

August RBI Monetary Policy Preview

August 2017

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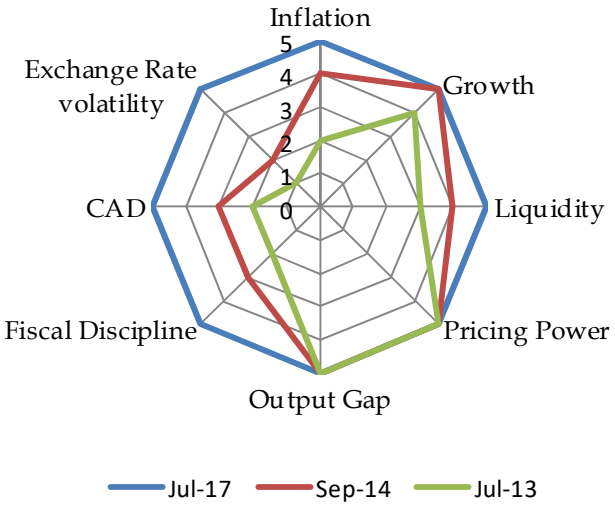
RBI Dashboard

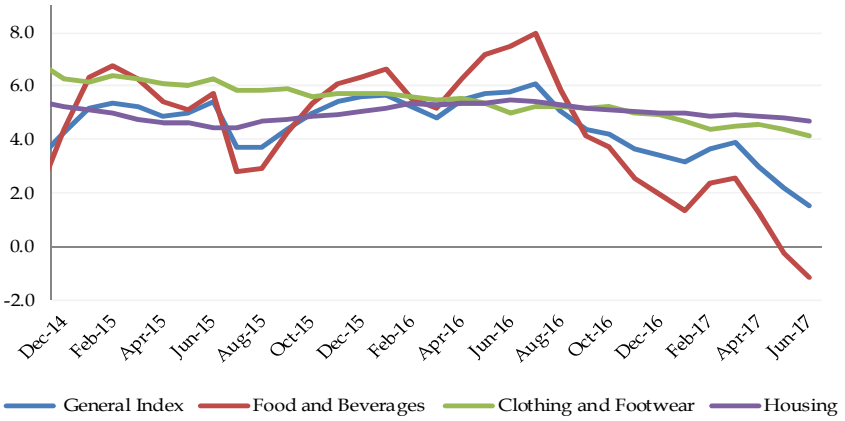
- RBI's objectives as set out in Urjit Patel Committee Report:
  - Headline CPI - nominal anchor for policy communication.
    - Target: 4% with a band of +/- 2% tolerance
  - Monetary Policy Committee (MPC) vested with Monetary Policy decision
    - Policy rule defined in terms of a real policy rate that is expected to be positive when inflation is above nominal anchor
    - Monetary policy to be consistent with sustainable growth and financial stability
  - Stable exchange rate with minimal volatility
- In assessing these objectives the RBI has and will continue to focus on certain key variables:
  - Current stance has been changed to neutral from accommodative. The RBI has indicated the neutral stance gives it more flexibility to respond to changing economic conditions.
  - There is been a dramatic improvement in all variables including inflation

Note: Scale 1-5 refer to conditions for monetary easing, 5 being most favorable

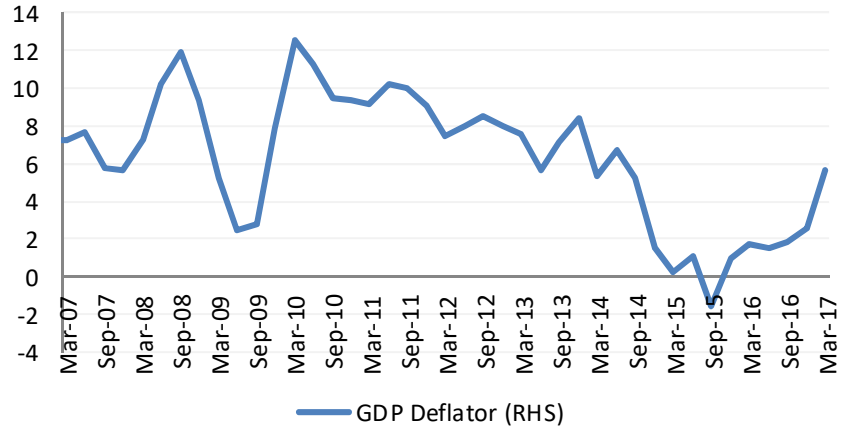


Inflation Picture: CPI at record lows

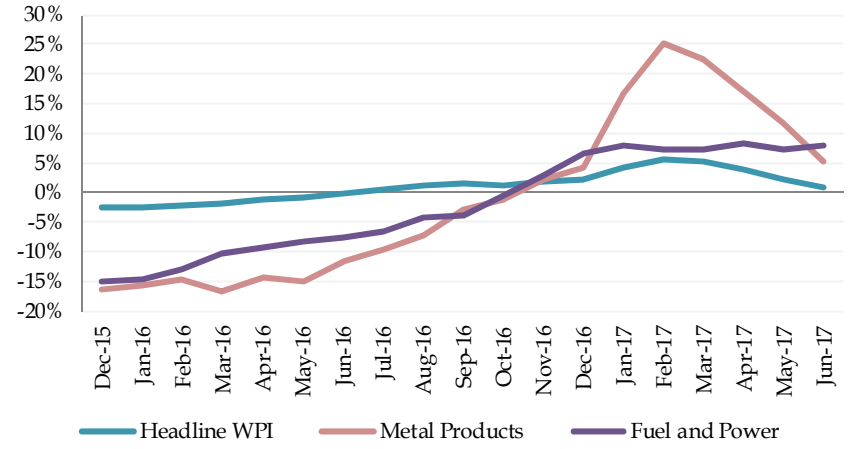
India CPI



GDP Deflator



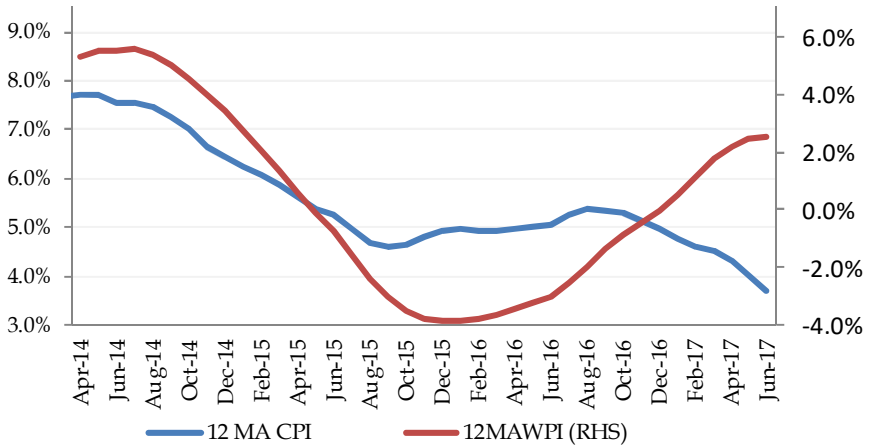
WPI



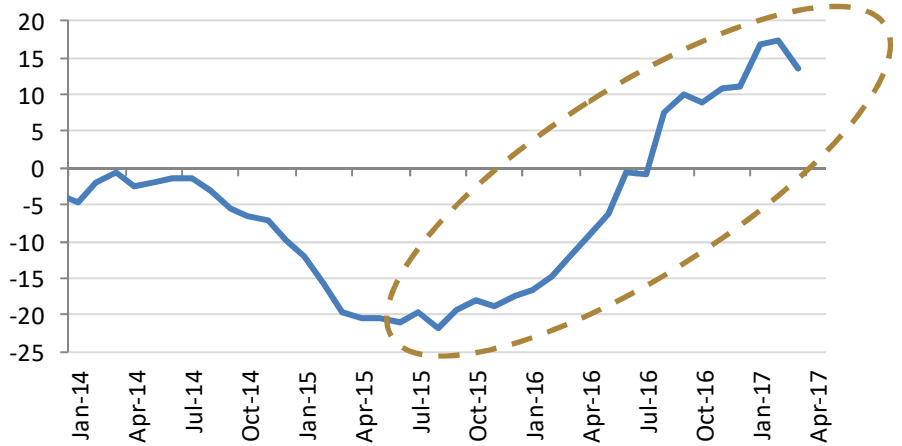
- CPI inflation has fallen below with RBI's medium term trajectory and we expect this trend to continue
- Key drivers of CPI inflation remain manageable. Pulse and vegetables prices which were the main drivers of the past upticks have dropped significantly reflecting increased sowing, better supply management and higher imports.
- WPI had risen in the recent past driven by metal and petroleum products, however even those factors have now stabilized and WPI is also coming down and the fall is even more pronounced after the base revision to 2011-12.
- Furthermore the outlook for food inflation continues to improve as the progress of the monsoon is normal.

Inflation Picture: Global food prices have firmed up but domestic prices stable

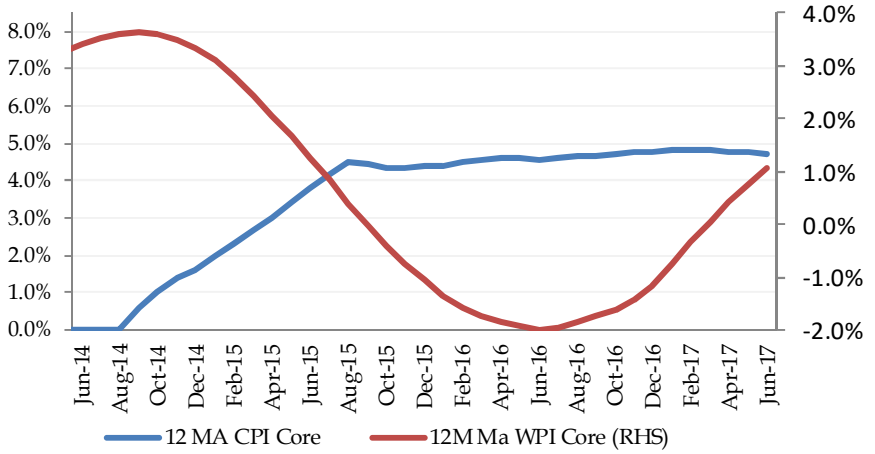
Twelve Month Moving Average Headline Inflation



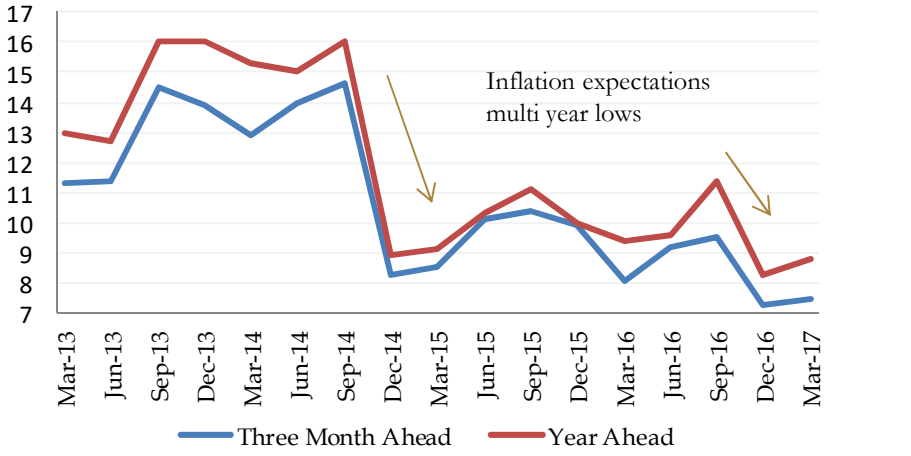
FAO Global Food Index (% Growth)



Twelve Month Moving Average Core Inflation

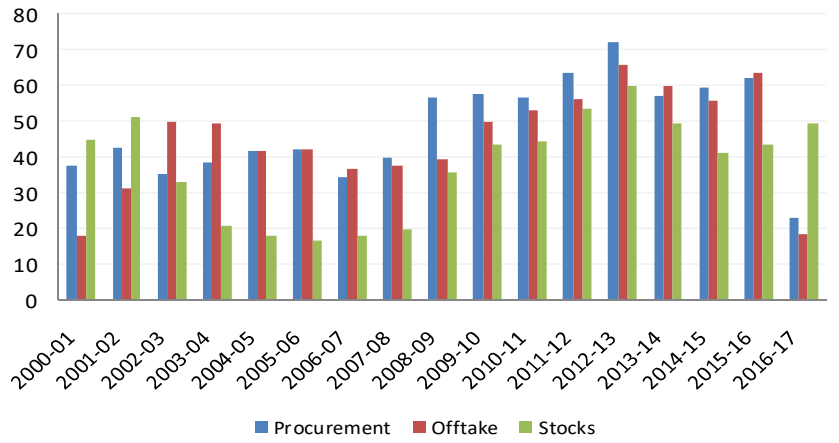


Inflation Expectations

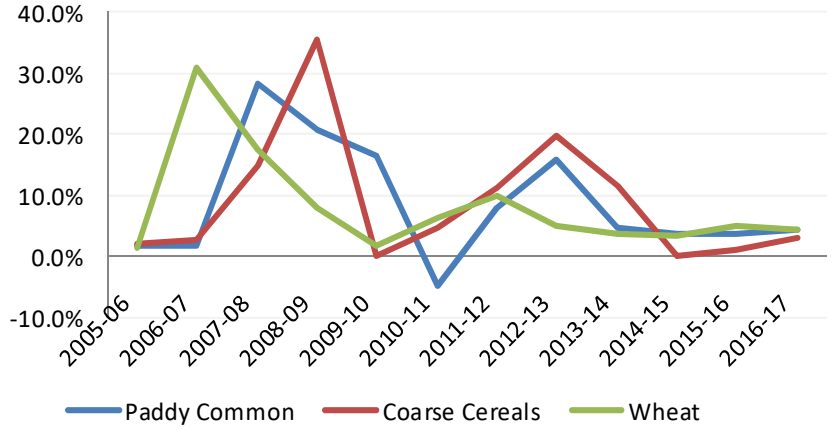


Inflation Picture: Adequate food stocks in conjunction with slower price growth and improved agricultural output

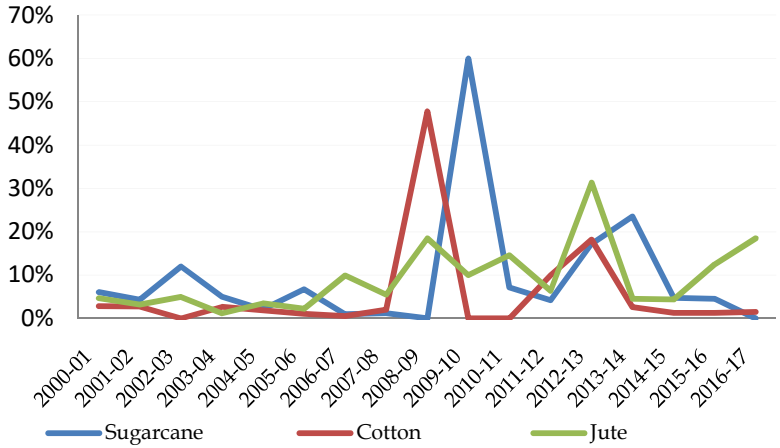
Public Distribution System (Million Tonnes)



MSP Prices – Food Grains (%chg)



MSP Prices – Non Food Grains (%chg)

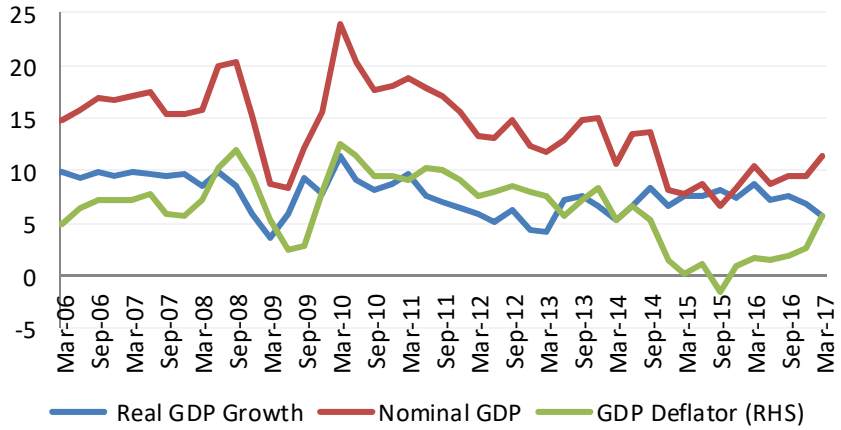


Rural Wage Growth

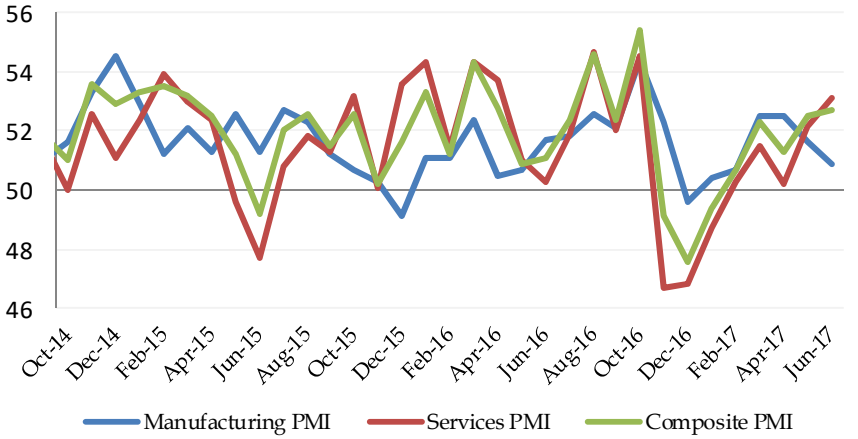


Growth Picture: PMI has recovered post the demonetisation slump

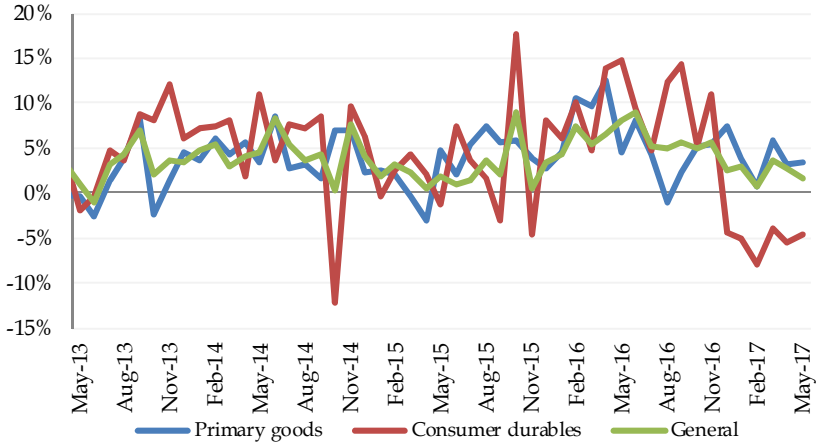
Real GDP Growth



India PMI



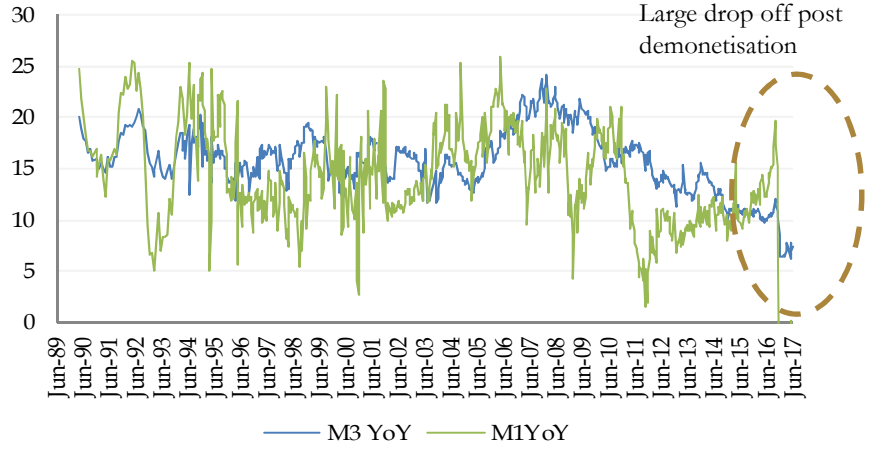
Index of Industrial Production



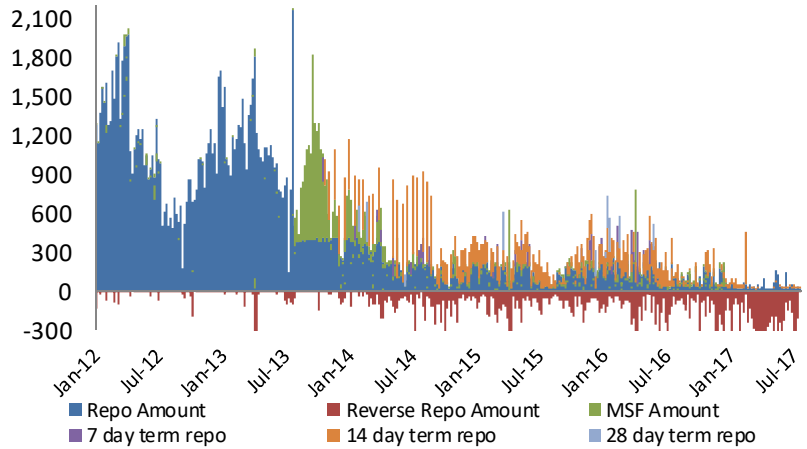
- The revised GDP figures indicate there has been a slowdown in GDP as the market has suspected all along
- Muted industrial production across all sectors. The consumer sector had slumped after the demonetisation but is now showing signs of recovery.
- We expect the IIP to be less volatile under the new series and track other indicators closely
- There also has been a sharp move up both in service and manufacturing PMI post demonetisation slump. Although it still remains below recent levels.

Liquidity Picture: Comfortable liquidity conditions

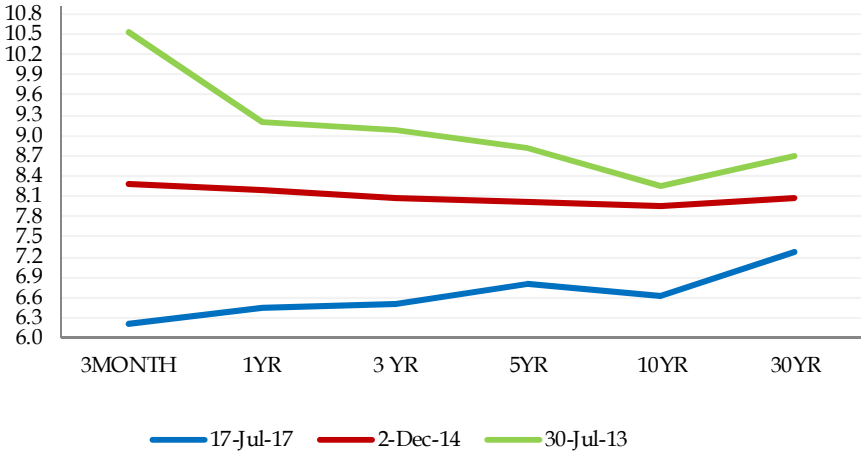
Money Supply Growth



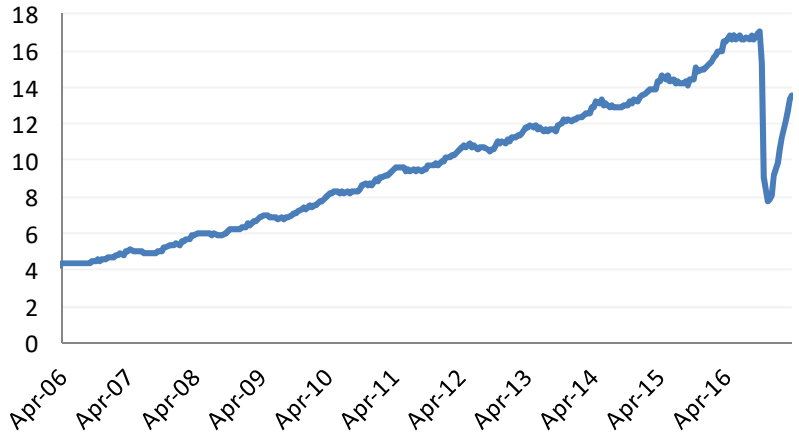
Liquidity Adjustment Facility (Rs. B)



Yield Curve

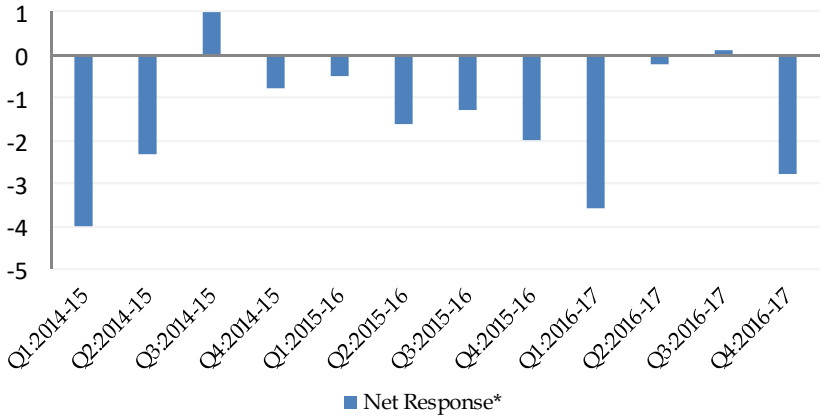


Currency in Circulation (Rs. TRN)

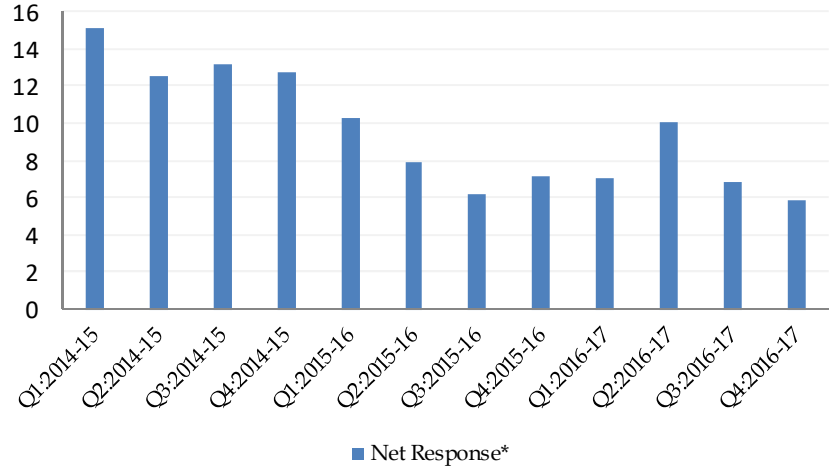


Pricing Power: Producer's pricing power compromised

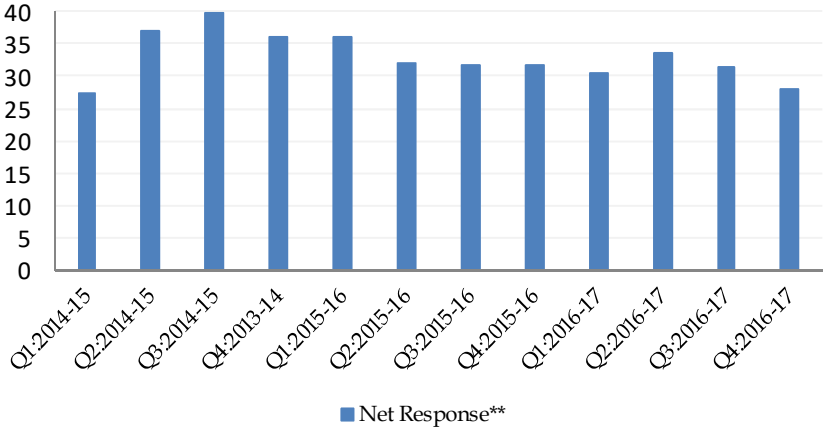
Expectations of Profit Margin – RBI Industrial Outlook Survey (% response)



Expectations of Selling Price– RBI Industrial Outlook Survey (% response)



Expectations of Overall Business Situation – RBI Industrial Outlook Survey

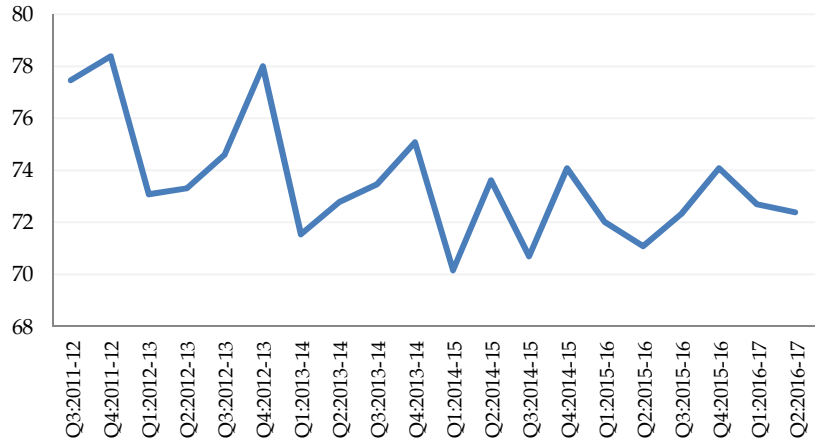


- FY16 saw a continued drop in operating profit growth indicating moderation in pricing power
- Companies highly impacted by high interest rates as interest costs as a percentage of operating profits increased
- RBI's Industrial Outlook indicates companies' expectation of selling price and profit margin remains muted
- Companies do not expect their pricing power to improve in the short term. However companies will want to pass on cost inflation at the earliest opportunity

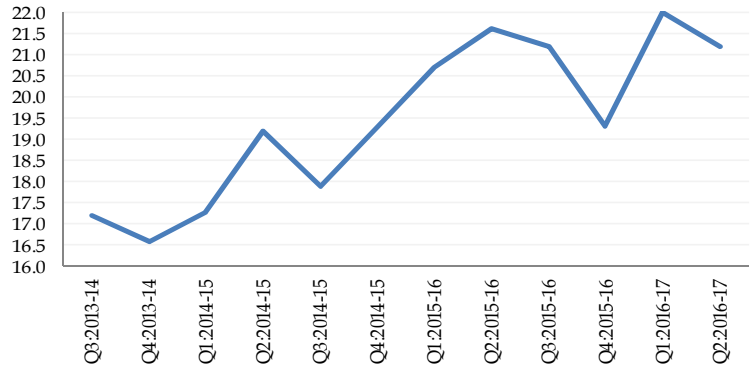
* The difference between % of respondents which indicated that profit margin and selling price will increase and those that answered it will decrease
** The difference between % of respondents which indicated that the overall business situation will improve and those that indicated it will worsen

Output Gap: Capacity Utilisation down, inventory build up

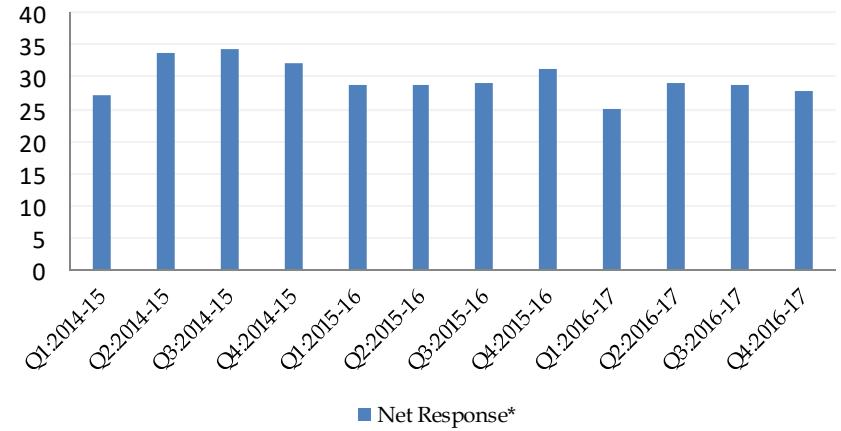
Capacity Utilization (OBICUS %)



Average Finished Goods Inventory / Sales Ratio (OBICUS)



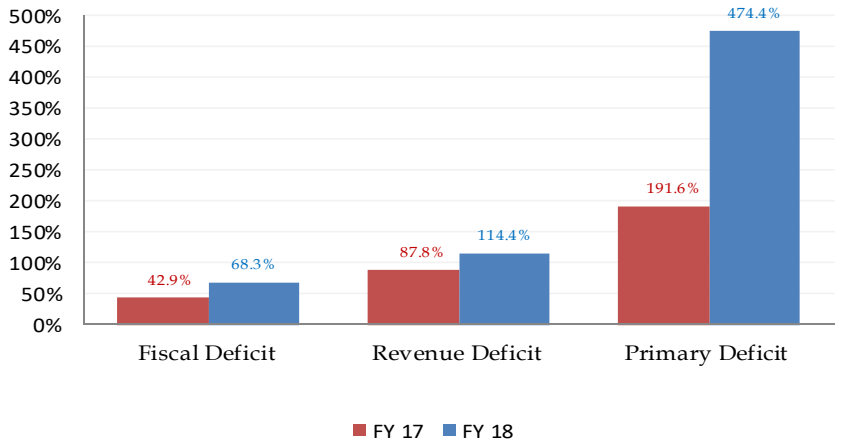
Expectation for Production (Industrial Outlook Survey %)



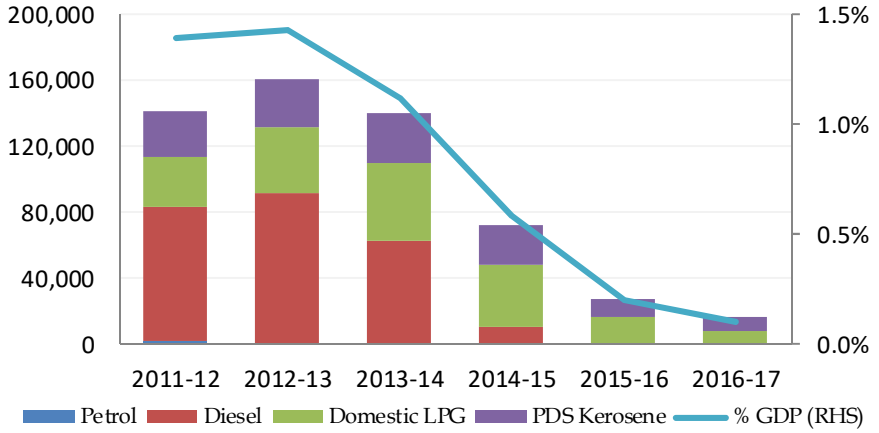
- The RBI's Order Books, Inventories, and Capacity Utilisation Survey (OBICUS) survey continues to show a decline in the level of capacity utilization
- The fall in capacity utilisation is visible across industry groups and especially pronounced in sponge iron and petroleum products
- Inventory levels have continued to remain elevated over the last several quarters.

Fiscal Discipline: Budget has outlined a prudent consolidation path

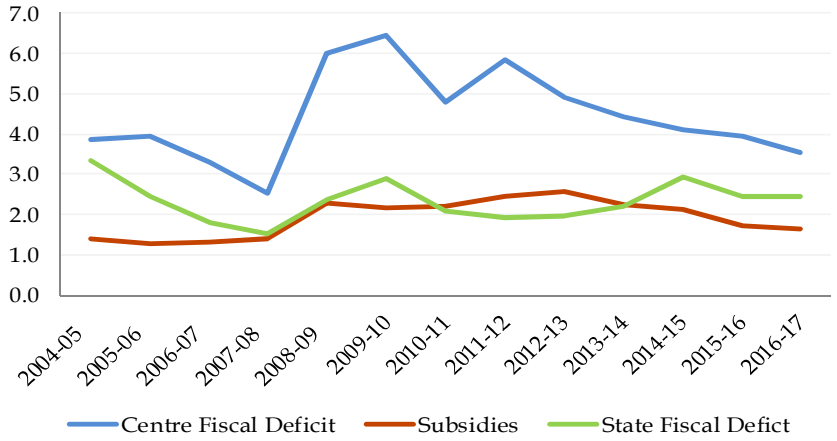
Fiscal Position up to May 2017 % actual to budget estimates



Public Sector Oil Marketing Companies Under recoveries



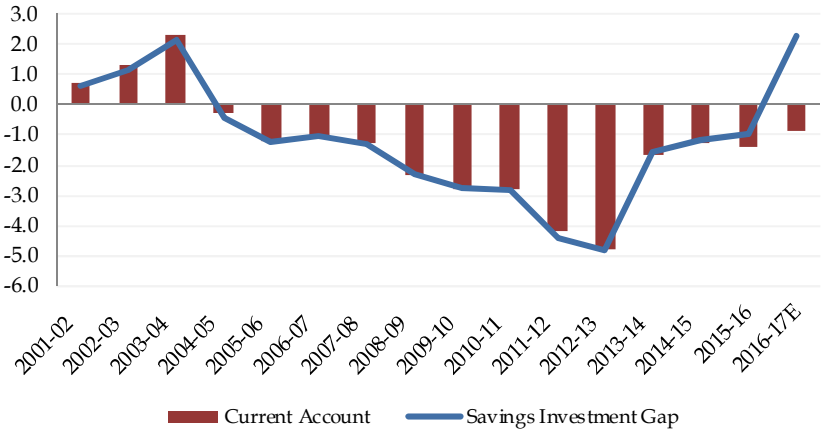
Fiscal Deficit (% of GDP)



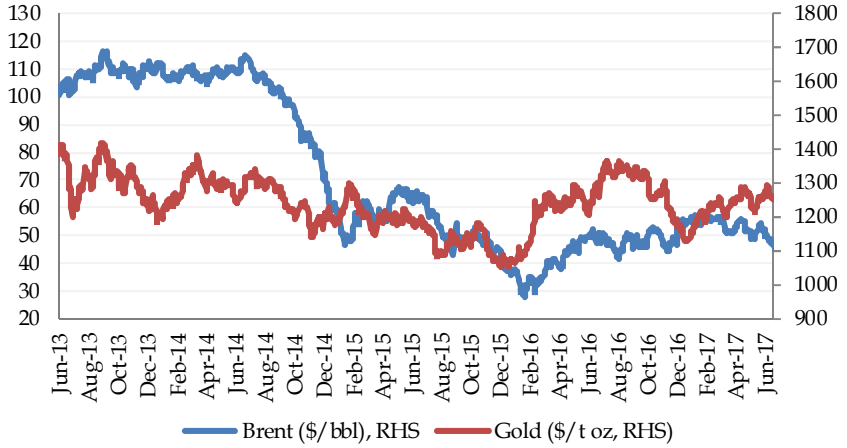
- The RBI has repeatedly stated that fiscal consolidation is very important.
- The government has made deep commitment to fiscal discipline at 3.5%, and lowered structural impediments to lower rate transmission by reducing PF, small savings and Kisan Vikas Patra rates.
- Given all the improvements the government has achieved its fiscal deficit target of 3.5% as forecasted by the budget for FY17 despite the aggressive front-loaded infrastructure spending. We also expect next year's target of 3.2% will be achieved. The government is making a concerted effort to widen the tax base along with disciplined expenditure control.
- Key risks that need to be monitored for fiscal targets are the pay commission increases and farm loan waivers.

CAD: Substantial improvement over the last two years

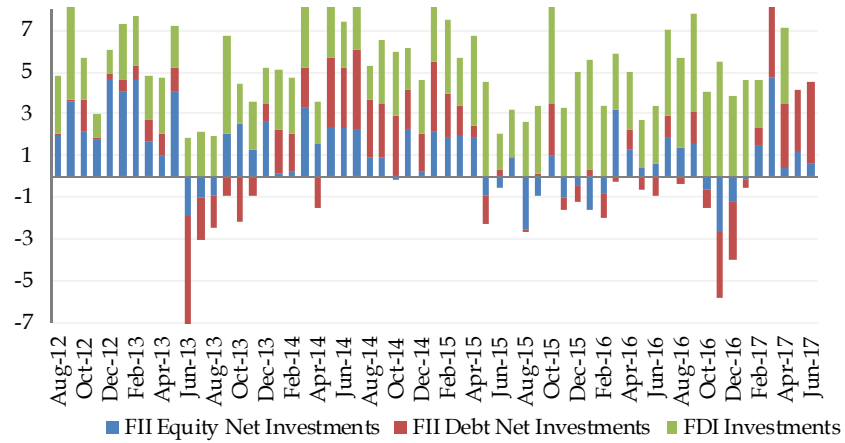
Current Account and Saving Investment Gap as % of GDP



Oil and Gold Prices



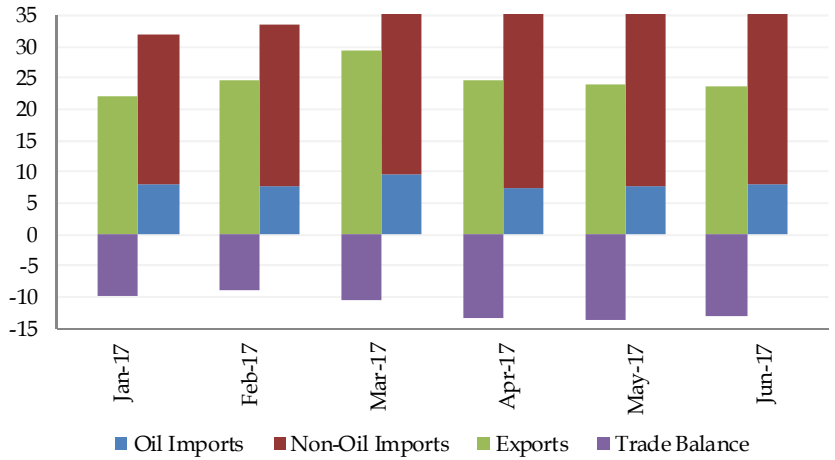
FII Investments



- The current account deficit (CAD) had emerged as a major source of concern for both monetary policy and financial stability
- The CAD for Q4FY17 came in at 0.6% of GDP and for FY17 as a whole at 0.7% of GDP, a significant improvement over the last several years.. The moderate prices of oil and gold, the two commodities India imports in large quantities, will ensure that CAD will remain manageable.
- Financing of the deficit has also become easier due to significant FII inflows
- The improving CAD situation has reduced India's vulnerability to external shocks.

Trade: Export growth starting to recover

Trade ($B)



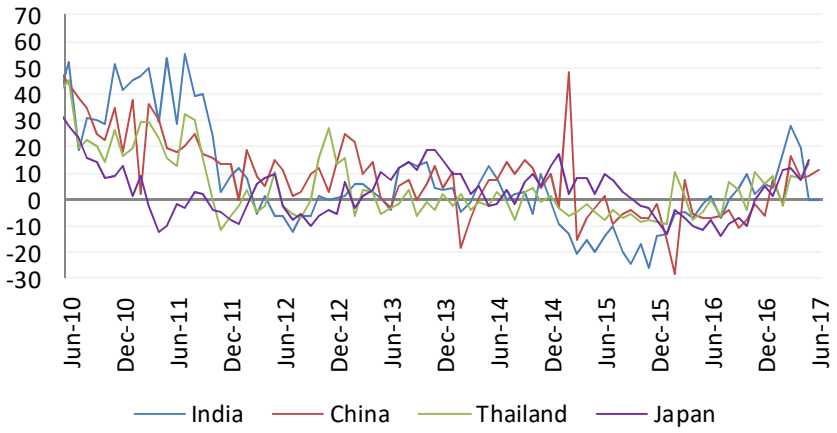
Top 10 Imports ($M)

Commodity Group	Apr-May 2016	Apr-May 2017(P)	%Growth	%Share
Gems & Jewellery	7,621	16,548	117	22
Pertoleum Crude & Products	11,712	15,079	29	20
Electoronics Items	5,464	8,406	54	11
Machinery	4,898	6,041	23	8
Chemicals & Related Products	5,187	6,431	24	8
Ores & Minerals	3,197	4,871	52	6
Base Metals	3,396	4,092	20	5
Agri & Allied Products	2,809	3,941	40	5
Plastic & Rubber Articles	2,351	2,936	25	4
Transport Equipments	2,195	2,017	-8	3
Total	**53,992**	**76,159**	**41**	**100**

Top 10 Exports ($M)

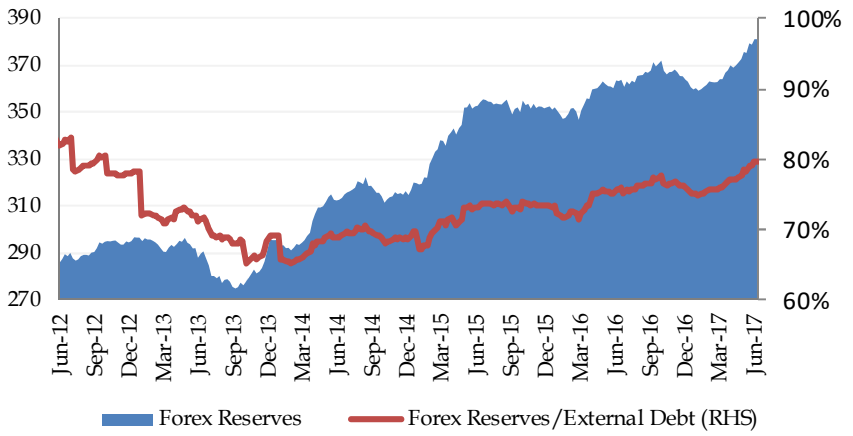
Commodity Group	Apr-May 2016	Apr-May 2017(P)	%Growth	%Share
Gems & Jewellery	7,287	7,910	9	16
Pertoleum Crude & Products	4,215	5,508	31	11
Chemicals & Related Products	5,179	5,305	2	11
Agri & Allied Products	4,001	4,405	10	9
Base Metals	2,522	4,094	62	8
Machinery	3,241	3,647	13	8
Transport Equipments	4,616	4,246	-8	9
Plastic & Rubber Articles	1,042	1,134	9	2
Electoronics Items	930	971	4	2
Leather & Leather Manufactures	843	844	0	2
Total	**43,288**	**48,629**	**12**	**100**

Export Growth

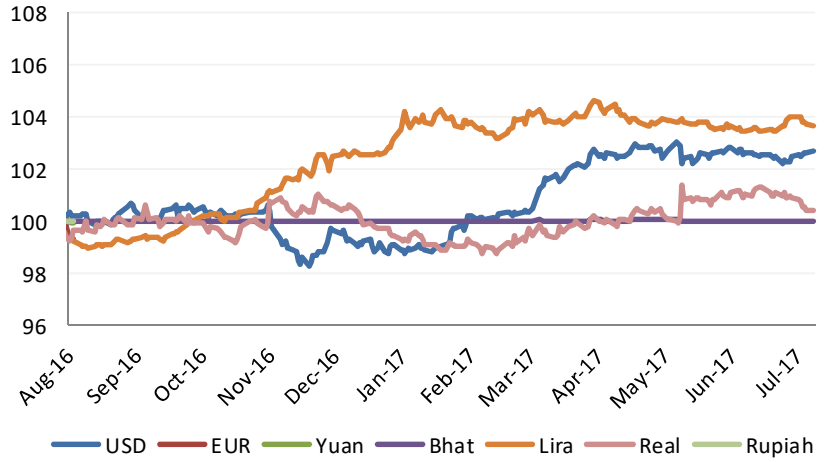


India's forex reserves have grown in absolute and relative terms

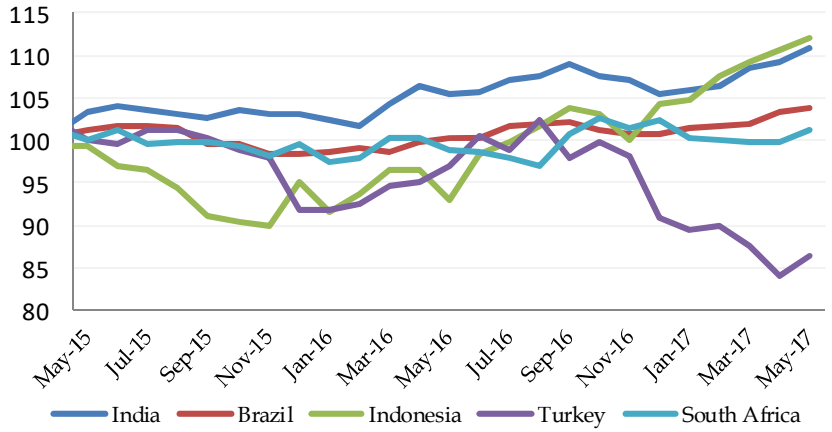
Foreign Exchange Reserves (SB)



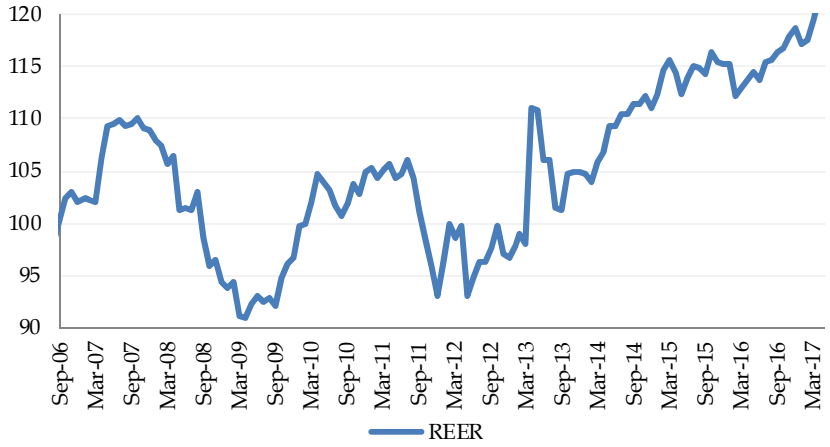
Rupee vs Selected Currencies



Foreign Exchange Reserve Additions

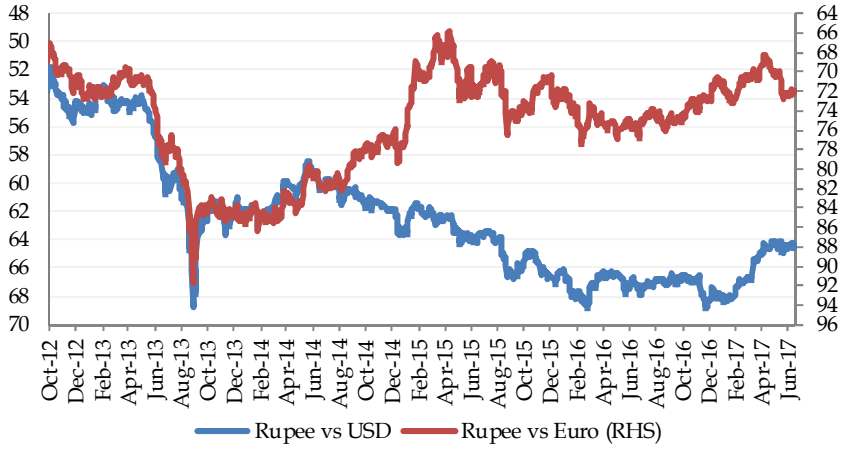


Real Effective Exchange Rate

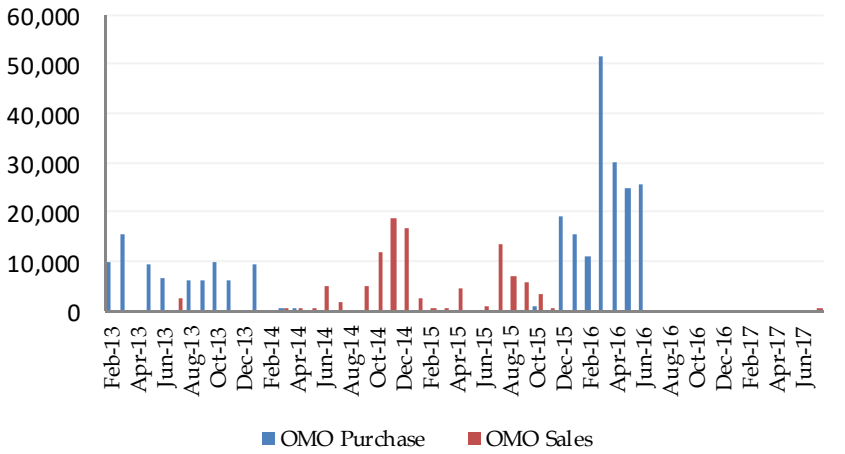


RBI constrained by excess liquidity in intervening in FX markets

Rupee Performance



Net RBI OMO Sale/Purchase



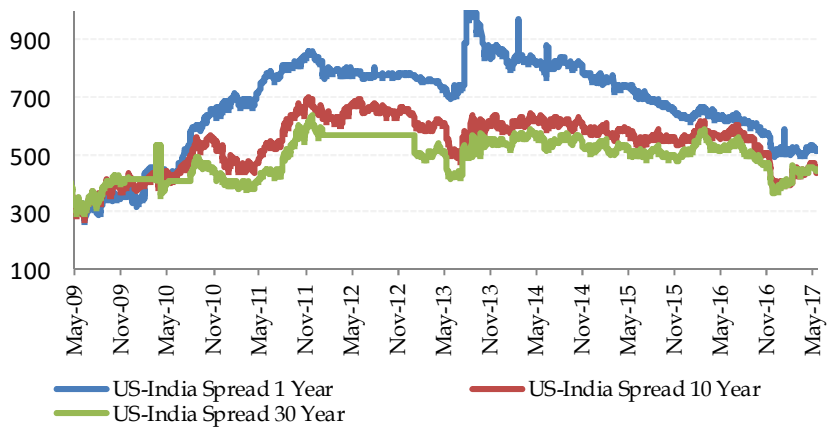
Sale/Purchase of Dollars by RBI

Period	RBI Gross Sale $	RBI Gross Purchase of $	RBI Net Purchase of $	Outstanding Forward Sales (-)/Purchase (+)
May-17	2,014	7,020	5,006	13,601
Apr-17	1,185	1,751	566	13,553
Mar-17	1,486	5,024	3,538	10,835
Feb-17	1,011	2,201	1,190	2,842
Jan-17	1,749	1,335	-414	501
Dec-16	4,534	4,997	463	586
Last 12 Months	**57,497**	**73,527**	**16,030**	

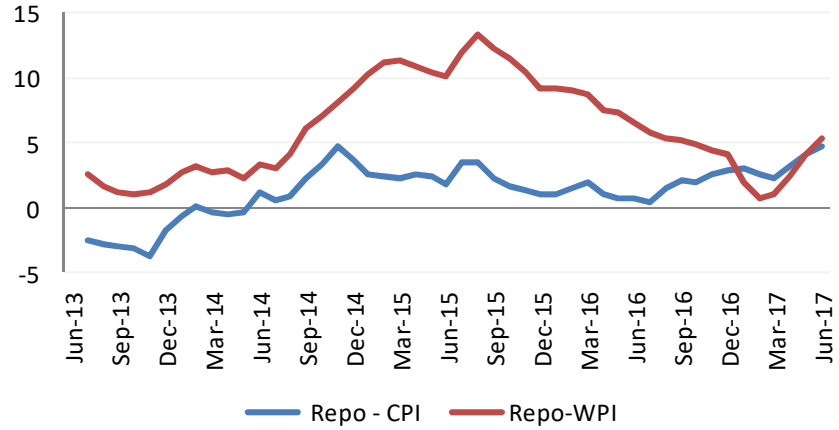
- The Rupee has actually appreciated against the dollar after the state assembly election to a 11 months high. The results of the election has increased the governments ability to carry out reforms.
- While the RBI continues to intervene in FX markets ,its ability to slowdown the INR appreciation has been constrained by the surplus liquidity in the banking sector
- Even as it works to reduce the surplus liquidity in the banking system, the RBI has reiterated its approach of providing adequate durable liquidity to the market as compared to previous years.

Real rates remain positive

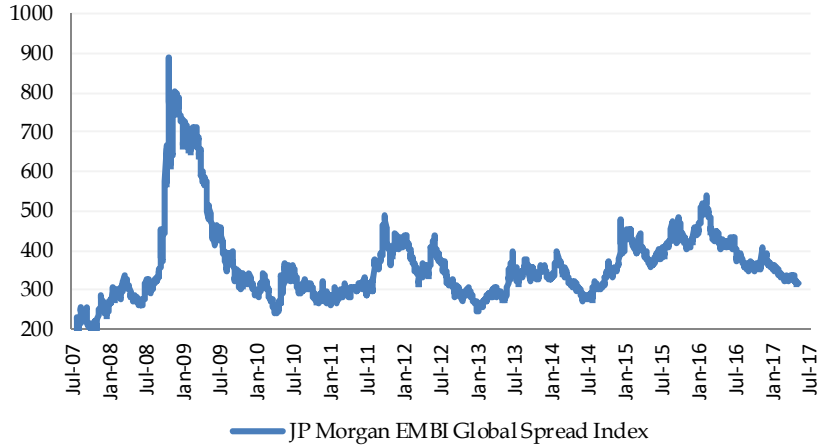
U.S Treasury-India G-sec Credit Spreads



Real Rates*



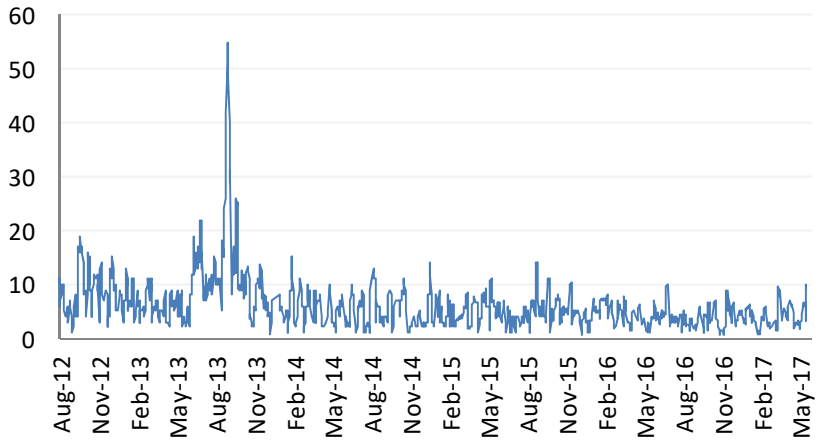
JP Morgan EMBI Spread Index



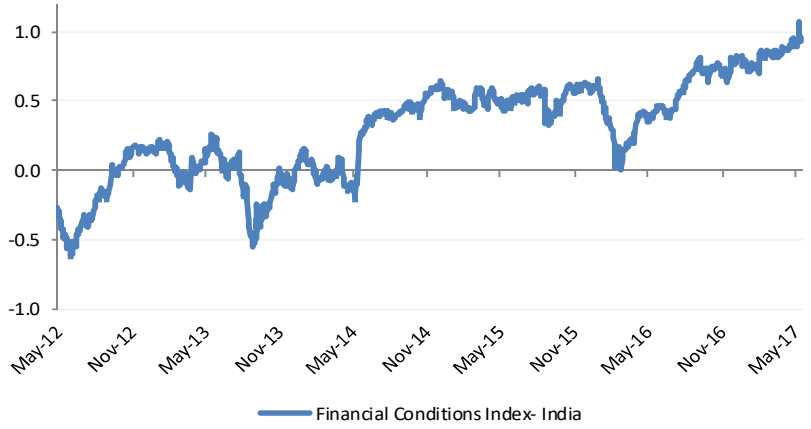
- As the U.S yields have risen and Indian yields moving down, the U.S India spread has come down from its recent highs
- India is also currently experiencing positive real rates. The real rate as measured by the Repo-CPI has moved up CPI has fallen faster than the policy rate. The real rates for producers has also come to zero as the WPI has increased.
- The wedge between real rates for borrowers and consumers has narrowed
- The RBI has indicated that a real rate around 1.25% is reasonable for India
- However rising commodity prices imply a drop in real rates for most other emerging economies.

Global financial conditions remain relatively stable

Rupee 5% day volatility



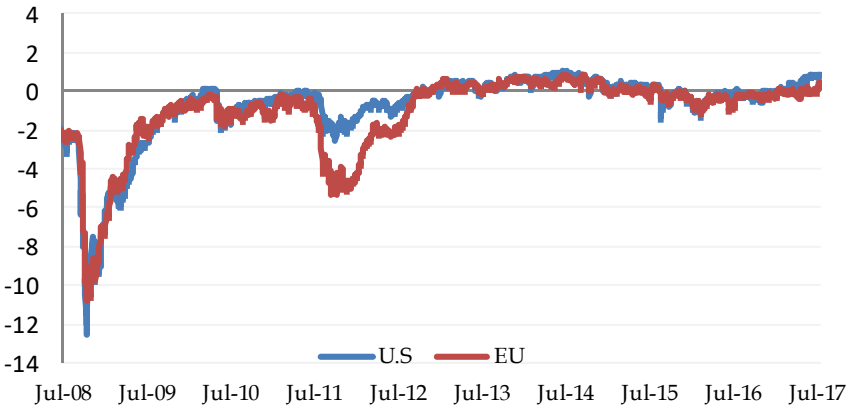
Trust India Financial Conditions Index



Bloomberg Asia Ex-Japan Financial Conditions Index

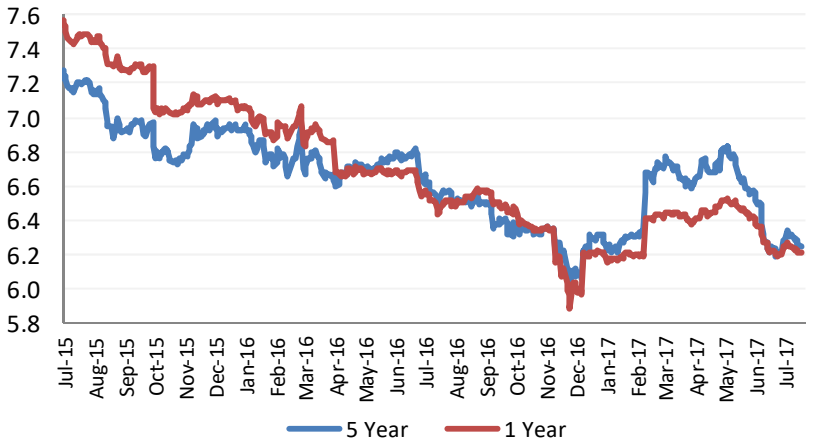


Bloomberg U.S EU Financial Conditions Index

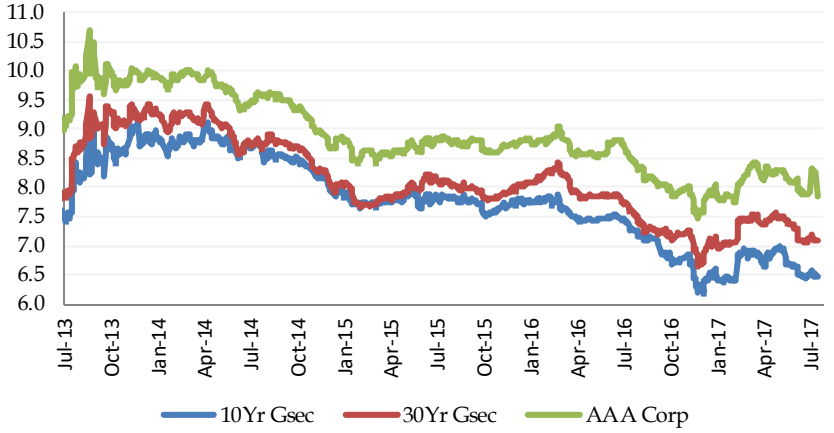


The rally in Indian bond markets continues as inflation falls

On-shore Swap Rates



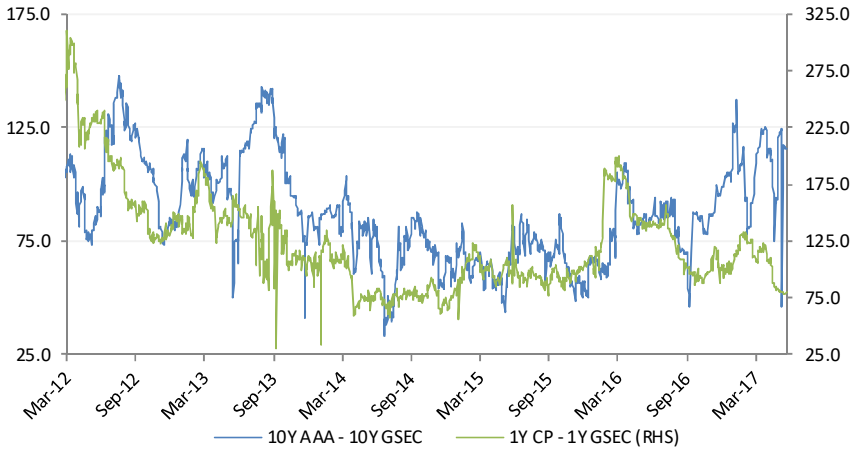
Selected Yields



3 Month CP Rates



10 Year and 1 Year Corp AAA Spreads (bps)



Our View: Rates to come down with the falling inflation

- In its February policy the RBI surprised the market by shifting its stance from accommodative to neutral.
- Since the RBI's change in monetary policy stance we have consistently argued that the RBI's was being overcautious and inflation was likely to undershoot the RBI forecast.
- The RBI's change in stance was partly predicated on the view that food inflation was headed higher. However the latest data clearly indicates the RBI's fears on food inflation were overblown as it does not show acceleration as feared by RBI but rather a decline in food inflation. The most recent data actually shows that food and beverages inflation has moved to negative territory brought by deflation in pulses and vegetables. Furthermore the data shows that the seasonal uptick in food inflation that typically occurs during the pre-monsoon months has been muted so far. Moreover the outlook for food inflation continues to improve as the monsoon proceeds normally.
- We expect this trend of muted inflation to continue and inflation to remain below the RBI's target in the medium term not only driven by food inflation but by other factors as well.
- First, given the announced structure of the GST the impact on inflation is expected to be minimal as also stated by the RBI. The RBI was previously worried that GST would be inflationary in the initial stages. Second the abundance of global crude supplies has put pressure on oil prices which will keep energy inflation low. Third, the recent strength of the Rupee will continue to keep imported inflation in check.
- The lower inflation certainly creates room for the RBI to lower policy rates
- The RBI had also highlighted volatility on the exchange rate on the account of global financial developments as an upside risk that could impart uncertainty on the baseline inflation path. However the Rupee has appreciated to four year highs further limiting inflation.
- Given this backdrop, with domestic inflation significantly undershooting its target, we believe there is substantial room for policy rates to come down in India. We therefore expect the RBI to cut its policy Repo rate by 25bps in its August policy meeting. We do not expect the RBI will front load and go for a 50bps cut as it remains cautious and wants to see the fall inflation is sustained.

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Thank You

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