INDIA MONETARY POLICY OCTOBER 2016

NAB Group Economics

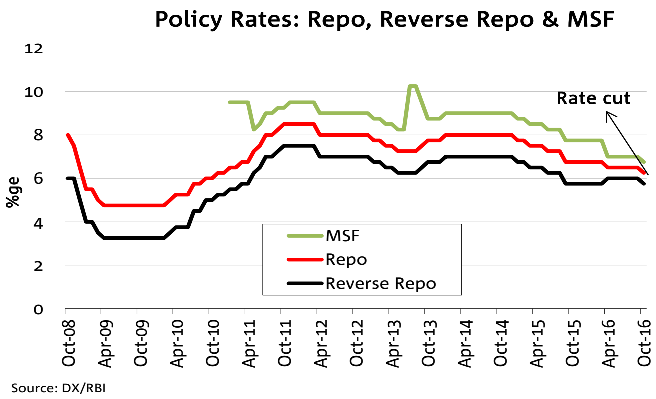
National Australia Bank

The RBI cut the policy rate by 25bp to 6.25% at the October meeting. This decision was chaired by the 6-member Monetary Policy Committee under the newly-appointed Governor, Urjit Patel. While committed to the medium term inflation target of 4%+/-2%, there was a specific mention of supporting growth. NAB Economics is forecasting one more rate cut to 6% by the end of March 2017. The main risk to the forecast stems from higher than expected food price inflation.

Monetary policy decision

At the 4th October meeting, the RBI cut the policy repo rate by 25bp to 6.25%. This was a landmark meeting for a number of reasons. It was the first meeting under the helm of Dr. Urjit Patel, who succeeded Dr. Raghuram Rajan. The decision was made by a 6-member Monetary policy committee, as opposed to one solely made by the Governor. The six-member committee consists of 3 members from the RBI (including Governor Patel), and 3 respected academics. A final point worth mentioning was the medium term commitment to the 4%+/-2% inflation target was adhered to. However, there was no explicit reference to attaining a 4% inflation target by March 2018 – as in prior statements. This, coupled with a focus on growth, suggests a somewhat more dovish stance.

Policy rates

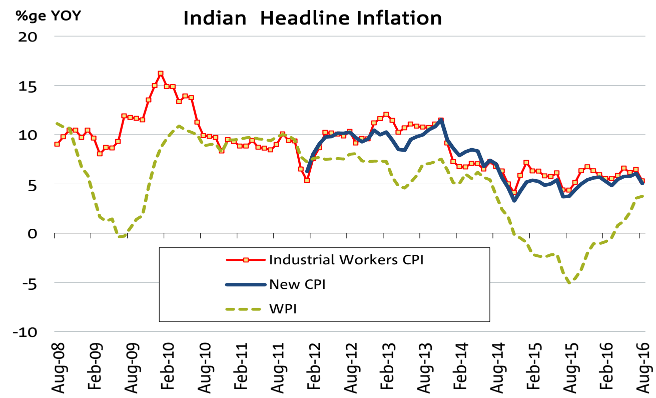


Source: DX/RBI

An easing in inflationary pressures in August, combined with soft industrial activity indicators, helped facilitate the rate cut.

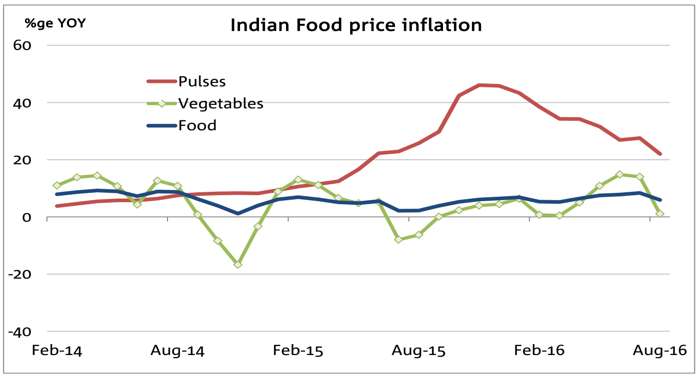
Consumer price inflation fell – in yoy terms - from 6.1% in July to 5.1% in August. Lower food prices were a critical factor in bringing down the overall level of consumer prices. Year ended growth in food prices eased from 8.35% in July to 5.9% in August, with notable declines in the pace of price increases for pulses and vegetables.

Headline inflation measures



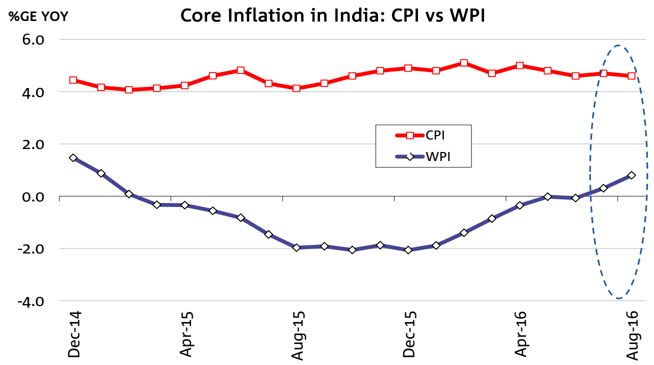
Source:CEIC

Food price inflation



Further, the RBI indicated that sowing for the kharif (summer) crop exceeded last year, except for cotton, sugarcane, jute and mesta. As a result, the Ministry of Agriculture's advance estimates (135.03 million tonnes) for the summer crop have exceeded the targets (132.75 million tonnes) set for the year: This increased level of food production should ease overall prices, given that food accounts for slightly under 50% of the CPI basket. Core (ex food and fuel) inflation remains sticky around 4.6%, largely impacted by higher prices in health, education and personal care products.

Core inflation

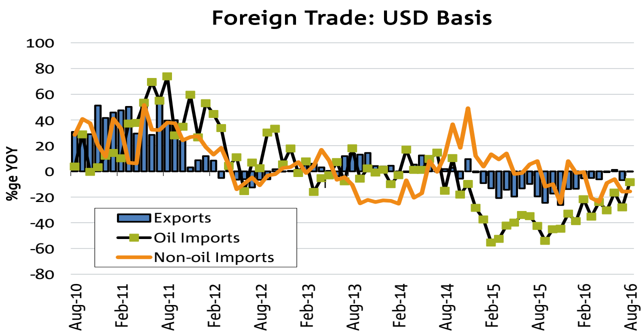


Source: NAB Economics

Economic conditions

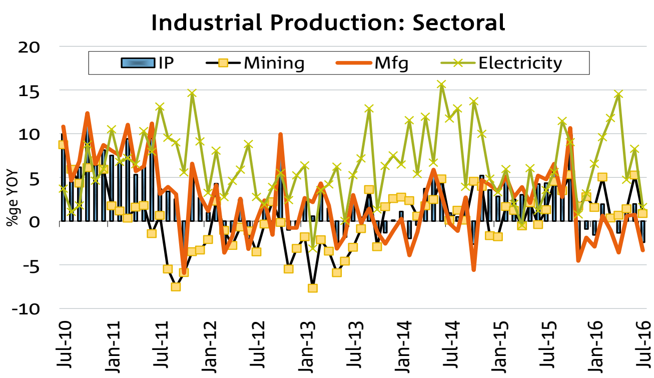
The RBI mentioned the anaemic pace of global trade in its Monetary policy statement. India has also been affected by the general malaise in global trade. Exports have generally been weak since the beginning of 2015. In July, they contracted by -0.3% in yoy terms. Imports fell more sharply (-14.1%), which helped keep the trade deficit in check.

Merchandise trade



Source: CEIC

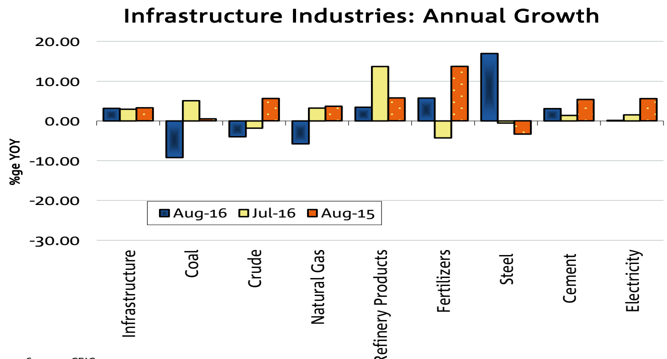
Industrial production -Sector



Source: CEIC

Industrial activity remains weak, with the index of industrial production contracting by -2.4% in July, driven by a -3.4% decline in manufacturing. More recent data on the infrastructure sector in August revealed growth in the steel, cement and fertilizer sectors. Against that, coal, crude oil and natural gas declined.

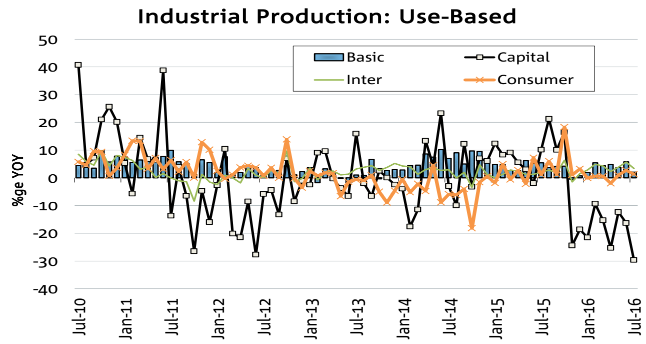
Core Industries



Source: CEIC

Finally, an upturn in investment activity is critical for India to achieve faster rates of growth. Investment activity remains muted, and this is clearly evident in the poor outcomes for the capital goods segment of industrial production.

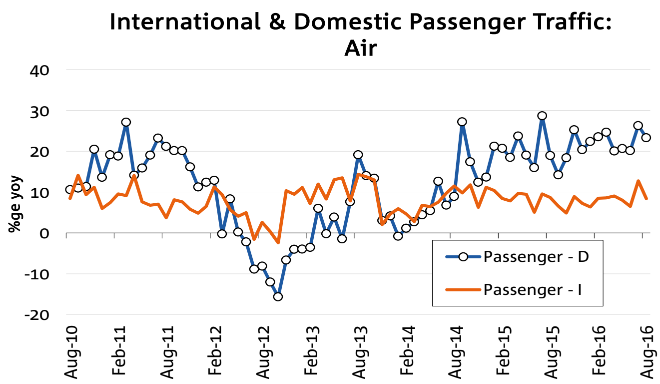
Industrial production – by use



Source: CEIC

Despite weakness in the industrial sector, other activity indicators remain encouraging. Motor vehicle sales surged by 15.8% yoy in September, building on the strong momentum in August. Further, air passenger traffic- particularly for domestic aviation – has been growing strongly.

Air passenger traffic

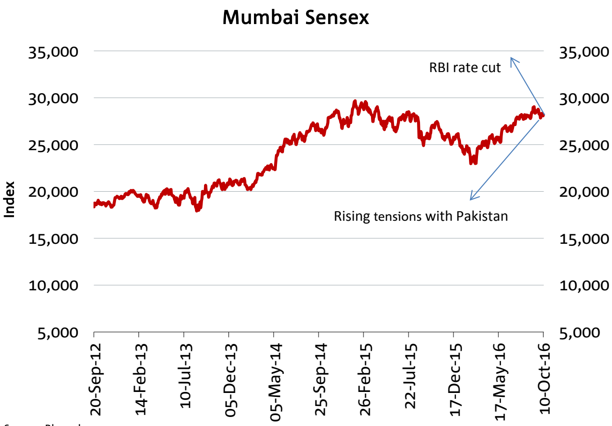


Source: CEIC

External and Financials

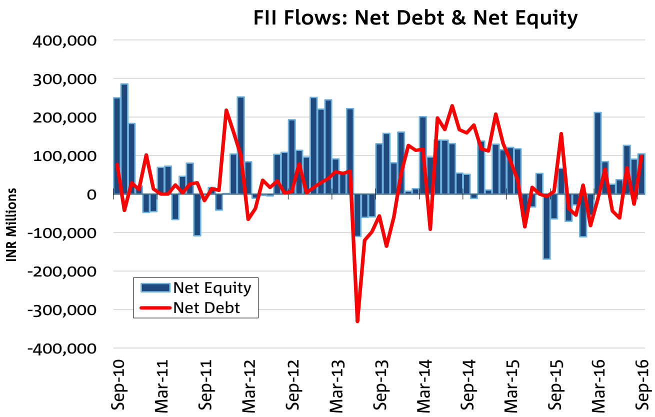
Indian equities have steadily increased over the past 3 months, but have ebbed and flowed with geopolitical and economic developments. Heightened tensions with Pakistan in late September led to a decline in the Mumbai Sensex, but it recovered following the rate cut announcement. Interestingly, public sector banks too gained from the rate cut, indicating the expected beneficial impact of the rate cut on their stressed asset portfolio. Foreign portfolio investors remained net buyers of Indian debt and equity in September. During the first week of October, foreign investors purchased USD217.1 million in equities, continuing the positive trends in September.

Indian equities



Source: Bloomberg

Foreign portfolio investors

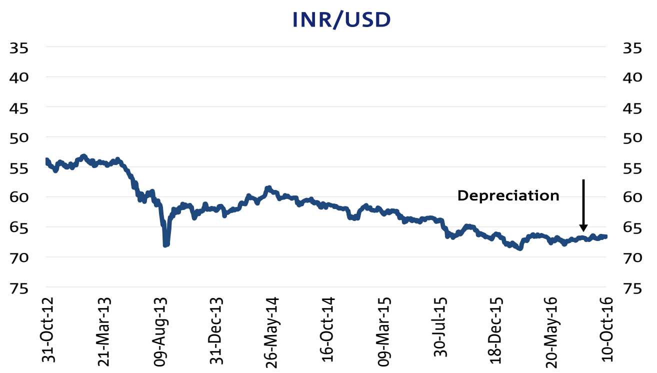


Source: DX

The Indian rupee has remained broadly range-bound around 66.50 INR/USD. More recently, the rupee rose slightly against the USD following sustained inflows from overseas equity investors, a somewhat weaker than expected US labour market release, and selling of the greenback by banks and exporters.

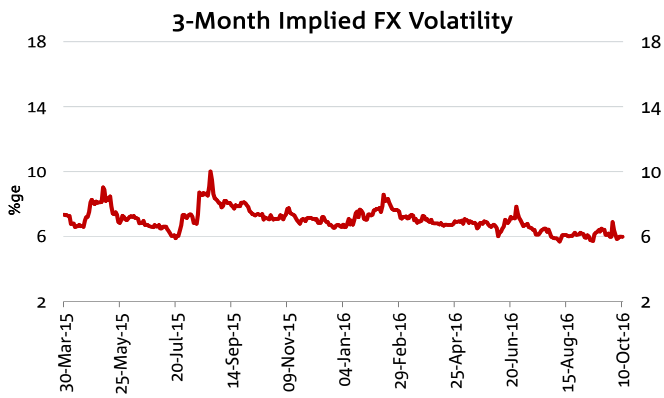
As with the exchange rate, FX volatility remained steady. It did spike up slightly towards the end of September, when tensions with Pakistan rose appreciably in the Kashmir region.

Indian Rupee



Source: Bloomberg

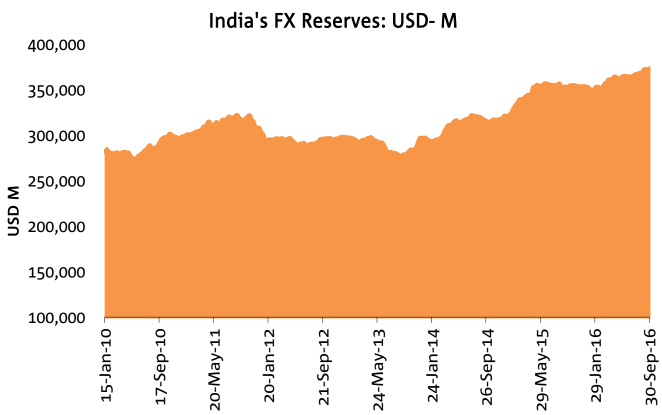
FX Volatility



Source: Bloomberg

India's foreign exchange reserves have continued to increase. The most recent data indicate that reserves have risen to a recent high of USD372bn. This should help it tide over external challenges, including the reversal of the FCNR (Foreign Currency Non Resident) swaps over the next 2-3 months.

FX Reserves



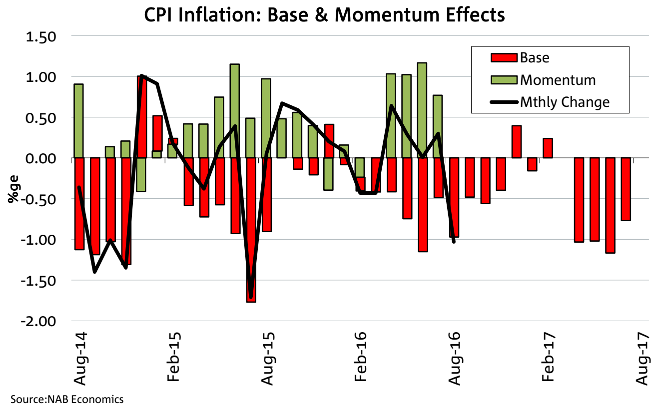
Source: Bloomberg

Outlook

At the monetary policy meeting, the RBI indicated a continuation of its accommodative monetary policy stance. A major development is the lower target for the neutral real rate: it has been brought down to 1.25% from 1.5-2% previously Further, the 1-year Treasury bill rate is the reference rate for the purpose of calculating the real interest rate. Moreover, the policy (Repo) rate is typically 25-50bps below the T Bill rate, opening up space for one more cut to the policy rate. While the RBI has highlighted upside risks to its 5% inflation projection by March, 2017 due to 'cost push factors, including the 7th Pay Commission awards, it mentioned that the upside risks were lower than prior projections. Further, the RBI indicated improved sowing and Government measures to improve supply, as well as ease food inflation – particularly pulses

NAB Economics is forecasting the RBI to cut the policy rate once more to 6% by the end of March 2017.

Inflation projections



Looking ahead, the 'base effects' are largely favourable for inflation outlook, with the exception of January and February 2017. However, the *momentum* of inflation will be keenly watched for by the RBI.

A final issue is the upcoming GST legislation. Whilst this should boost growth and improve the business environment, it could generate inflationary pressures. According to the RBI, an 18% rate would likely have very modest impacts on the inflation outlook. However, at 22% this would rise to between 0.3-0.7%, with the impact most keenly felt in segments such as healthcare (excluding medicines). With uncertainties regarding the GST during the 2017-18 financial year (year to March, 2018), the RBI might prefer to front load the rate cut, and wait and see how the GST impacts on prices.

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