India –Monetary Policy Review

National Australia Bank

- At its first bi-monthly Monetary policy statement for 2014-15, the RBI maintained the policy Repo rate at 8%, as expected.
- India's headline inflation indicators have improved with easing vegetable prices, although the Core CPI remained sticky at 8%, reflecting high prices for services
- Recent activity indicators are mildly positive, but do not signify any strong recovery. India's potential growth is likely to have fallen to around 6%, limiting the scope for rate cuts to support growth.
- India's external indicators remain strong with the Current Account Deficit projected to be around 2% of GDP for the 2013-14 Financial Year. Moreover, FX Reserves are over USD 300bn, the highest since December 2011.
- The Indian Rupee is trading around INR 60/USD, stronger than levels reached over the past few months. A comment by Governor Rajan that indicated a level of 55 INR/USD would be considered 'high', did exert some modest downward pressure on the Rupee.
- Improved external indicators and optimism about a more business friendly government has led to a surge in Foreign Institutional Investor Interest in Indian Equities.
- The economic policies of the newly formed Government in May will be critical to the performance of India's economy and financial markets.
- Election related uncertainty is manifest in India's Volatility Index (Nifty VIX), which has continued to trend up.
- NAB Economics is maintaining its forecast for the Repo rate at 8% through the 2014-15 Financial Year, albeit with slight upside risks. The latter stems from potentially higher inflation projections from a possibly weaker monsoon, and increased pricing power among Indian Corporates due to a smaller output gap.

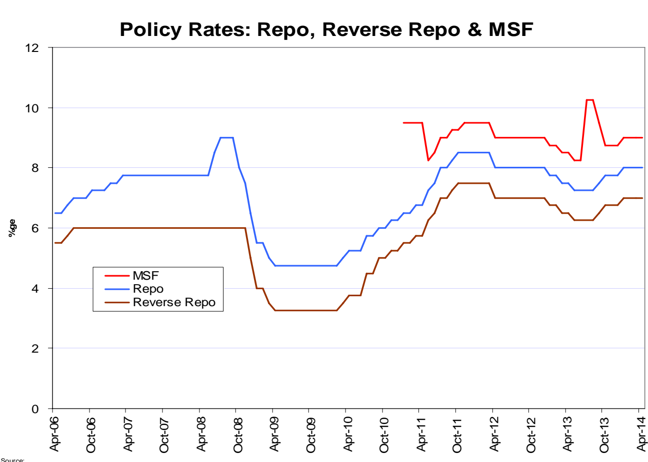
RBI's Decision

At its first bi-monthly Monetary policy statement for 2014-15 on the 1st of April, the RBI:

- Maintained the policy Repo Rate at 8%
- Kept the Marginal Standing Facility Rate unchanged at 9%
- Held the Cash Reserve Ratio stable (CRR) at 4%.

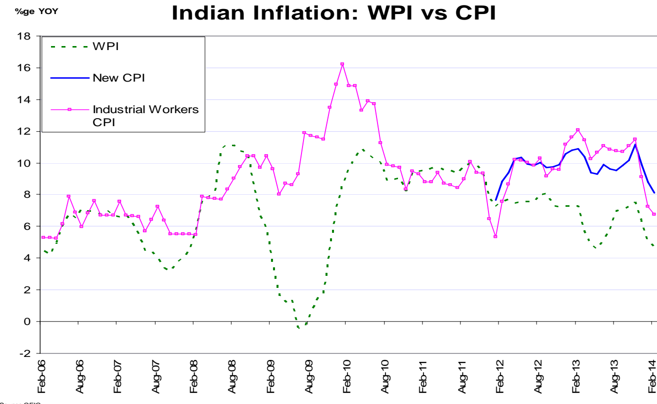
The decision was expected by both NAB Economics and financial markets. Following a cumulative 75bps rise in the policy rate over the September- January period, the RBI decided to remain on hold to observe the effects of the recent rate rises. *What has clearly emerged is the RBI remains firmly committed to the disinflationary path, aiming for headline CPI to decline to 8% by January 2015, and 6% by January 2016.*

Policy Rates



Turning to recent inflation outcomes, there has been a decline in various measures of Headline inflation. The all-important *New CPI* measure decelerated to 8.1%, the lowest since January 2012. *Industrial Workers CPI* fell to a low of 6.7%, and *Wholesale Price inflation* too declined to 4.7%, the lowest since May 2013. One of the driving factors behind these much improved outcomes has been the sharp deceleration in vegetable prices. From a recent peak of 61% over the year to November 2013t, they have eased considerably to 14% over the year to February 2014.

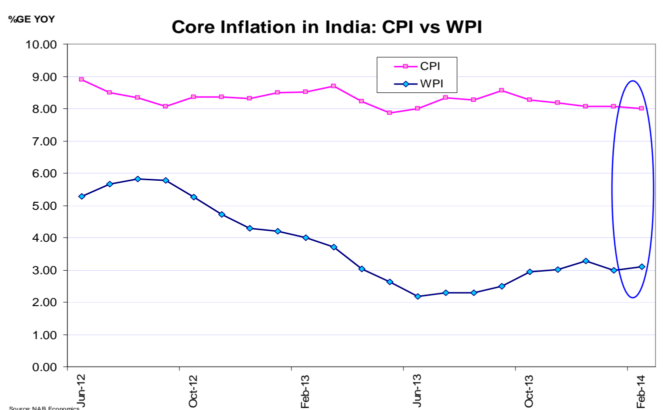
Headline inflation measures



Despite the positive trends in the headline inflation, Core CPI (ex food and fuel) continues to remain sticky at high levels. Core CPI fell slightly from 8.1% over the year to January 2014 to 8% in February, 2014. Core WPI (non food manufacturing inflation) edged higher to 3.1% in February due to higher prices for chemical and paper based products, in part

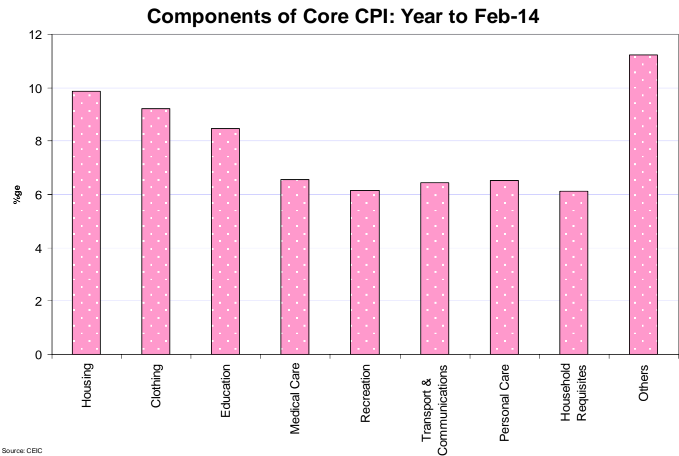
impacted by exchange rate pass through effects. The wide disparity between Core CPI and WPI is quite instructive, and we believe the CPI is a more accurate reflection of inflation in the Indian economy.

Core Inflation: CPI vs. WPI



Whilst not specifically targeting Core CPI, the RBI places a lot of value on it as a measure of inflation persistence. NAB Economics has split Core CPI into its constituent elements. Looking more closely, housing (9.9%), clothing (9.2%), education (8.5%) and others (11.2%) have been the main drivers, and partly reflect wage pressures in the economy.

Core CPI Components

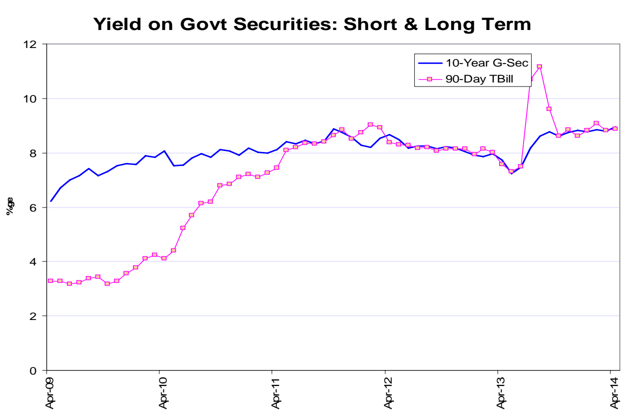


Inflation expectations have also eased, although they still remain high. The RBI's most recent edition of its *Household Inflation Expectations Survey* revealed that households expected somewhat lower inflation over the course of the next 3 months, as well as the following year, relative to three months ago. To the extent that expectations impact on actual outcomes, the easing in expectations is welcome – provided it can be sustained.

Another significant development to emerge from this meeting has been increasing the liquidity provided through term repo facilities in favour of the overnight repo facility. More specifically, the RBI increased the liquidity provided under the 7-day and 14-day term repos from 0.5% of Net Demand and Time Liabilities in the banking system to 0.75%;at the same time they reduced liquidity provided under the overnight facility from 0.5% to 0.25%. The aim of the RBI has been to improve the transmission of monetary policy across the interest rate spectrum, help in the evolution of market based benchmarks and ensure the call money (interbank borrowing rate) tracks the Repo rate as far as possible.

In the immediate aftermath, bond yields rose as market participants were concerned about the loss of liquidity at the overnight window.

Core CPI Components



Growth and Production

India's economy remains stuck in low gear, with the December quarter GDP recording a moderate 4.7% expansion. More recent indicators have offered a glimmer of hope, but nothing enduring.

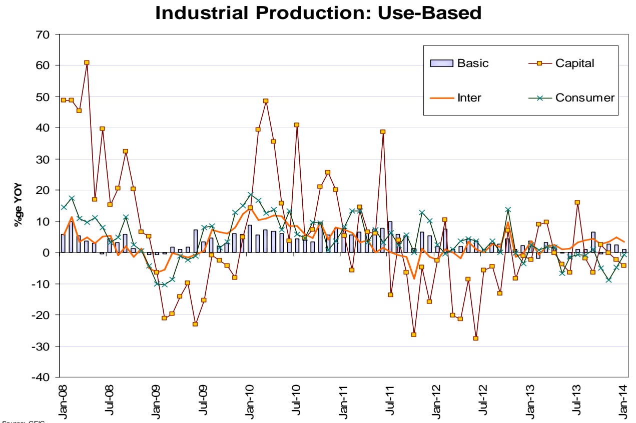
Industrial production activity grew by a slight 0.1% over the year to January, 2014. Whilst modest, it is an improvement on the negative outcomes over the preceding 3 months. By sector, electricity was the strongest at 6.5%, whilst mining grew by 0.7%. Manufacturing was the laggard (-0.7%), although somewhat less so than previously.

By use, the capital goods sector contracted by -4.2%, indicating no visible improvement in the investment cycle. The Intermediate goods sector – a measure of downstream demand – was the best performing among the various categories. Consumer durables (-0.6%) improved slightly relative to previous quarters, but was altogether weak.

Industrial Production: Sectoral

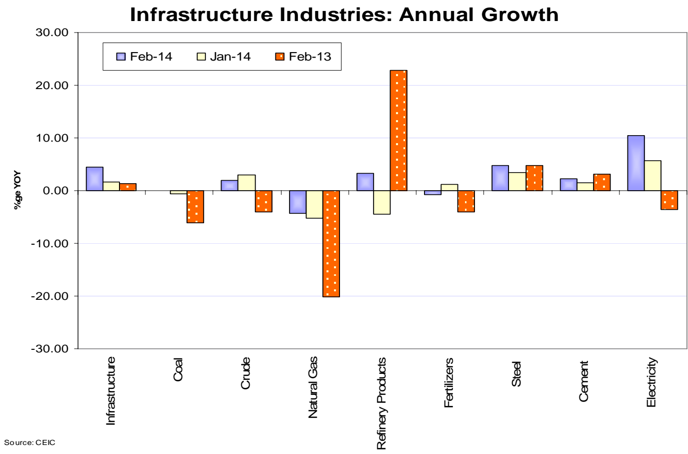
Industrial Production: Sectoral

Industrial Production: Use Based



The performance of the *Infrastructure* sector in February is more encouraging. it grew by 4.5% over the year, the fastest pace since September, 2013. Steel, cement and electricity were somewhat better performing segments. As the infrastructure sector comprises 38% of industrial production activity, this should hopefully lead to better industrial production data for February.

Infrastructure Industries



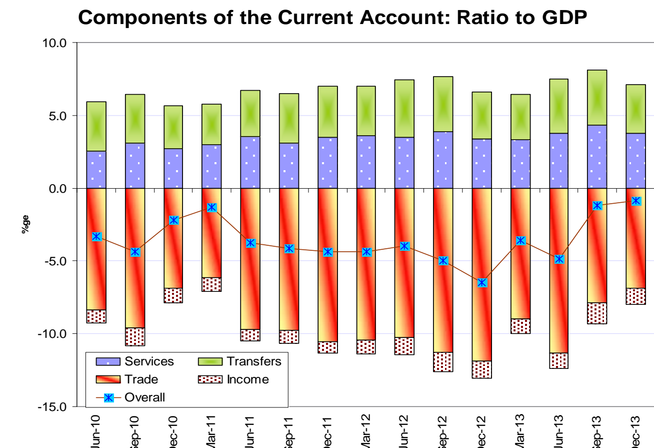
Recent estimates by the RBI suggest that India's potential growth rate may have fallen. From around 8% in 2008-09, India's potential growth may have declined to 6%. What this means is that the negative output gap (actual less potential GDP) is not as large as previously anticipated, and that the disinflationary impulse from this will likely not be that strong.

In summary, the RBI is mindful of India's modest growth, but also aware that the output gap is not as large as widely believed. Such a scenario will likely limit the scope for rate cuts, and ensure rates remain on hold.

External and Financial

India's external situation has improved considerably over the past 6-8 months. This is most evident in the Current account balance, with the Current Account Deficit falling to a historical low of 0.9% of GDP in the December quarter of 2013. It is estimated that the Current Account Deficit will be around 2% of GDP for the 2013-14 Financial Year, well below the 4.7% in the 2012-13 Financial Year.

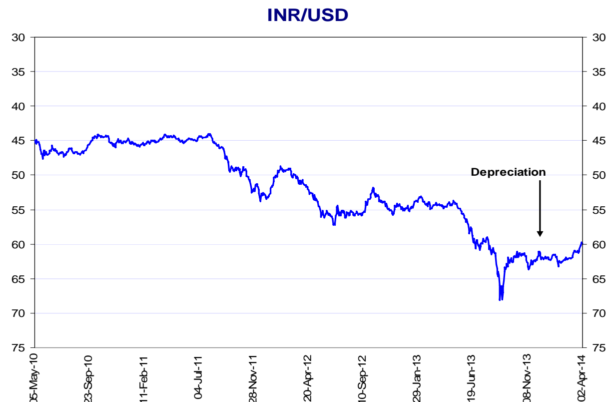
Current Account Deficit



In addition, India's Foreign Exchange reserves have swelled to USD 303.7billion, the first time they have crossed the USD300bn mark since December, 2011. Measures such as the expanded Foreign Currency Non Resident Deposit (FCNR B) deposit facility have helped. A further accumulation in reserves is anticipated as oil marketing companies return dollars back to the RBI that they borrowed under the FX Swap facility.

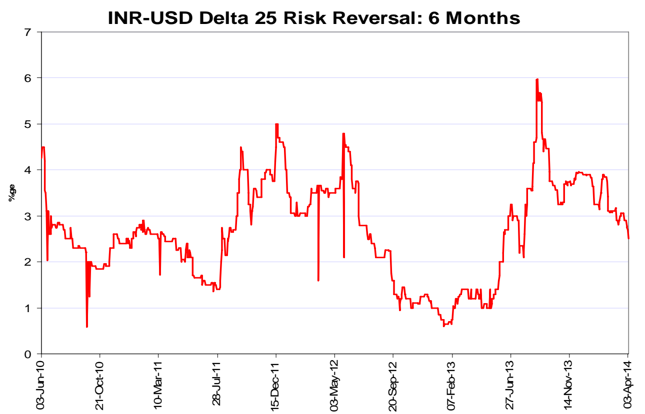
As a result, the Indian rupee has strengthened and has been trading around the 60 INR/USD. This is an improvement on recent outcomes, and considerably stronger than the lows reached in August. Interestingly, RBI Governor Rajan indicated that an exchange rate of 55 to the USD would be considered too 'strong', a measure which would most likely lead to intervention by the RBI in financial markets.

INR/USD

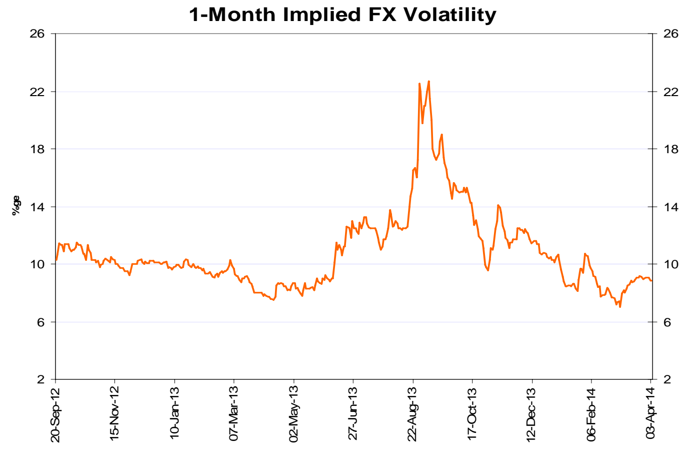


Financial market participants are also more sanguine on the outlook for the. *Delta 25 reversals* – a key measure examined by the RBI for Financial Stability – indicate option market participants expect modest depreciation pressure over the next 6 months, considerably less than the stress periods in late August. Put simply, a higher value means option market participants expect a weaker Rupee relative to the USD. Furthermore, 1-month implied FX volatility, a measure of expected moves in the exchange rate used to price options was around 8.9%. The slight increase could indicate election related uncertainty.

Delta Risk Reversals: USD-INR

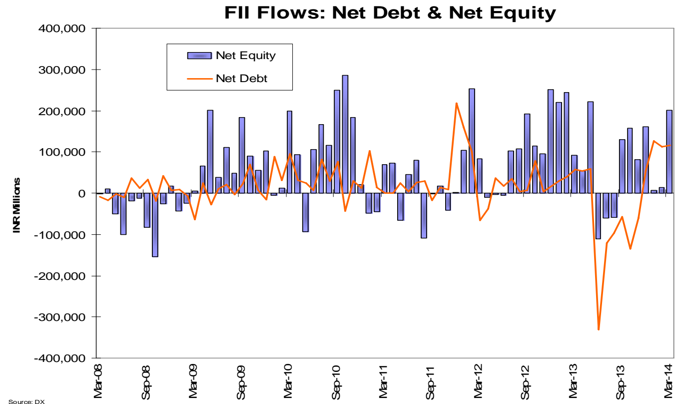


FX Volatility: 1-month Implied



The Indian Equities market has performed well over the year to date, rising by over 6%, with gains evident in erstwhile weaker performing sectors such as engineering. Improved external stability, as well as strong demand from Foreign Institutional Investors (FIIs) has helped propel the Indian stock market. After having broadly sat on the sidelines during January and February, Foreign Equity investors returned strongly in March.

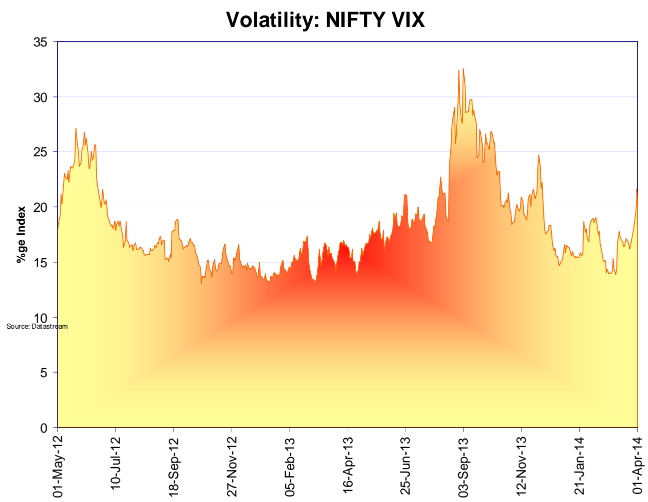
FII Flow: Debt and Equity



One critical factor going forward, will be the outcome of the upcoming elections, and the economic policies of the newly formed Government in May this year. This will be a pivotal factor in determining both India's financial market as well as overall economic performance.

India's *VIX indicator*, an indicator of market volatility over the ensuing 30 days, rose to a recent high of 20.7% on the back of election-driven uncertainty. This is likely to persist during the election season.

India VIX Indicator



Outlook

Following the Monetary Policy meeting, we are forecasting the RBI to remain on hold for an extended period, albeit with slight upward risks. The RBI higlighted that it was broadly comfortable with current interest rate settings given inflation projections, based on their expected glide path: 8% by January 2015, and 6% by January 2016. Further, they indicated they would look through temporary factors such as an expected easing in inflationary pressures towards the September quarter due to high base effects.

The RBI also noted that inflation risks had an upside bias. The reasons include: possible adverse monsoon leading to higher food price inflation; increased pricing power from firms due to a lower output gap; higher commodity prices due to geopolitical risks resurfacing (note events in Ukraine); and finally, abrupt exchange rate movements due to possible faster-than anticipated Fed tapering.

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. Risks are tilted slightly to the upside, due to the possibility of higher than expected inflation outcomes.

John Sharma

Economist – Sovereign Risk

john.sharma@nab.com.au

Tom Taylor

Head of International Economics

Tom_Taylor@national.com.au

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics

SpirosPapadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy

Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy

Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research

Michael Bush
Head of Credit Research
+61 3 8641 0575

Equities

Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior MarketStrategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

UK/Europe

Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Senior Credit Strategist
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Tom Taylor
Head of Economics, International
+61 3 8634 1883

Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Important Notice

This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances. NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click **here**to view our disclaimer and terms of use.