INDIA MONETARY POLICY FEB 2017

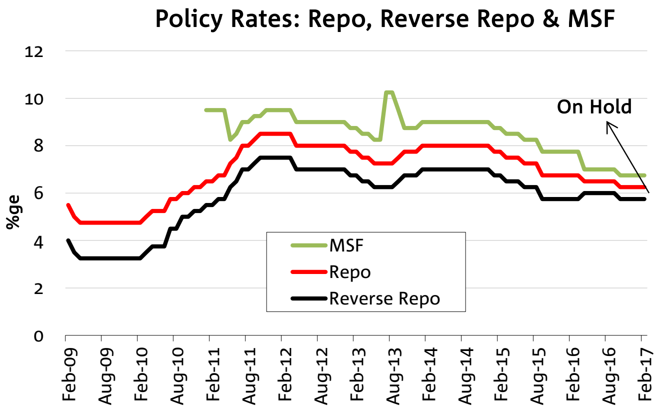
NAB Group Economics

The RBI, somewhat surprisingly, maintained the policy repo rate at 6.25%. Uncertainty about the effects of demonetisation and sticky core inflation were factors. The Central Government's Budget reflects a prudent fiscal stance, with the fiscal deficit anticipated at 3.2% for 2017-18. NAB Economics is forecasting one more rate cut to 6% (most likely August), the last of the current rate-cutting cycle. Higher crude prices, a weak monsoon projection and uncertainty in the external environment might preclude a further rate cut.

Monetary policy decision

At the 8th February meeting, the RBI held the Repo (policy) rate at 6.25%. The Reverse repo rate and the Marginal standing facility rates were also held constant at 5.75%, 6.75%, respectively.

Policy rates



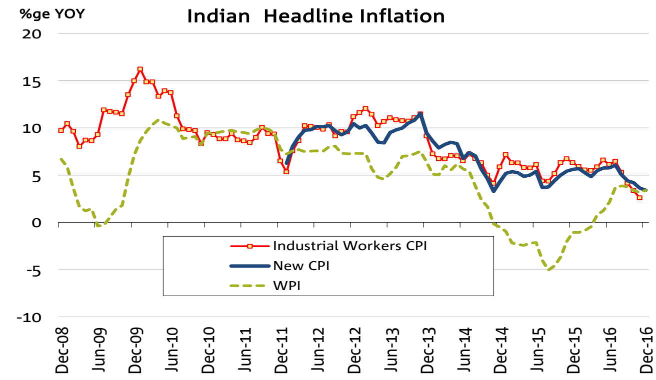
Source: DX/RBI

The decision surprised markets, as well as ourselves. With an economy facing headwinds from demonetisation, a prudent Central Budget and historical low levels of inflation, many thought it appropriate to go in for a rate cut. More surprising than the decision, however, was the change in stance from accommodative to neutral, which effectively has provided RBI with the flexibility to both lower as well as raise rates.

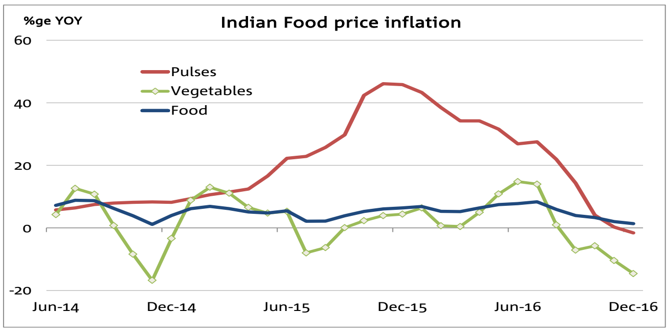
The RBI indicated it was unsure as to the overall impact of demonetisation. In this regard, it is worth noting that the RBI recently indicated that all restrictions on bank withdrawals would be lifted from the 13th of March.

Further, it identified 3 upside risks to the inflation outlook: hardening of international crude oil prices; exchange rate volatility possibly due to international developments; and the impact of the housing rent allowances stemming from the 7th Pay Commission.

Headline inflation measures



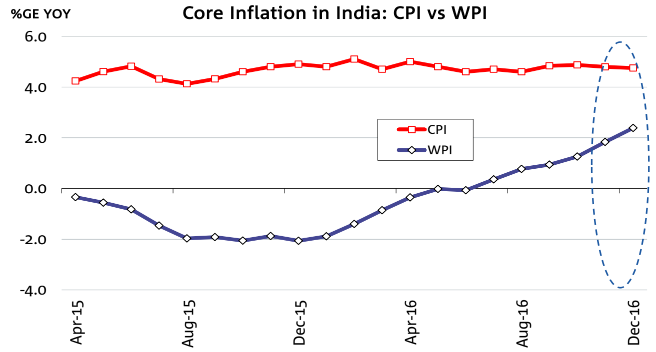
Food price inflation



Headline CPI fell to a recent low of 3.4% in December 2016, the lowest reading since November 2014. This was driven largely by lower food prices, namely pulses and vegetables. While a favourable winter crop was a factor, the demonetisation exercise, which commenced on the 8th of November, would have exerted some downward pressure due to demand weakness. The RBI feels that some of these price declines might reverse as the impact of demonetisation fades.

Another significant area of concern highlighted by the RBI was the stickiness of core inflation around 4.8%. This reflects somewhat elevated prices of services such as housing, health, education and personal care (excluding gold and silver).

Core inflation

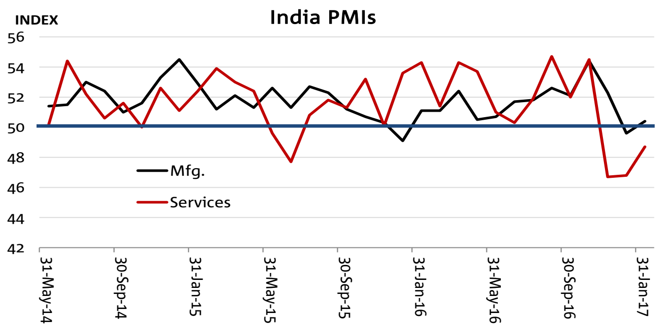


Source: NAB Economics

The RBI also indicated that the demonetisation has led to a sharp improvement in transmission of past rate cuts based on the Marginal cost of lending rates, and by extension, policy rates, due to a sharp increase in deposits. Governor Patel also suggested that there was scope for banks to further cut rates, as banks had transmitted only 85-90bps of interest rate cuts, whereas the RBI had cut rates by 175bps.

It is also worth examining the rate cuts in the context of recent economic indicators. Recent purchasing manager indices for both manufacturing and services have been weak, with the services PMI continuing to languish in negative territory (below 50).

Indian PMIs

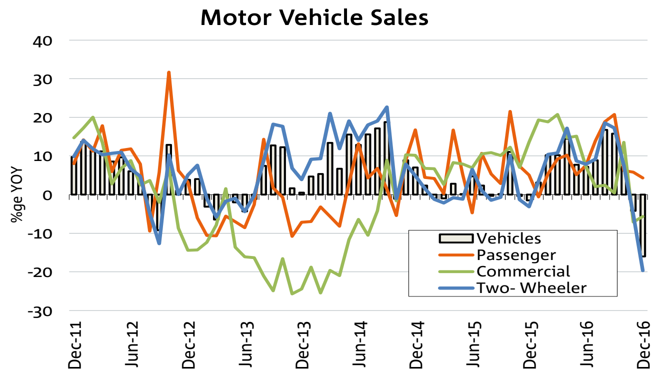


Other activity indicators also point to a demonetisation-induced slowdown in the Indian economy. Bank credit growth to the industrial sector fell by -5.5% yoy for the 2016-17 financial year, based on data available to date. Moreover, automobile sales have been contracting, and so has railway freight movements and cement production.

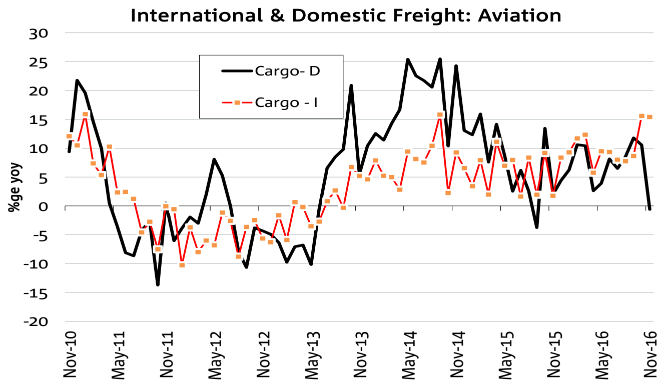
With regards to freight, domestic freight movement seems to have been badly impacted. However, international freight seems to have held up well.

According to the RBI, tractor sales, steel consumption, international tourism and mobile phone subscription numbers have held up reasonably well.

Automobile sales



Air freight

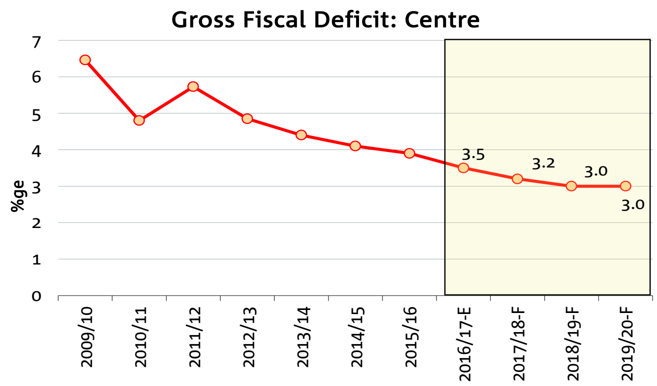


In summary, the demonetisation exercise has not brought the economy to a halt, but has generated headwinds to growth.

Budget

Finance Minister, Arun Jaitley, released the Central Government Budget on the 1st of February. It was a responsible budget, with the fiscal deficit for the 2017-18 (April to June) estimated at 3.2% (of nominal GDP), following a 3.5% outcome for the 2016-17 period. Further, the Government has committed to maintaining a 3% deficit over the subsequent 2 years.

Fiscal Deficit



Source: Union Budget

The Budget focussed on some key areas. These include: higher infrastructure spend (particularly roads, railways and affordable housing). Economists and policy analysts have emphasised the need to maintain capital spending and cut down on revenue spending so as to boost the country's growth potential in a fiscally responsible manner. It does appear the Government has done just that. For example, the revenue deficit is projected to gradually recede from 2.1% of GDP in 2016-17 to 1.4% by 2019-20. Further, the revenue estimates also look credible, with gross tax revenues slated to grow by 12.2%, considerably lower than the 17% growth in the current fiscal year. The somewhat weaker projections relate to lower estimates for excise tax collections.

Besides, there have also been initiatives to assist the agri-sector (e.g. credit facilitation, crop insurance); empowering the rural population (e.g. increased expenditure on employment guarantee scheme); tax cuts for low income earners and SMEs; and maintaining the concessional withholding tax of 5% earned by foreign entities extended to 2020; and exempting certain categories (1 & 2) of foreign portfolio investors from indirect transfer provision.

All up, this has been a prudent Budget, and has afforded the RBI the space to cut rates, should the situation so permit.

One area of concern, though, has been the limited capital infusion in public sector banks. Analysts have questioned whether the INR 100 billion of capital infusion is sufficient. Among the options canvassed to deal with the high bad debt burden include the setting up of a 'bad bank'. Viral Acharya, Deputy Governor of the RBI, indicated it was a possible option, but necessitated careful design, with regard to the appropriate price to sell the assets to asset reconstruction companies.

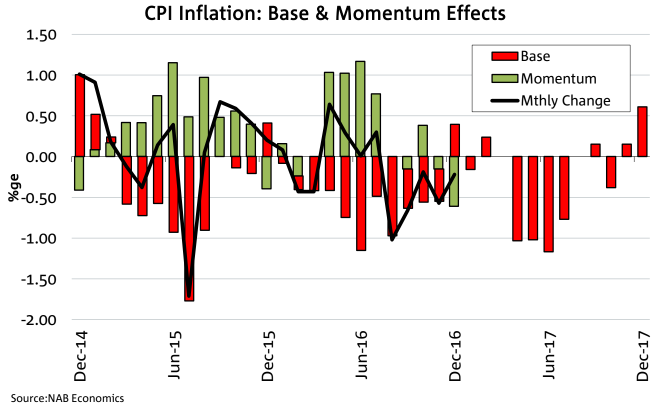
The issues of banking recapitalisation and addressing of the nonperforming assets were mentioned in the Monetary policy statement as important factors in aiding monetary policy transmission.

Outlook

At the monetary policy meeting, the RBI projected inflation to be between 4-4.5% during the April-September 2017 period, rising to between 4.5-5% in the October 2017 to March 2018 period. This follows an unwinding of the favourable base effects in the latter period. Besides the factors already discussed by the RBI, the proposed implementation of the GST in September would add upward price pressures.

The RBI is aiming for a 5% headline CPI outcome by March 2017, and a medium term outcome of 4%+/-2%, whilst supporting growth. Notwithstanding the move from an accommodative stance to a neutral stance, we believe the Indian economy would benefit from additional support in the form of a rate cut.

Inflation projections



NAB Economics is forecasting one more rate cut from 6.25% to 6% (most likely in August), which would be last of the current rate cutting cycle.

The August timetable would provide sufficient time for the RBI to examine developments in the external environment, see how the economy is faring post-demonetisation, as well as get a handle on the outlook for the current year's monsoon rains.

A poor monsoon season, a sudden upsurge in global commodity (particularly fuel) prices, and volatility in the rupee due to an uncertain global environment might preclude a further rate cut.

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