INDIA MONETARY POLICY
FEBRUARY 2018

NAB Group Economics

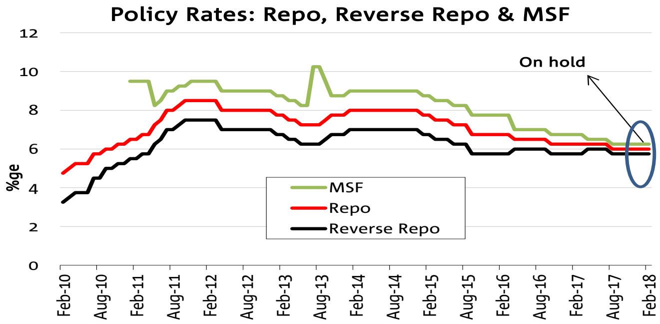
The RBI held the benchmark Repo rate at 6% at its February meeting. This decision was in line with expectations. They also raised their inflation outlook, and highlighted upside risks to the forecasts. In light of the elevated inflation outlook, NAB Economics has changed its interest rate projection. In particular, we are forecasting a rate hike in the December quarter 2018, which will raise the Repo rate to 6.25%. Risks to our forecasts are evenly balanced.

Interest Rate Decision

At its 7th December Monetary policy meeting, the RBI:

- Maintained the policy (Repo) rate at 6.0%
- Held the Reverse repo and MSF rate at 5.75%, and 6.5% respectively

India policy rates



Source: DX/RBI

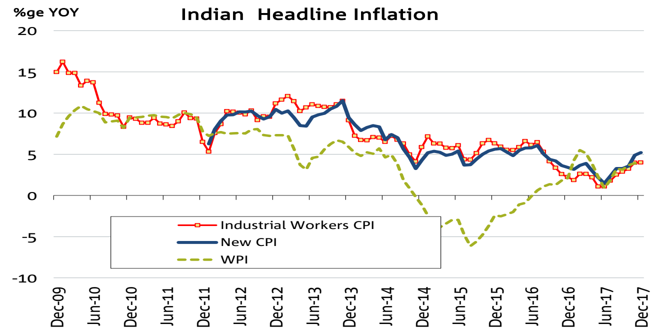
The decision was in line with market expectations, and the RBI reiterated its neutral policy stance. The decision to stay on hold was taken by a majority of committee members, with one member voting for a rate hike.

The RBI, however, indicated that from April 2018, banks would need to move to change how they lending rates on products such as home loans. Under this methodology, banks will set lending rates with reference to the marginal interest rates at which they themselves borrow money, along with a spread. Marginal costs of funds are more responsive to policy rate changes, and will assist in more effective policy rate transmission, an important consideration for the RBI.

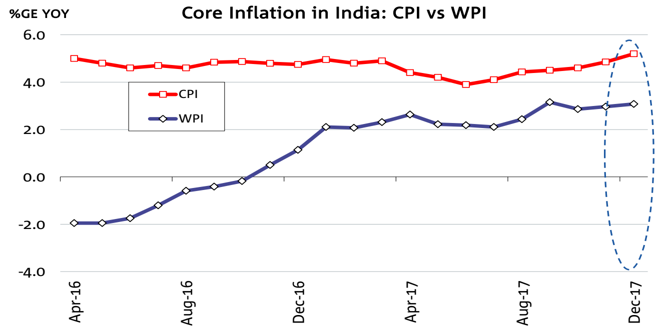
Price pressures have picked up in the Indian economy, with the headline CPI up 5.2% over the year to December. This is the highest increase since July, 2016, although it was partly impacted by unfavourable 'base effects'. Food prices (4.96%) gained momentum in December, driven by higher prices of vegetables (29.1%), fruits (6.6%) and proteins such as eggs (9.5%). Conversely, price declines in pulses (-23.5%) helped dampen the overall rise in food prices.

Core inflation (excluding food and fuel) also accelerated to 5.2% in December, reflecting underlying price pressures in the economy. This was driven largely by housing (8.25%) due to higher rent allowances for government employees. Health (4.96%) and personal effects (4.46) also increased, while clothing and education costs decelerated.

Headline and core inflation



Source:CEIC



Source: NAB Economics

Industrial production picked up in the month of November, rising by 8.4% yoy. This was the strongest

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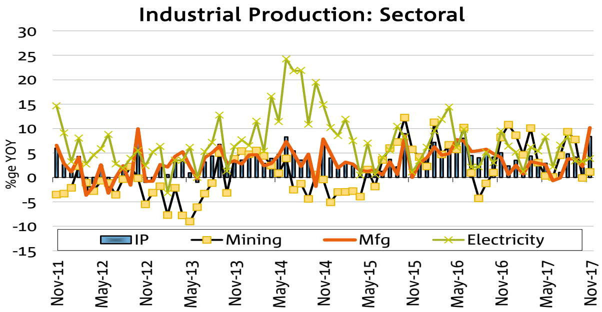
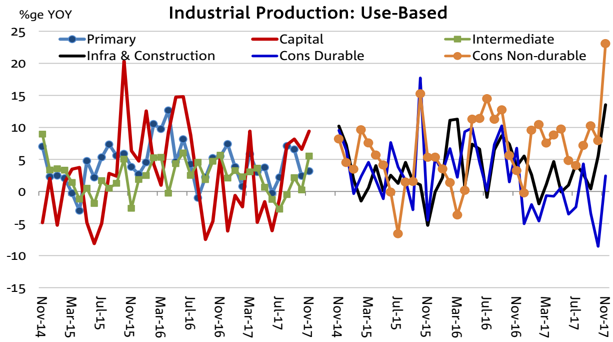
outcome since October, 2015 and underlies increasing momentum in the manufacturing sector, which expanded by 10.2%. Within manufacturing, transport equipment and pharmaceutical equipment were particularly strong segments. Interestingly, capital goods production recorded a 9.4% expansion, which augurs well for capital investment spending – if sustained.

Industrial Production – Sector and Use



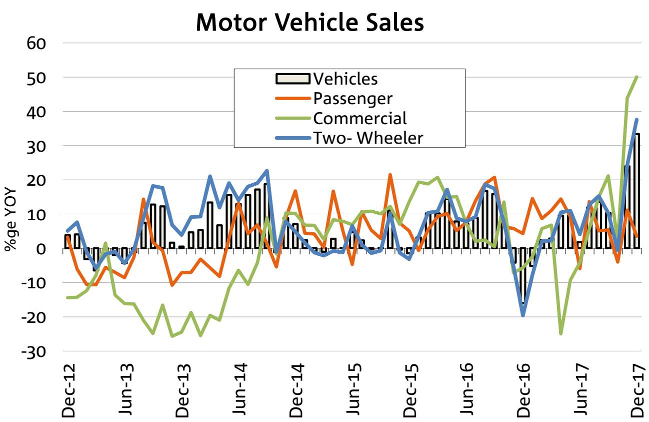
Source: CEIC



Source: CEIC

One area which has shown a notable improvement is the sale of commerical vehicles. Commercial vehicle sales surged by 50% over the year to December, the highest since May 2010. It also follows on the heels of a very strong result in November. These numbers are also confirmed by solid commercial vehicle sales results by Ashok Leyland, part of the Hinduja group. Sales of passenger vehicles, by contrast, have been somewhat restrained.

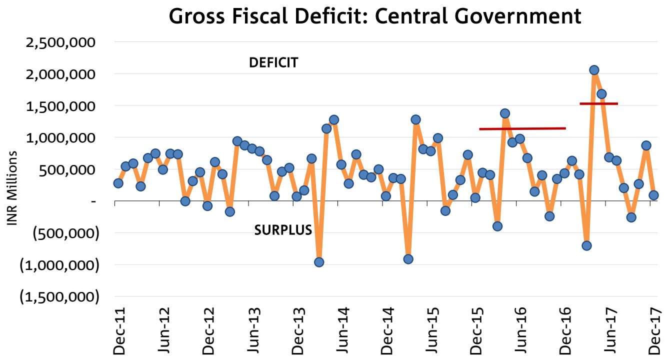
Industrial sector components



Fiscal position

The Indian Budget was released on the 1st of February, 2018. The budget aimed to aggressively pursure social and infrastructure spending while limiting the fiscal fallout. Measures included providing farmers with higher support prices for their crops, providing a lower tax rate of 25% to businesses in the Micro, Small and Medium sectors, as well as higher infrastructure spending on roads, railways and highways among other measures.

Fiscal spending



Source: DX

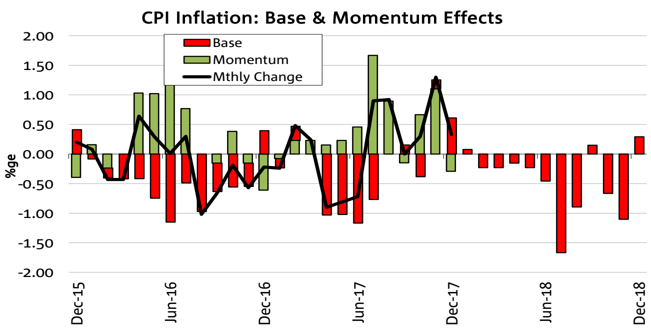
The policies announced should be supportive of growth, including helping to reinvogorate investment spending. However, there remain some concerns about the fiscal implications. For the 2017-18 year (to March 2018), the Government has estimated the fiscal deficit at 3.5% of GDP (up from 3.2%). Further, the 2018-19 deficit has been projected at 3.3%, up from 3% previously.

In response to the higher deficit targest, the RBI did allude to the fiscal slippage and the impacts it could have both on higher inflation as well as higher borowing costs as an increase in government spending can 'crowd out' private investment.

Outlook

The RBI lifted its inflation forecasts. For the April-September 2018 period it projected inflation to be around 5.1-5.6%; in the October 2018-March 2019 period inflation is forecast to have around 4.5-4.6%

Inflation – base and momentum effects



Source:NAB Economics

The RBI expects the inflationary impact of the Housing Rent Allowance to gradually dissipate.

However, they highlighted *upside* risks to the forecasts. Some of the factors which could cause upside risks include: fiscal slippage – including by State Governments; possible elevation in crude oil prices; higher Minimum support prices for agricultural produce; and finally, rising inflationary pressures from a weaker currency due to higher interest rates in developed economies such as the United States. The RBI did also mention possible mitigants such as subdued rural wage growth and modest level of capacity utilisation.

In light of the recent higher inflation outcomes and forecasts, coupled with the RBI's commitment to ensure that the inflation rate remains around 4% on a sustainable basis, we have decided to alter our interest rate outlook.

NAB Economics is forecasting the RBI to raise the benchmark Repo rate by 25bp to 6.25% (previously on hold) in the December quarter, 2018.

Risks to our forecasts are evenly balanced. Higher than expected inflation outcomes could prompt the RBI to act faster and more aggressively with regard to raising rates. Conversely, if inflation turns out lower than forecast, the RBI might not lift rates, and even consider a cut.

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