INDIA MONETARY POLICY OCTOBER 2017

NAB Group Economics

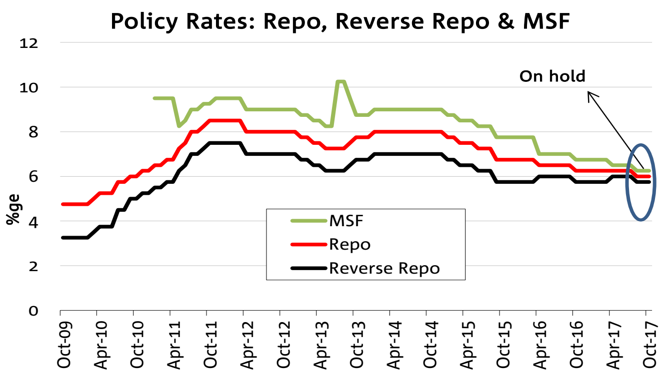
The RBI held the benchmark policy Repo rate at 6%. This was expected, in light of recent higher readings for headline and core inflation. NAB Economics is forecasting the RBI to remain on hold and maintain the Repo rate at 6%. At this juncture, supply-side measures are more likely to benefit the Indian economy than a cut in policy rates.

RBI Decision

At its 4th October Monetary policy meeting, the RBI:

- Maintained the policy (Repo) rate at 6%
- Held the Reverse repo and MSF rate at 5.75%, and 6.25% respectively

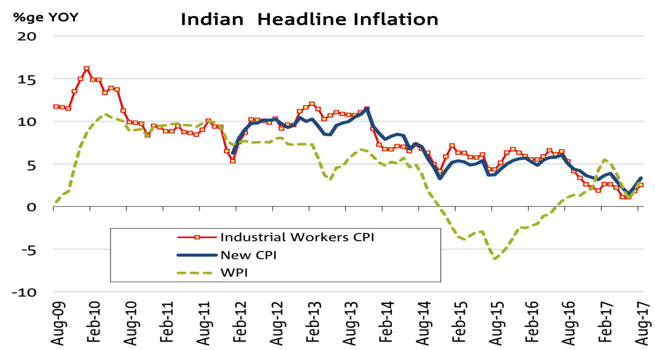
Indian policy rates



Source: DX/RBI

This decision was in line with market expectations. This comes against a backdrop of a weak June quarter 2017 growth outcome, which at 5.7%yoy was the weakest since March 2014. However, since the previous August meeting, there has been an uptick in inflationary pressures.

Headline inflation

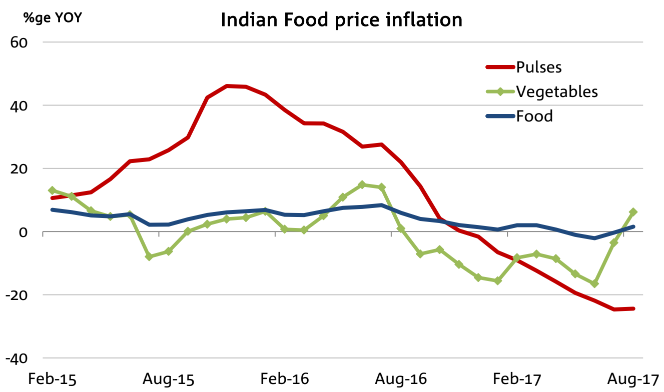


Source:CEIC

From a recent low of 1.5% yoy in June, inflation accelerated to 3.4% yoy in August, as the impact of favourable base effects faded away. Looking at food inflation – which has a share of around 45% of the CPI basket – there was a moderate increase over the past 2 months.

From a -2.1% fall in June, food price inflation rose by 1.5% in August, still low by historical standards. The prices of pulses continued to fall sharply, but the decline has stabilised somewhat. The overall rise in food prices was driven largely by accelerating prices for vegetables and fruits. The RBI also noted higher prices for prepared meals.

Food price inflation



Another concern for the RBI has been the jump in core inflation (inflation excluding food and fuel). From a recent low of 3.9% in June, core inflation escalated to 4.5% in August. This was driven largely by increasing housing costs. Rising fuel prices led to increases in transport costs, and prices rose in healthcare as well. Price pressures in education remained similar to June, although inflation decelerated in the personal care and effects category. The RBI monitors core inflationary pressures as it gives a measure of inflation persistence in the economy.

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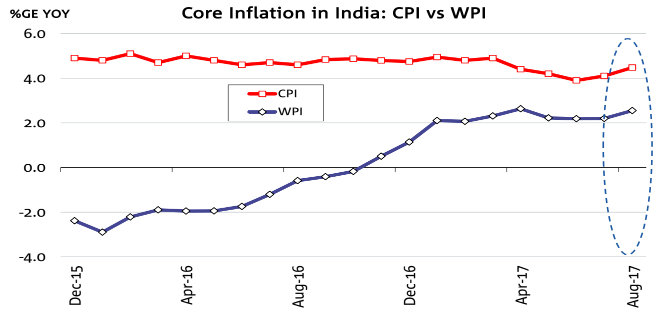
Core inflation



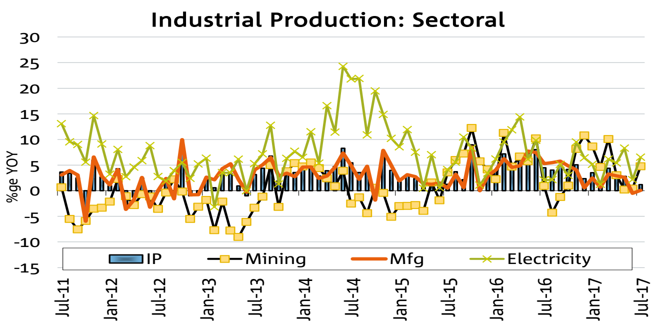
Source: NAB Economics

While mindful of inflationary pressures, the RBI was unhappy with the banking sector regarding the pace of transmission of earlier cuts in the policy rate. The RRBI indicated that the internal benchmarks used by banks to price loans have provided insufficient in facilitating effective monetary transmission. Instead, it suggested the use of external benchmarks such as the RBI's repo rate to price loans. Banks would be allowed to set their own spread. Adopting this would allow for greater transparency and make it easier for consumers to compare loan offerings from the various banks. The RBI indicated that this new pricing framework is expected to come into effect around March 2019.

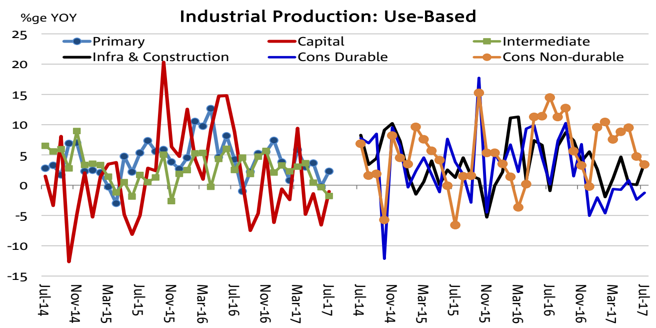
Partial Indicators

Industrial production picked up in July following on from the contraction in June. While the improvement was largely welcome, the flat outcome for manufacturing was somewhat of a concern. Elsewhere, there was more positive news on mining and electricity production.

IIP: Sectoral and Use



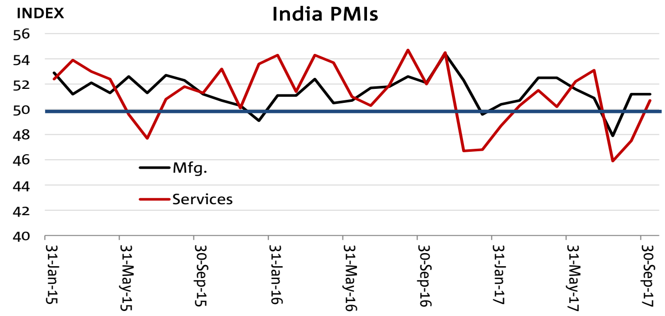
Source: CEIC



Source: CEIC

By use, spending on infrastructure and non-durable goods have held up. However, production of capital goods and non-durable consumption spending continues to contract, reflecting the current weak level of investment spending.

PMI – Gradually improving post-GST

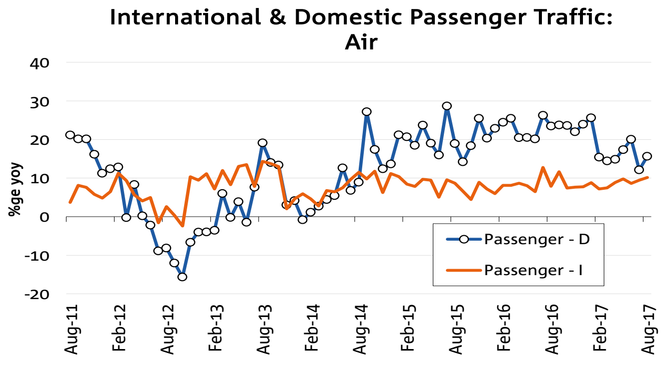


Source: Bloomberg

The launch of the GST in July led to a contraction in both manufacturing and service sector PMIs. However, the most recent (September PMIs) reveal that the post-GST slump is receding, with both manufacturing and services in positive territory. Manufacturing turned positive (a reading greater than 50) in August, while services only turned positive in September. The weak manufacturing outcome in July's industrial production data aligns with the corresponding PMI outcome.

In its policy statement, the RBI alluded to a divergence in service sector activity. Domestic air transport was weak, along with cement production and traffic movements at shipping ports.

Air passenger traffic & Motor Vehicle Sales



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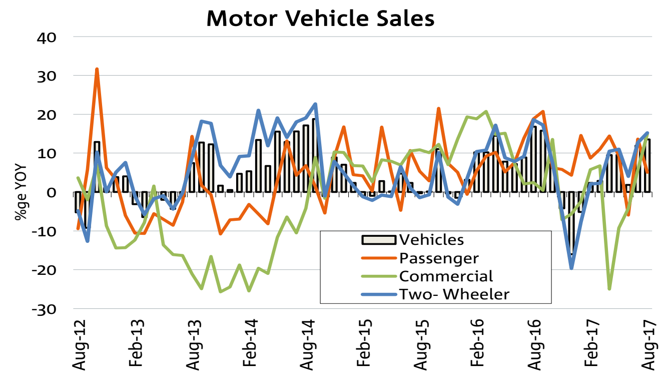
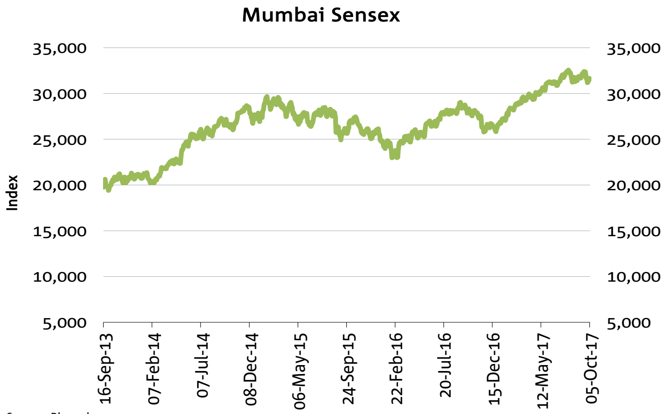


On a more positive note, international air passenger traffic held up well, along with rail freight movements. Motor vehicle sales have also been steady, and the recent improvement in commercial vehicle sales has been particularly encouraging.

External and Financial

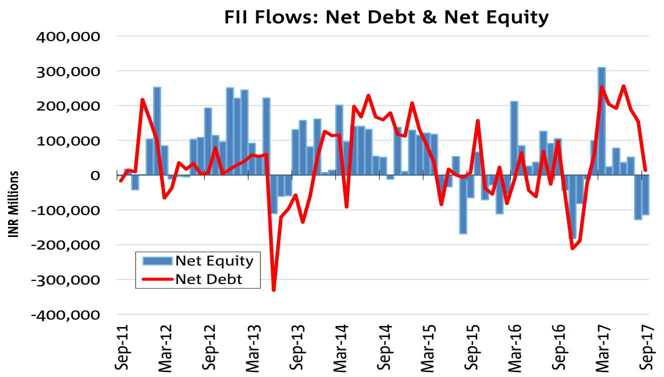
Indian equity markets have remained broadly rangebound, although the benchmark Sensex index continues to remain over the key 30,000 level, which was breached in April this year. The failure to accelerate further can be attributed, in part, due to selling of equities by Foreign Portfolio Investors. While the latter continued to show interest in Indian debt securities – attracted by the yield differential – they turned net sellers of Indian equities due to geo-political uncertainties, as well as increasing investor interest in US equities.

Indian Equities



Source: Bloomberg

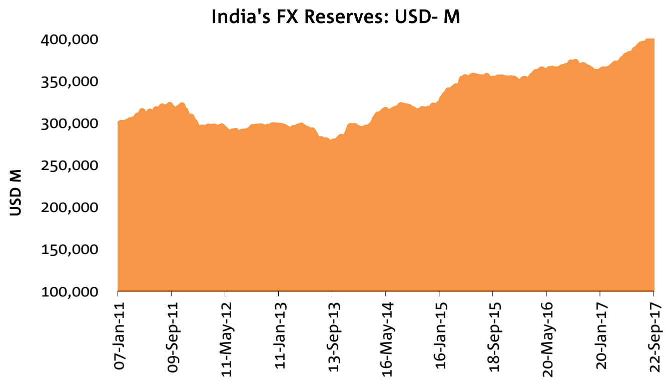
Foreign portfolio investors



Source: DX

India's FX reserves continue to swell, crossing the USD400bn level. They were USD402.3bn, according to latest estimates, more than sufficient to cover any external shock.

FX Reserves

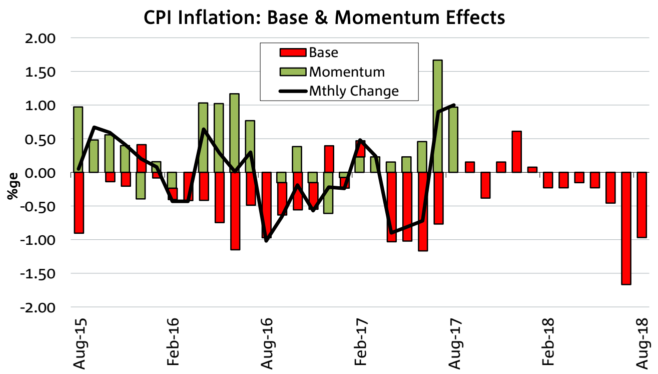


Source: Bloomberg

Outlook

The RBI lowered its growth and raised its inflation forecasts at the recent policy meeting. The RBI revised down the real growth for the 2017-18 (Year to March 2018) period to 6.7%, down from 7.3% in August. Implementation issues related to the GST, as well as uncertainties relating to the winter crop were cited. The inflation projections for the October to March period have been raised to 4.2-4.6%, up from 4-4.5% earlier. The increase in core inflation and firming in crude prices were among the factors mentioned. This also reflects the phasing out of the favourable 'base effects' that were evident earlier this year.

Inflation projections



Source:NAB Economics

NAB Economics has maintained its 6% outlook for the Repo rate, going forward. The RBI indicated that it was committed to maintaining headline inflation at 4% on a 'durable basis', which precludes any near-term rate cut in light of the higher inflation forecasts.

A higher inflation and lower growth outlook indicates an economy with supply-side challenges. As such, cutting interest rates in such an environment might prove counterproductive: they are more likely to stoke inflationary pressures. Supply-side reforms might be more beneficial at this juncture. The RBI emphasized the importance of these factors. They include: recapitalising public sector banks, improving the ease of doing business, speeding up the launch of the affordable housing program, addressing critical shortages in infrastructure, including implementing faster project clearances. Finally, simplifying the GST was also mentioned. With regards to the latter, the GST Council recently decided on providing relief to both SMEs and exporters, which should be supportive of growth.

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