INDIA MONETARY POLICY AUGUST 2016

NAB Group Economics

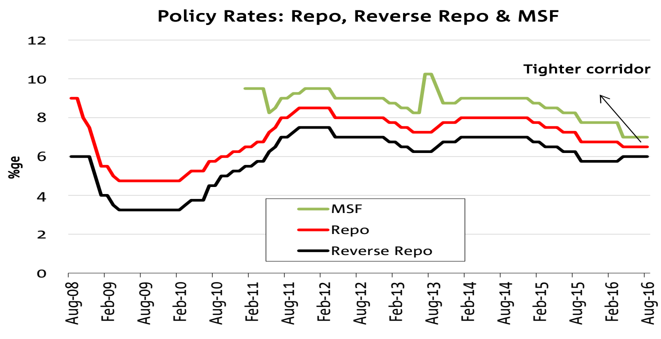
National Australia Bank

The RBI held the policy (Repo) rate at 6.5%, as expected. NAB Economics is forecasting a 25bp cut in rates to 6.25% in the December quarter, on expectation of softer food prices. However, there are still upside risks to the inflation outlook. The passage of the GST Bill is a landmark decision, which should improve India's medium-term growth potential.

Monetary policy decision

The 9th August meeting was the last presided by the current Governor, Dr. Rajan. At the meeting, the RBI maintained the status quo. The policy (Repo) rate was held at 6.50%, and the Reverse Repo and Marginal Standing facility rates were maintained at 6% and 7%, respectively. Further, the RBI committed to provide liquidity as required, which should assist in improved monetary transmission. Indian banks have thus far passed around 90bps of the 150bps cuts by the RBI.

Policy rates

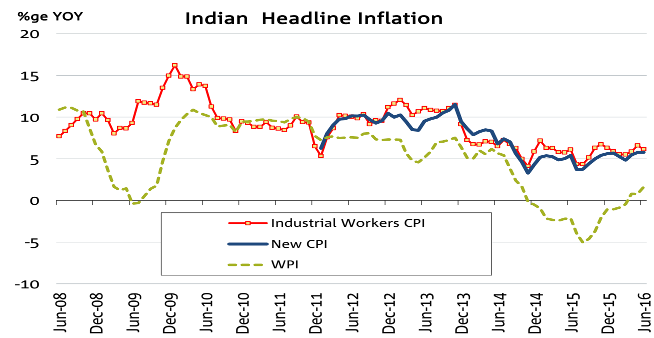


Source: DX/RBI

The decision was anticipated by both NAB Economics and the markets. This can be attributed, in part, to the recent acceleration in consumer prices, which rose by 6.1% in July, a recent high. This was driven largely by rising food prices, particularly for pulses and vegetables. This has fed into higher household inflation expectations for the year ahead, which rose to 9.6% in June 2016, up from 9.4% in March.

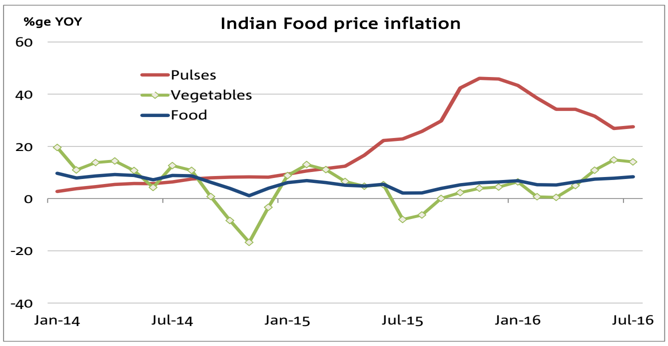
There is some optimism about the future path of food prices. After a delayed start, the cumulative rainfall till early August was 3% higher than the long-run average. Further, the total area sowed for the kharif (summer) crop was 5.2% higher than last year, with pulses showing the most notable increase. In fact, the RBI indicated an increase in the sowing area for most crops save for cotton, jute and mesta.

Headline inflation measures

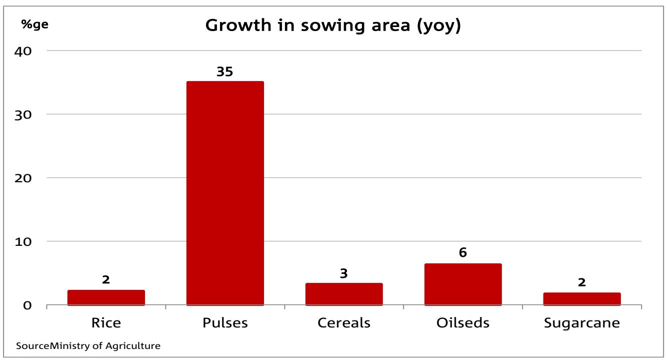


Source:CEIC

Food price inflation



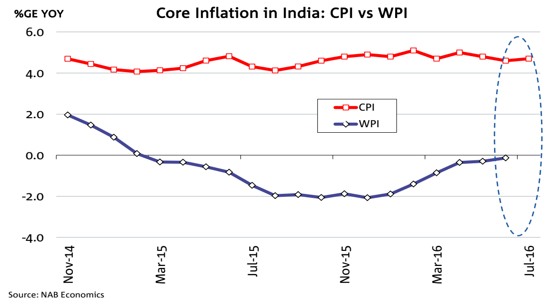
Crop Sowing



SourceMinistry of Agriculture

Core inflation (ex food and fuel) remains sticky, and has accelerated to 4.7% over the year to July. The increase in personal care and household goods prices offset modest contractions in education and healthcare. The RBI will look for lower core inflation readings, as it is an important gauge of second-round price pressures.

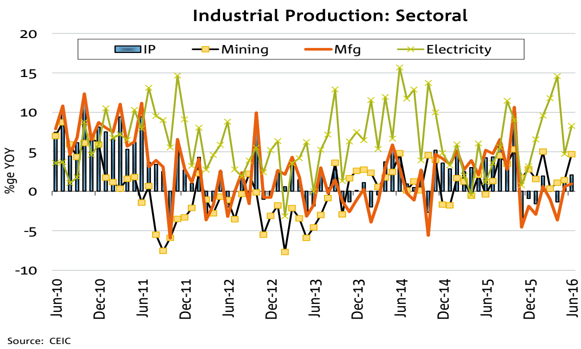
Core inflation



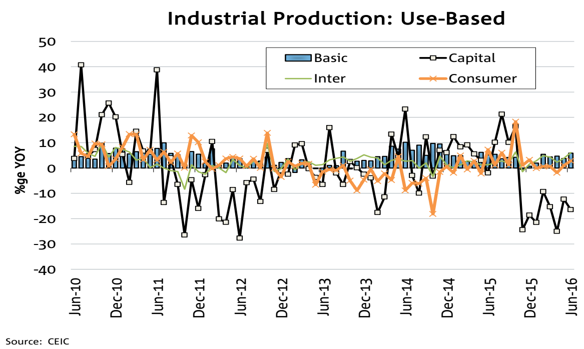
Economic conditions

India's economic indicators remain steady. Industrial production rose by 2.1% in June, building on the 1.2% growth in May. This was driven largely by acceleration in mining and electricity: 4.7%, 8.3% respectively. Manufacturing (1%) too recorded a positive outcome. By use, capital goods (-16.4%) continues to remain the main drag on growth, with basic, intermediate and consumer growth all growing solidly. In the consumer space, consumer durables have been particularly strong, rising between 5-12% during 2016. The weakness in the capital goods sector is a concern though.

Industrial production -sector

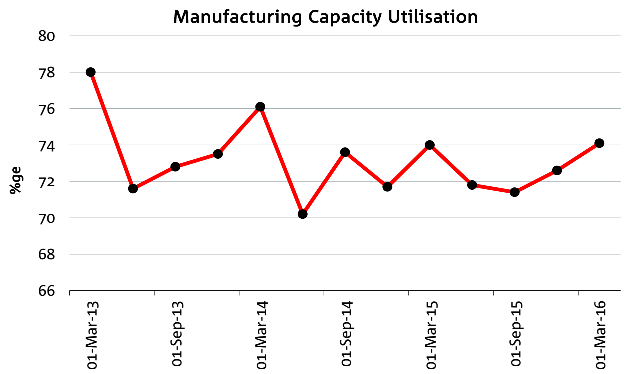


Industrial production -Use



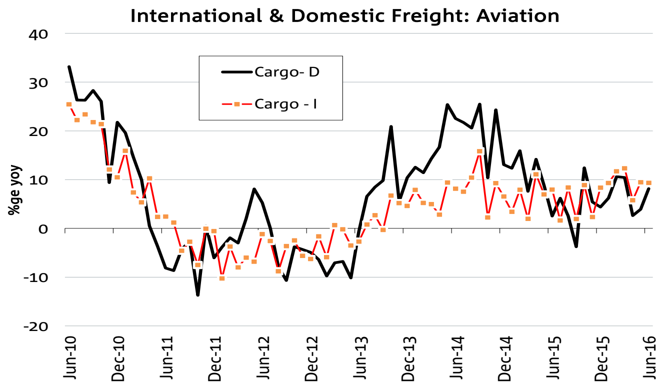
Recent indicators suggest an improvement in near-term manufacturing conditions. The July **Manufacturing PMI** rose to a recent high of 51.8. There was also an improvement in the outlook for New Orders in the RBI's latest **Industrial Outlook** survey. However, the closely watched Manufacturing **Capacity Utilisation** index is still around year-ago levels, and yet to show a meaningful improvement.

Capacity Utilisation



There have, however, been improvements in many service activity measures, including international tourism arrivals and earnings, automobile sales, domestic and international air freight, international air passenger growth and rail freight movements. The services PMI rose to 51.9 in July, lending further credence to encouraging conditions in this sector.

Air Freight



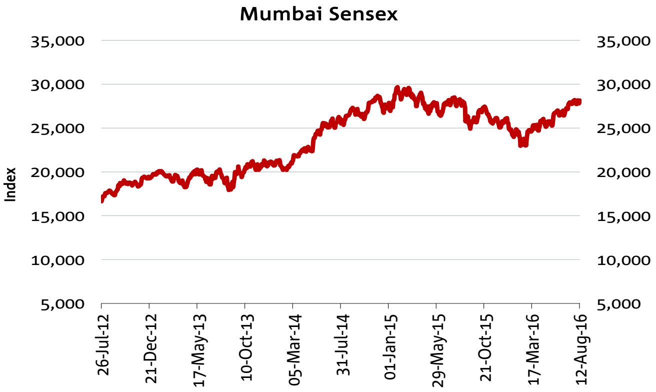
Finally, the government has passed the recommendations of the 7th **Pay Commission**. As part of these recommendations, 4.7 million government employees and 5.3 million pensioners will receive an increase in base pay and pensions, commencing from the end of August. This will likely boost consumption demand in time for the festive season, but could stoke inflationary pressures.

External and Financials

Indian equities have advanced close to 10% over the past 3 months, driven, in part, due to strong demand from Foreign portfolio investors (FPI's). Over the 3 months to July, FPI's have consistently been net buyers of Indian equities. More recent data indicates that FPIs have purchased USD 810million worth of

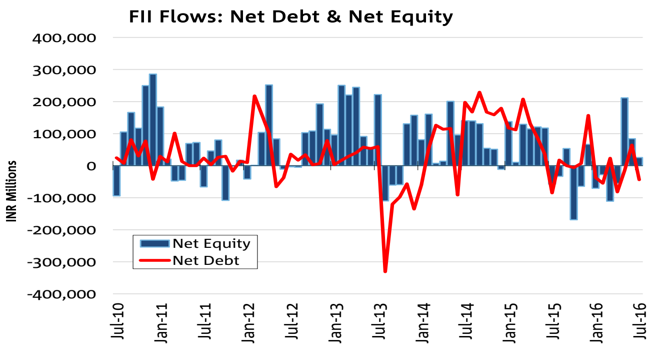
Indian equities till the 12th of August – partly buoyed by the passage of the GST bill.

Indian equities



Source: Bloomberg

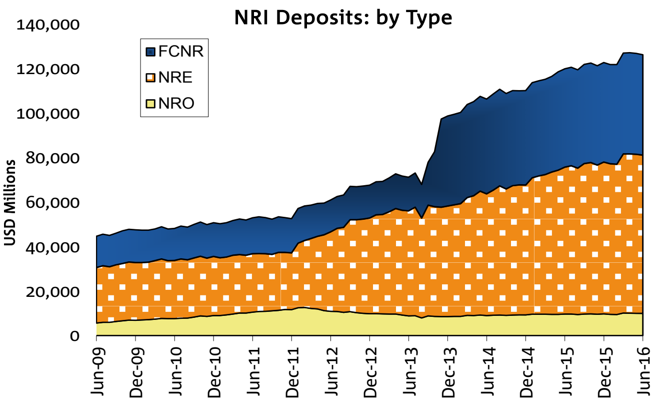
Foreign portfolio investors



Source: DX

Another important development is the maturing of USD20bn of FCNR (Foreign currency non-resident) deposits, commencing in September. To recall, in 2013 India experienced a sharp decline in the rupee due to concerns about its twin deficit. To increase the stock of foreign reserves, the RBI encouraged banks to offer non-resident Indians FCNR deposits, by providing them with foreign currency at attractive swap rates.

NRI deposits

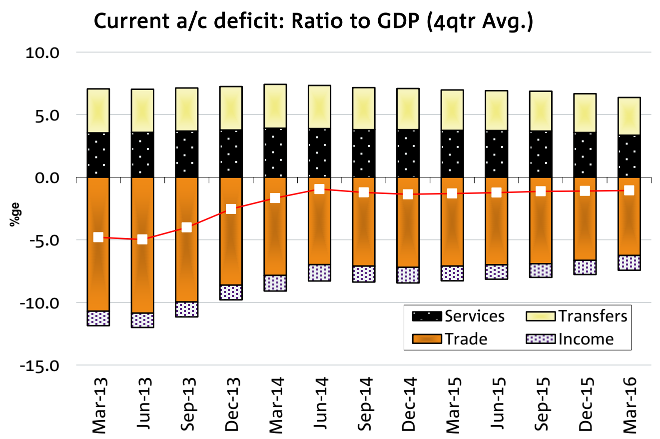


Source: DX

With both the deposits and the swaps maturing, there have been some concerns about the impact of on Indian FX markets. To address this issue, the RBI has covered over 80% of the value of the swaps by purchasing FX forwards. Additionally, to prevent a shortage of liquidity in domestic financial markets, the RBI infused INR 100bn into the financial systems by undertaking open market operations, which have helped pushed benchmark 10-year bond yields to a low of 7.38%.

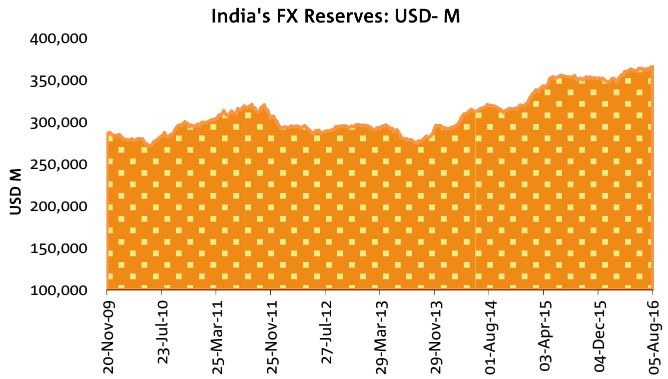
Besides, India's external situation is much stronger now than in 2013. The current account deficit is now only slightly above 1%, as opposed to around 5% in the first half of 2013. Moreover, recently released data on gold imports for the 4 months of July reveal that they totalled USD4.97bn, a 52.5% fall on the previous corresponding period, further reinforcing India's healthy external metrics. Finally, India's foreign exchange reserves have increased to a recent high of USD366bn. The improvements in India's external metrics have occurred under the watch of Dr. Rajan.

Current account



Source: CEIC

FX Reserves



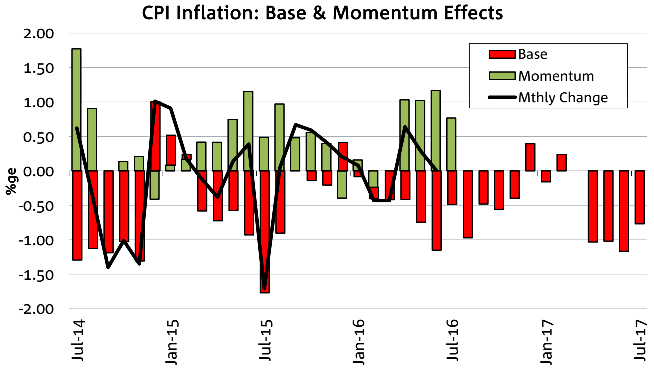
Source: Bloomberg

Outlook

At the monetary policy meeting, the RBI indicated an accommodative monetary policy stance. The recent signs on monsoon rains and summer crop sowing suggest some downward pressure on agriculture prices. Further, base effects are likely to exert downward pressure over the next few months. **NAB**

Economics is forecasting the RBI to cut the policy rate once more to 6.25% in the December quarter.

Inflation projections



Source:NAB Economics

Risks to the 5% inflation target by March 2017 are tilted towards the upside. Uncertainty in fuel prices and the possible effects on prices stemming from the 7th Pay Commission Awards are some of the risk factors. Besides, the RBI will be keenly watching service price inflation (education, health, etc.) and, by extension, the trajectory of core inflation. If the future path of prices look like breaching the 5% target by March, 2017 the RBI might stay its hand.

India operates an **inflation targeting regime**, with the Headline CPI as the target variable. The aim is to achieve a Headline CPI target band of 4% +/-2%. In the event that the inflation reaches breaches 6% (on the upside) or 2%(on the downside) for 3 consecutive quarters, the RBI will need to explain to the Government the reason for the breach, as well as remedial measures that need to be undertaken to resolve the situation.

On the economic front, it is worth mentioning the recent passage of the **GST** (Goods and Service Tax) **Bill**. At this stage, the rate has not yet been decided, and it is unlikely to commence before April 2017, at the earliest. However, it is a landmark decision, and likely to improve India's business environment, and medium-term growth potential. Sectors such as automobiles, logistics and cement are likely to benefit from the implementation of the GST.

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