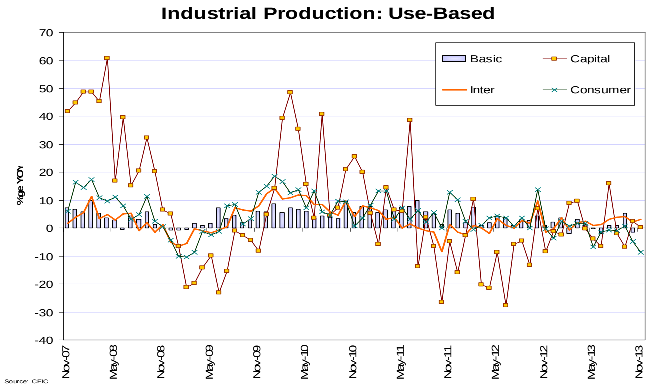
Economic activity continues to disappoint, with Industrial Production contracting by -2.1% in November, driven largely by a -3.5% fall in manufacturing. Electricity production (6.3%) was the standout on a sector basis, and mining (1%) too recorded a welcome expansion, due to an increase in coal production.

In manufacturing, segments such as communication equipment, computer equipment, and furniture were very weak; conversely, chemicals, along with electrical machinery and apparel were better performing.

Industrial Production: Sectoral



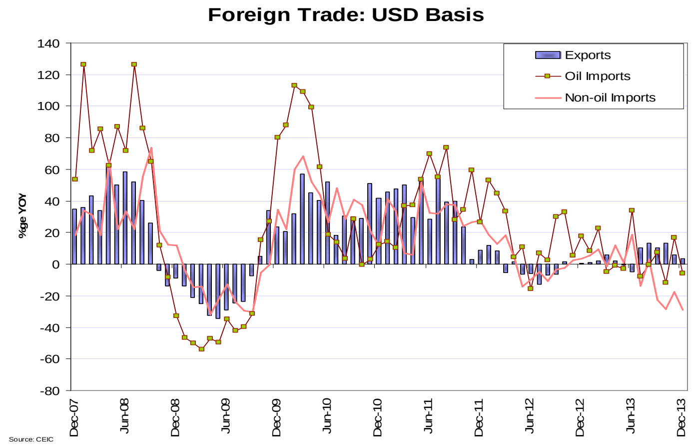
Industrial Production: Use Based



By use, the weakness was clearly evident in the production of consumer goods (-8.7%): this was clearly impacted by the sharp fall in consumer durables (-21.5%). A weak economy, combined with a high inflationary environment has clearly taken its toll on consumer spending. The volatile capital goods segment was flat, although improved from October's contractionary reading. Intermediate goods production – a measure of downstream demand – grew by 3.3%. *All up, these results indicate that a significant turnaround in domestic demand is yet to eventuate*.

The external sector continues to be supportive, with export growth outpacing imports, resulting in a diminution in the trade deficit. Export growth eased to 3.5% in December (from 5.9% in November), although they have expanded for 6 months in a row. The easing in export growth more than offset declines in imports, with both oil (-5.8%) and non-oil imports (-28.8%) shrinking. As a result, the trade deficit for December was 42% below year ago levels. *For the April-December 2013 period, the trade deficit was 25% below year ago levels*.

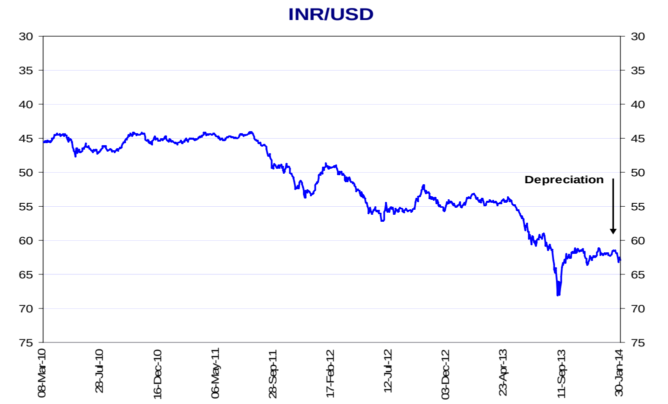
Trade



External and Financial

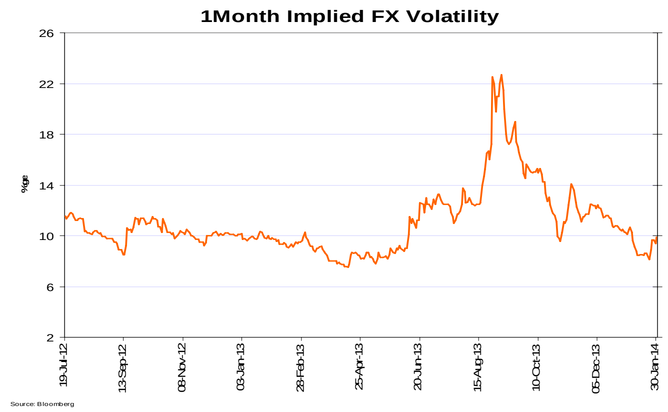
Following the release of the Monetary Policy Announcement, the Indian Rupee appreciated to 62.4/USD. However, there was a slight depreciation when the Fed announced that it was scaling back its asset purchases to USD65bn/month. The INR was trading at 62.9/USD – well ahead of the lows it reached in late August.

Indian Rupee to US Dollar



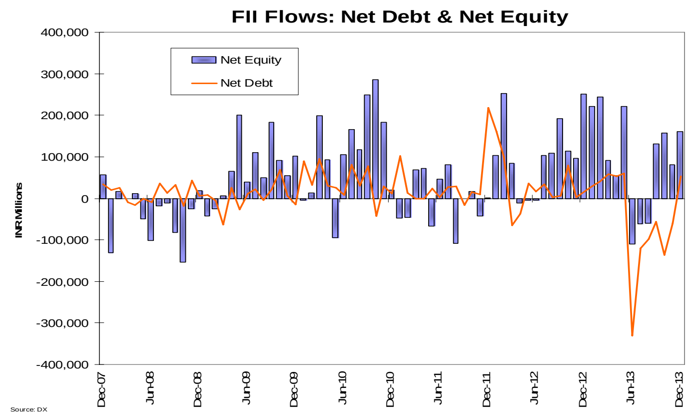
The 1-month implied FX volatility, a measure of expected moves in the exchange rate used to price options, was around 9.9%, well below the recent peak of 22.7% in September.

FX Volatility: 1-Month Implied



Improvement in the rupee volatility has helped bolster foreign investor sentiment in Indian financial assets. Volatility creates exchange rate risk for overseas investors and acts as a deterrent to investment in Indian financial assets. In fact, this is exactly what happened when investors (particularly debt investors) shunned Indian assets when the currency came under severe pressure during the 3rd quarter of last year. However, they have since returned to market.

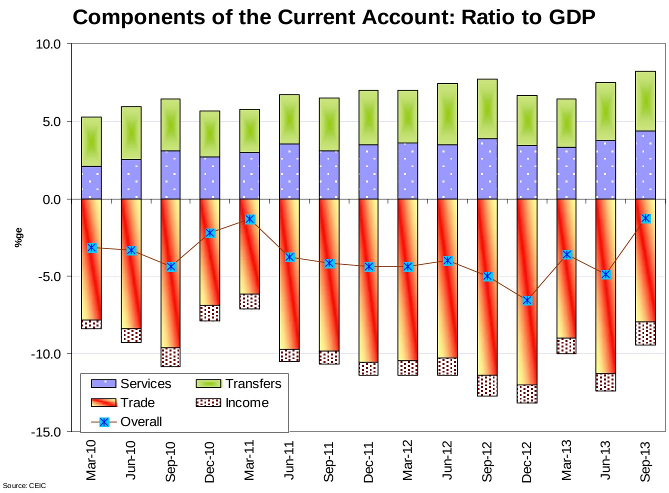
FII Flow: Debt and Equity



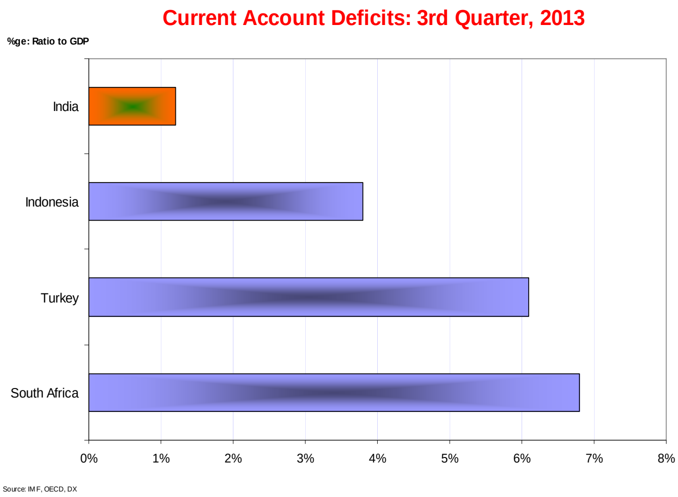
India's external position has considerably strengthened during the course of 2013. There has been a sharp compression in the trade deficit. This has manifested in a much improved Current Account position. During the September quarter, India's Current Account Deficit (as a ratio to GDP) was 1.2%: by comparison it was 6.5% as at December quarter, 2012. Restrictions on gold imports, as well as softer domestic demand have helped. *It is expected that India's Current Account Deficit for the 2013-14 Financial Year will remain below 2.5% of GDP, almost half the 4.8% recorded in the 2012-14 FY*.

Recent tapering by the US Federal Reserve, as well as concerns about China's growth have generated ructions in certain Emerging market currencies are under pressure, the most glaring examples being the South African Rand and the Turkish Lira, not to mention the steep decline in the Argentinean Peso. India faces less external vulnerabilities compared to Turkey and South Africa, and to a lesser extent, Indonesia stemming from its much improved Current Account position.

India's Current Account Deficit

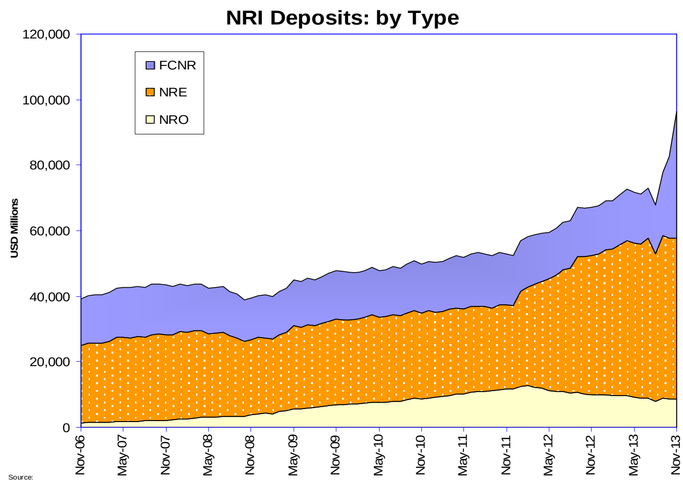


Current Account Deficit: Selected Countries



In addition to lowering the Current Account Deficit, External funding concerns have also receded. The RBI offered banks (up to 30th November) a Concessional Swap facility to attract FCNR(B) deposits, and also allowed them to borrow 100% of their unimpaired Tier 1 Capital from overseas. These 2 measures have together raised USD34bn in overseas funds.

NRI Deposit Flows



Outlook

Following the Monetary Policy meeting we are forecasting the RBI to remain on hold for an extended period. The RBI noted that it accepted the Urjit Patel Committe 'glide path' for Headline CPI moving to 8% by the end of the 2014-15 financial year, within a 7.5%-8.5% band. It indicated that it would like to watch the evolution of prices, and expected a disininflationary path stemming from recent rate rises, a broadly stable exchange rate and a negative output gap. It will also likely keep a close eye on Core CPI to assess the underlying inflationary pressures when formulating its decision making.

We forecast the RBI to keep the Repo rate on hold at 8% till the end of the 2014-15 Financial Year, consistent with the Headline CPI easing to 8% by the end of the period. Inflation surprises (both positive and negative) would result in further intervention by the RBI.

This is consistent with the following comments from the RBI: '*The extent and direction of further policy steps will be data dependent, though if the disinflationary process evolves according to this baseline projection, further policy tightening in the near term is not anticipated at this juncture*'.

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