India Monetary Policy

by Group Economics

August 2015

National Australia Bank

Summary & Overview

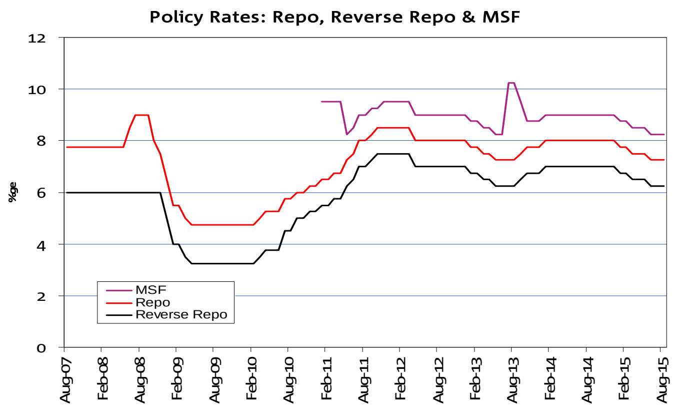
- The RBI maintained the Repo rate 7.25%, as expected.
- The Government and the RBI are broadly in agreement regarding the future composition of the Monetary policy committee.
- Inflation, both headline and core, accelerated in June. Headline pressures are expected to abate during July and August due to favourable 'base effects'.
- The RBI will closely observe movements in core inflation as to whether the increase is temporary or not.
- The Government and the RBI are working on adopt a medium term framework for Foreign Portfolio investment in Indian debt securities.
- NAB Economics is forecasting the Repo rate to remain on hold at 7.25%, with an easing bias.
- The outlook for the remainder of the monsoon - and it impact on food prices, as well as the impact of the Fed's anticipated rate rise are two critical determinants of future interest rate movements.

RBI Decision

At its 4th August Monetary Policy meeting, the RBI:

- Maintained the Repo Rate steady at 7.25%;
- Kept the Cash Reserve Ratio (proportion of funds to be kept at the RBI) of scheduled banks stable at 4% of net demand and time liabilities (NDTL);
- Continued providing liquidity using both overnight (0.25% of NDTL) and 14-day term repos (0.75% of NDTL).

Policy Rates



Source: DX/RBI

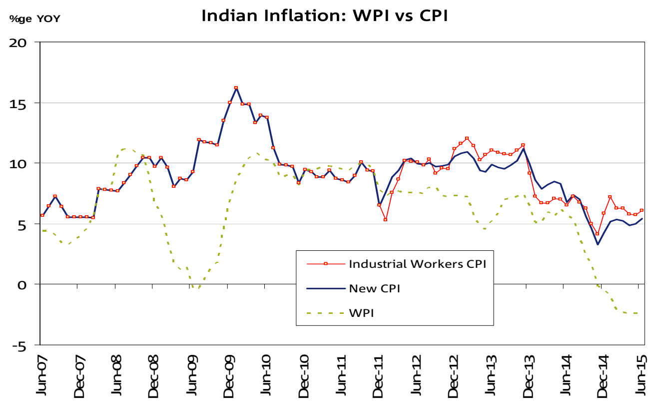
This decision was expected, both by the market and the NAB Economics team. As in the June meeting, the RBI indicated it would await the flow of data, and make its decisions accordingly. However, this time around, Governor Rajan struck a distinctly dovish tone: "*As we await greater transmission of our front loaded past actions, we will monitor developments for emerging room for more accommodation*".

Another significant development highlighted by Governor Rajan during the meetings was that the RBI and the Government were broadly in agreement over the composition of the monetary policy committee going forward.

Prices and Activity

Inflationary pressures accelerated a touch in June, with the headline CPI rising to 5.4% on a yoy basis, the strongest outcome since March. There have been food price pressures, particularly in pulses (7.2%), milk products (9.6%), spices (7.9%) and fruits (14.9%). Thus far, the monsoon deficit has amounted to 7%. That said, the total area sown for the *kharif* (summer) crop was 5% higher than a year: 84.74 million hectares. There was an increase in plantings in rice and oilseeds. There are some concerns about the August- September period, with the Indian Meteorological Department (IMD) forecasting rains in the August-September period at 84% of long term average. *August is a critical month for sowing, so the progress of the monsoon needs to be watched carefully for its impact on food prices*.

Headline Inflation indicators



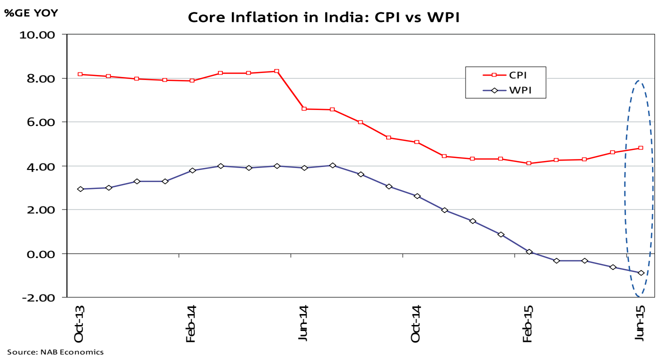
Source:CEIC

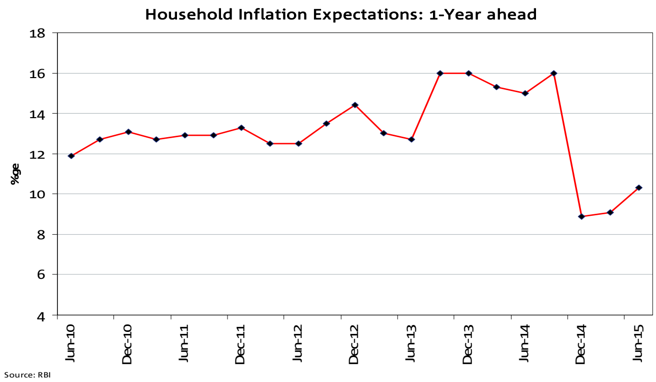
In contrast to the headline CPI, the headline WPI (Wholesale Price Index) contracted by -2.4% over the year to June. This fall largely reflects the weak prices for non-tradeables, which are largely determined by global factors, reflecting weak energy prices. The RBI emphasised that they do consider movements in the WPI, however, it presents an incomplete picture of prices actually faced by consumers, hence the focus on the CPI measure.

Another concerning factor is the increase in the Core (ex food and fuel) measure of inflation. It has been rising steadily since February, and increased (in yoy terms) by

4.8% in June. In the core consumer category, there have been increasing price pressures witnessed in household goods, personal care and health sub-sectors. The Indian authorities raised the service tax rate from under 12½% to 14% in June, in preparation for the introduction of the GST in 2016. *The RBI will be carefully observing trends in core inflation, as to whether the recent increase is of a transient nature or not*. This is pertinent, given the role in framing inflationary expectations, which have quickened in June.

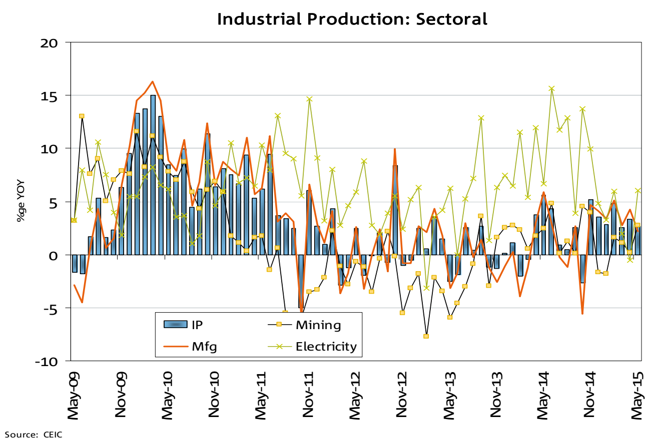
Core Inflation & Inflationary Expectations

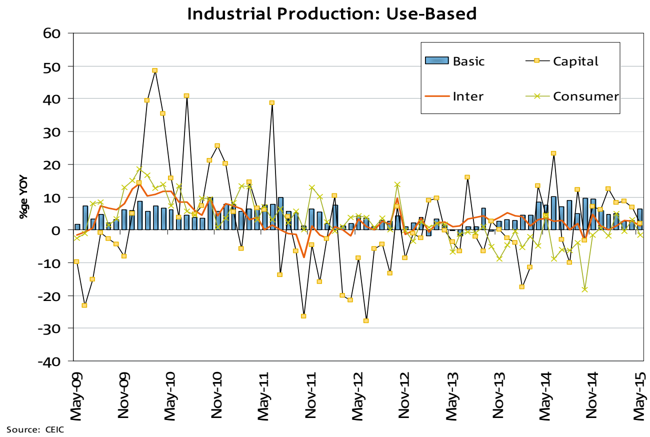




Activity indicators remain muted in India. The Index of industrial production expanded by a restrained 2.7% over the year to May, the slowest since October last year. Manufacturing (2.2%) was the weakest, and electricity (6%) the strongest. On the latter, a number of electricity distribution companies remain financially constrained, and this was highlighted by the RBI.

Industrial Production: Sources & Uses

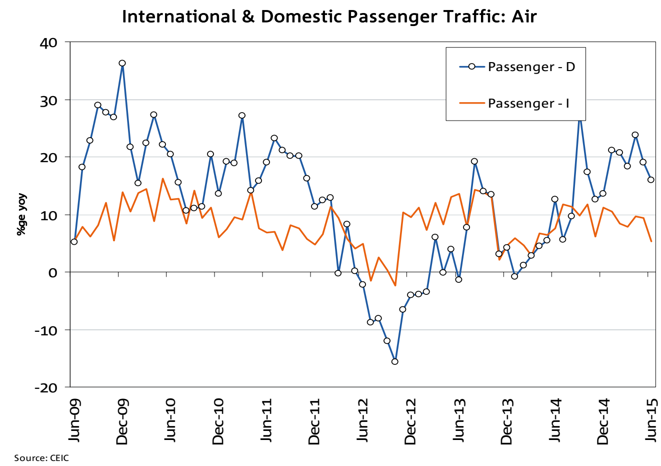




By use, consumer goods contracted (-1.2%), and capital goods production (an indicator of investment activity) recorded only a marginal improvement (1.2%). The latter was impacted by weak capacity utilisation, which at 75.2%, was below year ago levels, 76.1%.

However, not all indicators point to weakness in the Indian economy. The *Manufacturing PMI* rose to 52.7 points in July, up from 51.3 in June. The July reading is the highest since January. More importantly, there was an increase in both domestic and export orders. Besides, indicators such as car sales (primarily among urban consumers) and air traffic movements recorded strong growth. Further, the consumer packaged goods sector is estimated to have grown by 11% over the year to June quarter, according to Nielsen. Urban consumer spending is shown to have increased in both food (e.g. chocolates) and non-food (conditioners and deodorants) categories.

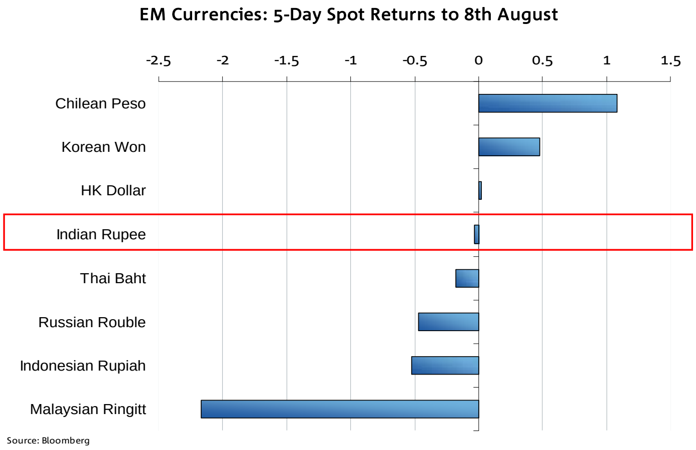
Air passenger movements



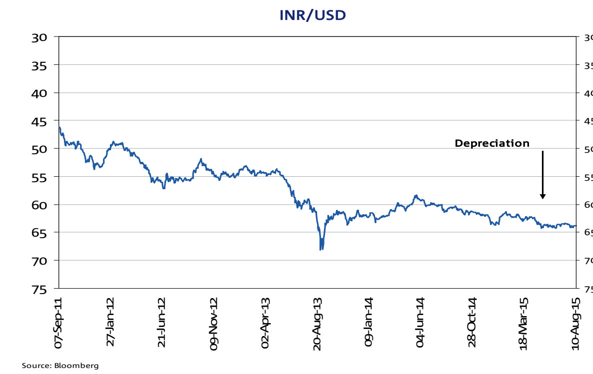
External and Financial

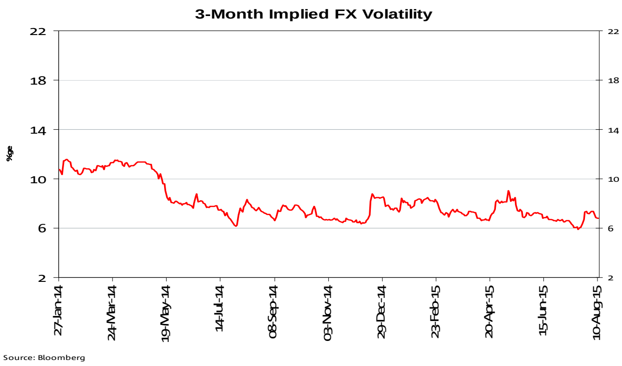
The Indian rupee has been broadly range bound around the INR63-64/USD mark. The broad stability is also confirmed by volatility indicators such as the 3-month implied volatility used to price foreign exchange options. The Indian currency has – so far – not been adversely impacted as some other emerging market currencies such as the Malaysian Ringitt, Indonesian Rupiah. The latter currencies have been negatively impacted by weaker oil and commodity prices – broadly favourable to India - amid concerns about slowing commodity demand from China.

EM Currencies: Relative Performance



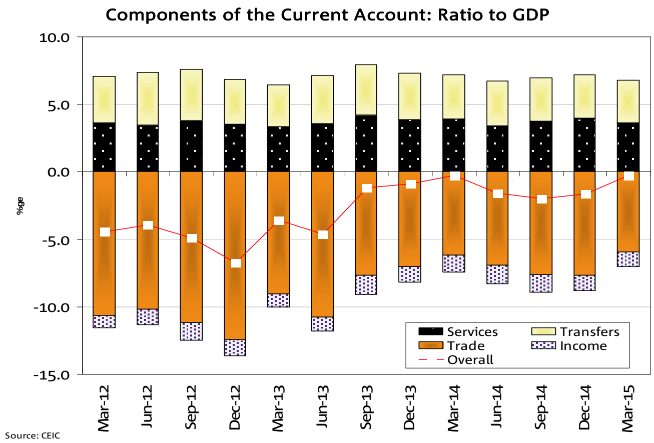
FX Rate and Volatility





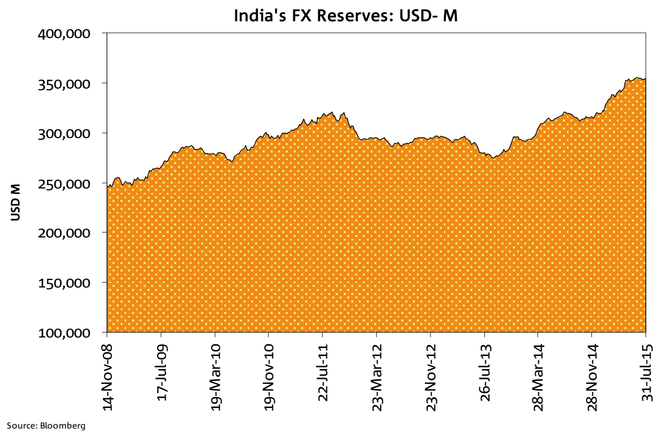
India's current account deficit for the March quarter was a very low -0.2% of GDP. More recent trade data, however, points to a challenging picture for exports: they have contracted throughout. The weak export outcome has been mitigated by constricted import demand, limiting the impact on the trade deficit. As India' economy gains traction, there could be a moderate deterioration in the Current account deficit, with global demand remaining subdued.

Current account balance



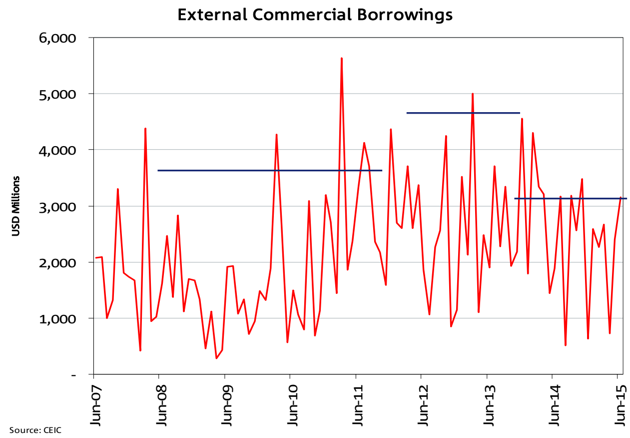
One visible area of improvement is in India' stock of foreign exchange reserves. As at the end of July, India's stock of foreign exchange reserves stood at USD 353.5bn. The high level of reserves, combined with improvements in the Current account, an inflation-targetting Central Bank, and a reform minded administration should assist India to broadly insulate itself from any fallout stemming from an expected rate hike from the US Federal Reserve. NAB Economics is expecting a Fed rate hike in September 2015, although it is not discounting the possibility of the rate hike being postponed towards the end of the year.

FX Reserves



The one potential area of concern in the external space relates to Indian corporates with unhedged foreign exchange exposure. According to the RBI, the hedging ratio for Indian corporates with FX exposure is close to 41%, with an average maturity of 7.5 years. The most recent RBI *Financial Stability Review* indicated that this segment could be vulnerable if there were to be ructions in the foreign exchange market. The pace of foreign borrowings has eased somewhat compared to conditions prevailing in 2011 and 2013.

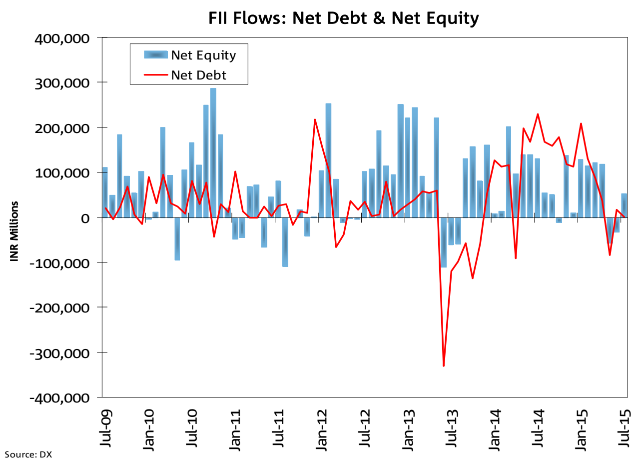
External Commercial Borrowings



Following a period of wilting demand for Indian securities in May and June, demand for equities improved somewhat in July. However, demand for Indian debt instruments by foreign portfolio investors have not recovered as much. The more recent data for August reveals a somewhat positive picture, particularly for equities: Net equity inflows totalled USD278.3 million; Net debt inflows were USD76.3 million.

In the press conference following the release of the Monetary policy Statement, the RBI Governor Rajan indicated the RBI was developing a Medium-term framework – along with the Government - for FPI (Foreign Portfolio Investment) participation in debt securities. This was likely to encompass different classes of foreign investors, including Pension funds, and Sovereign wealth funds who could be enlisted in market development, as they availed of the relatively higher rates on offer in India. *The Governor also cautioned that this framework would only be released to the market once there is greater clarity surrounding the impact of the anticipated hike by the US Federal Reserve, as well as liquidity prevailing in the Indian market.*

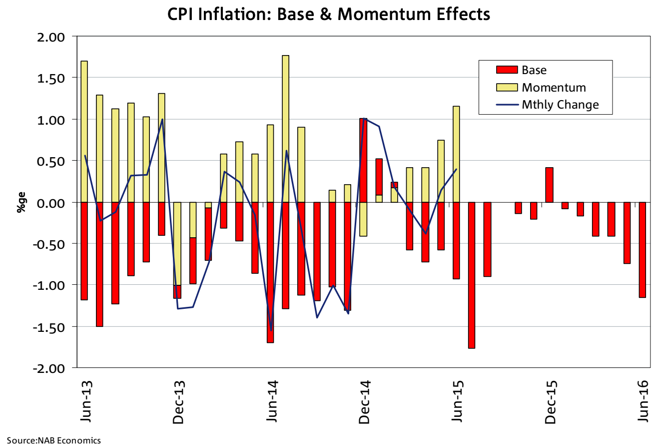
Foreign Institutional Investor inflows



Outlook

NAB Economics is forecasting the RBI to remain on hold at 7.25% with an easing bias. The near term inflation outlook is for a moderation in inflationary pressures during July and August, due to favourable 'base effects' (see below). However, these favourable outcomes are likely to dissipate towards the end of the year. The trajectory of core inflation will also be examined for signs of inflation persistence.

CPI Inflation: Base & Momentum Effects



The RBI has lowered its January-March inflation projections by 0.2% due to a weaker profile for crude oil prices. This opens the door for a rate cut if conditions remain favourable. The 2 most important factors affecting future monetary policy decisions include: the progress of the monsoon, and the attendant impact on food prices; and the impacts stemming from the anticipated rise in the Fed Funds rate. Other important elements for consideration relate to supply-side improvements in the Indian economy and progress on the reform agenda.

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Economics, Australia
+(61 3) 8697 9534

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

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

Phin Ziebell
Economist – Australia
+61 (0) 4 55051024

Amy Li
Economist – Australia
+(61 3) 8634 1563

Industry Analysis

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

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

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

Karla Bulauan
Economist – Industry Analysis
+(61 3) 86414028

International Economics

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

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

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

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

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

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

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

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 Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

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

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350