

June RBI Monetary Policy Preview

June 2017

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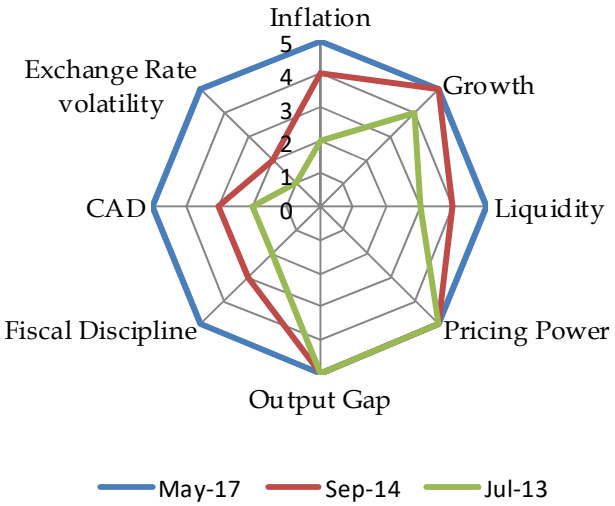
RBI Dashboard

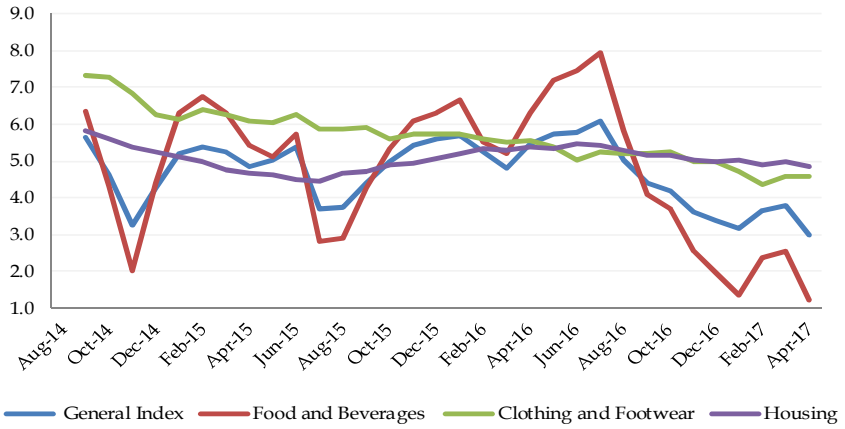
- RBI's objectives as set out in Urjit Patel Committee Report:
  - Headline CPI - nominal anchor for policy communication.
    - Target: 4% with a band of +/- 2% tolerance
  - Monetary Policy Committee (MPC) vested with Monetary Policy decision
    - Policy rule defined in terms of a real policy rate 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. Current stance seems to be influenced by RBI's own perception of the number of U.S interest rate hikes and their implication for emerging markets.
  - 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

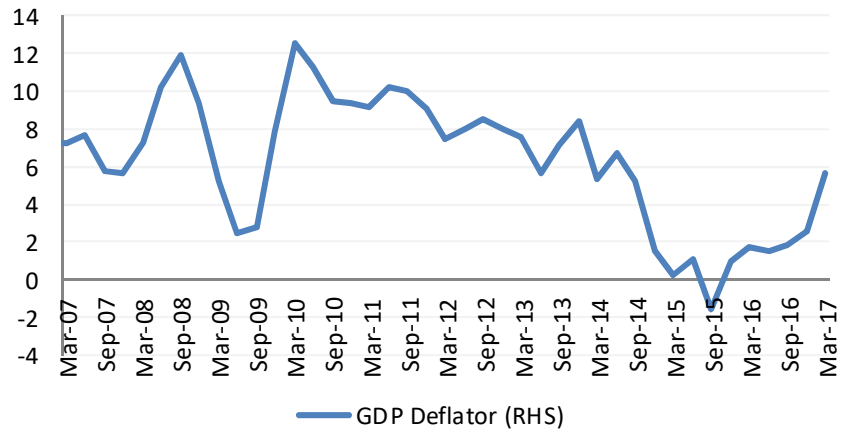


Inflation Picture: WPI stabilizing

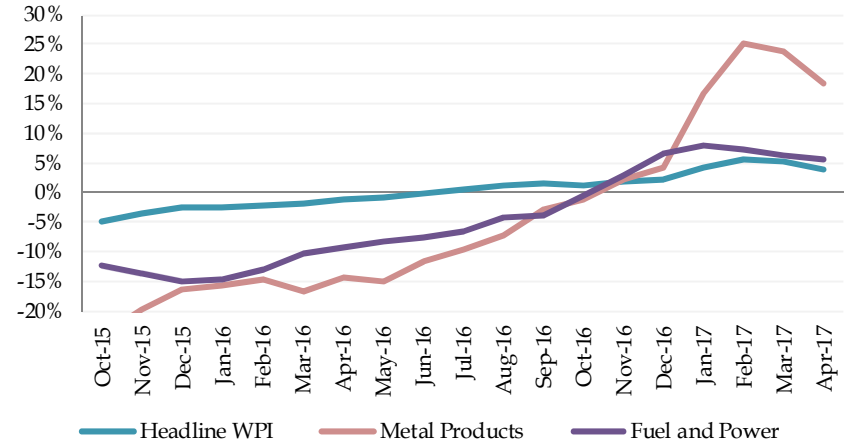
India CPI



GDP Deflator



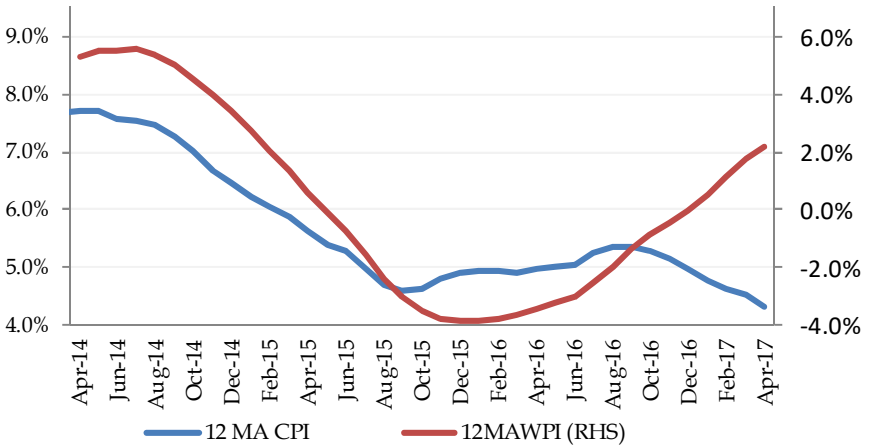
WPI



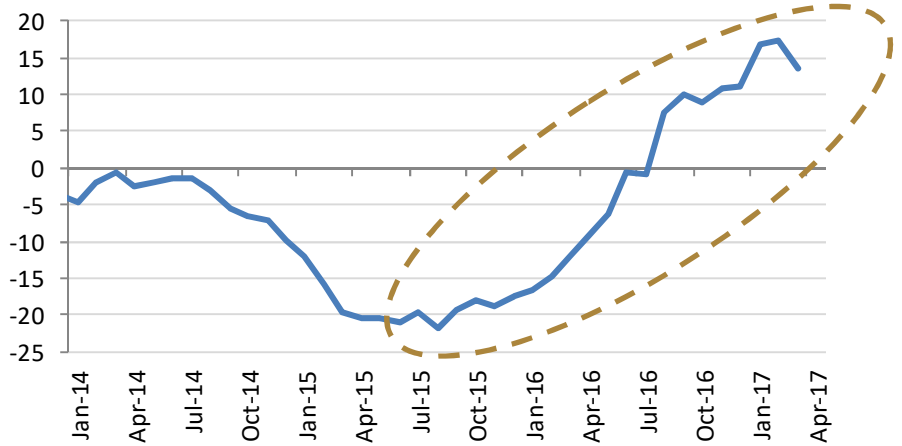
- CPI inflation has fallen below with RBI's medium term trajectory and we expect this trend to continue
- Key drivers of CPI inflation remain manageable. Pulse prices which were the main drivers of the recent upticks have dropped significantly reflecting increased sowing and higher imports.
- However there are upside risks to WPI inflation. Metals, coal and petroleum products which in the past have kept WPI low have picked up in recent months and pulling the WPI index higher.
- However even those factor have now stabilized and WPI is also coming down and the fall is even more pronounced after the base revision to 2011-12

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

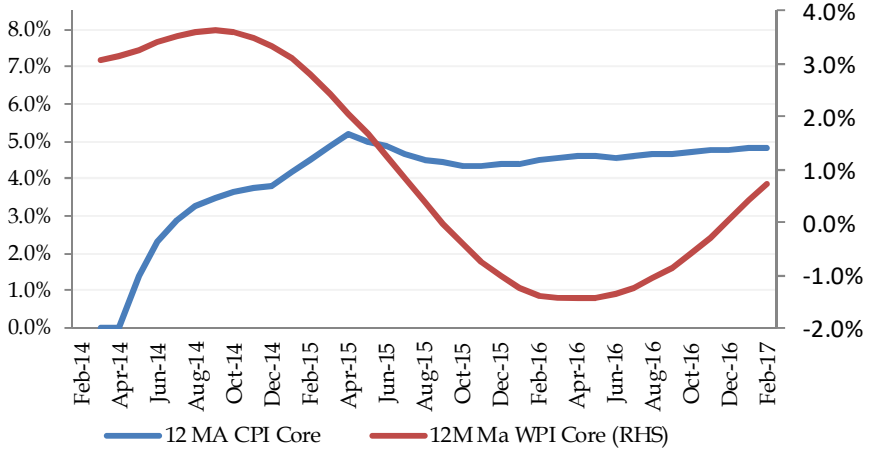
Twelve Month Moving Average Headline Inflation



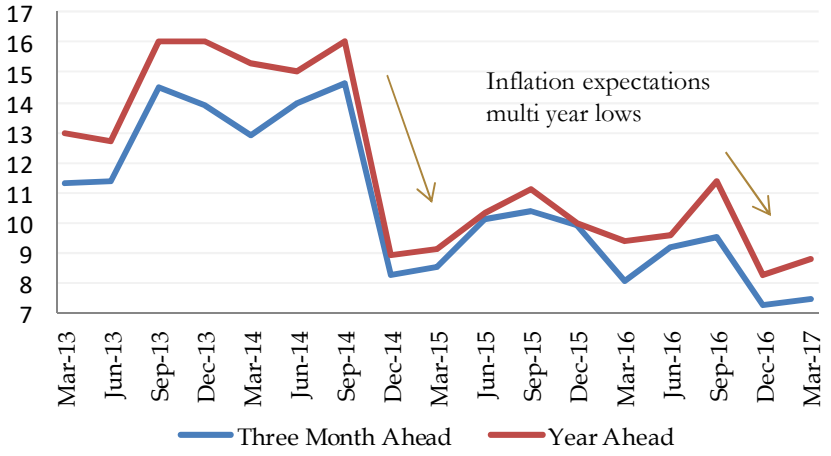
FAO Global Food Index (% Growth)



Twelve Month Moving Average Core Inflation

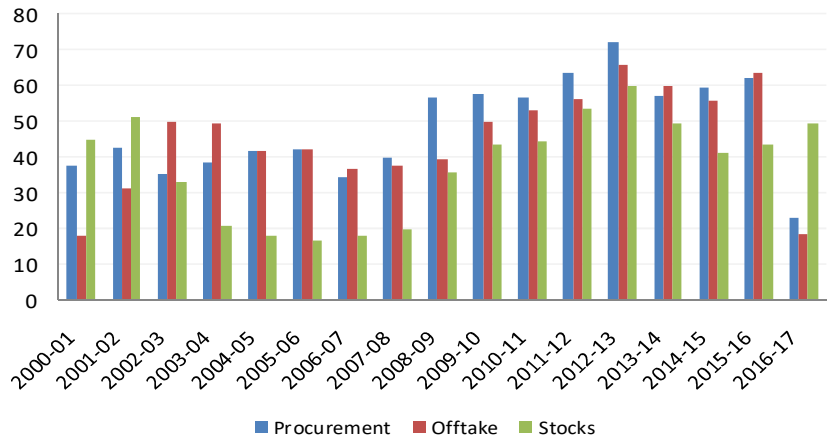


Inflation Expectations

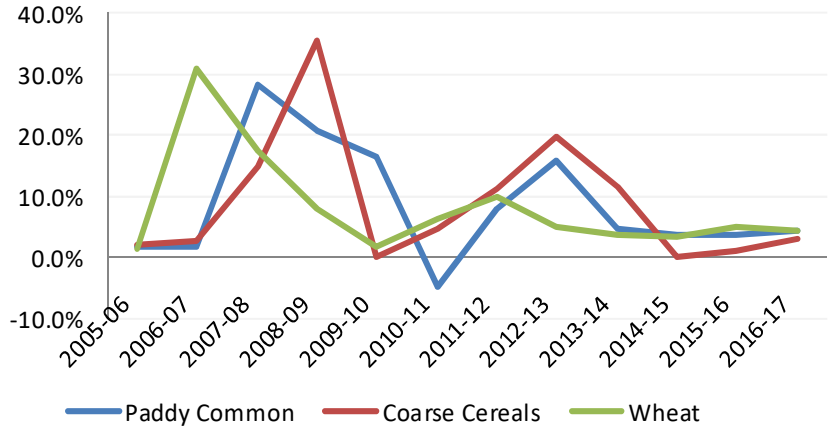


Inflation Picture: Adequate food stocks in conjunction with slower price growth and improved agricultural output

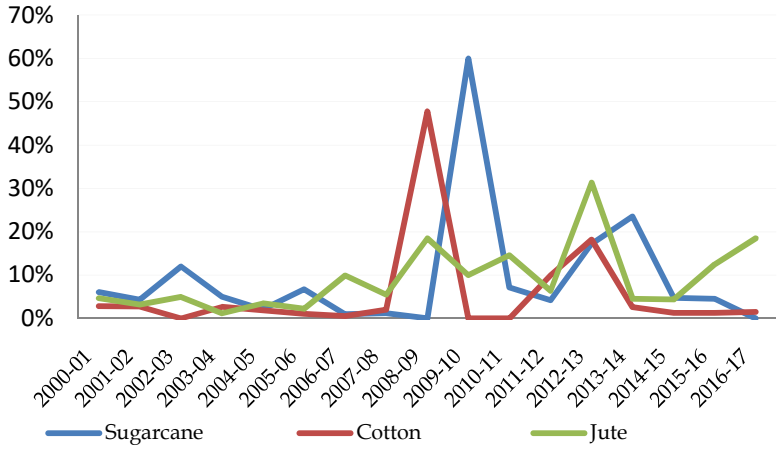
Public Distribution System (Million Tonnes)



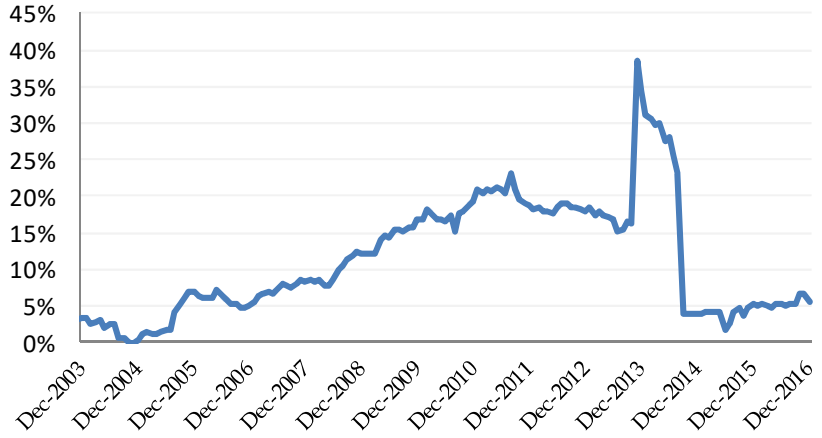
MSP Prices – Food Grains (%chg)



MSP Prices – Non Food Grains (%chg)

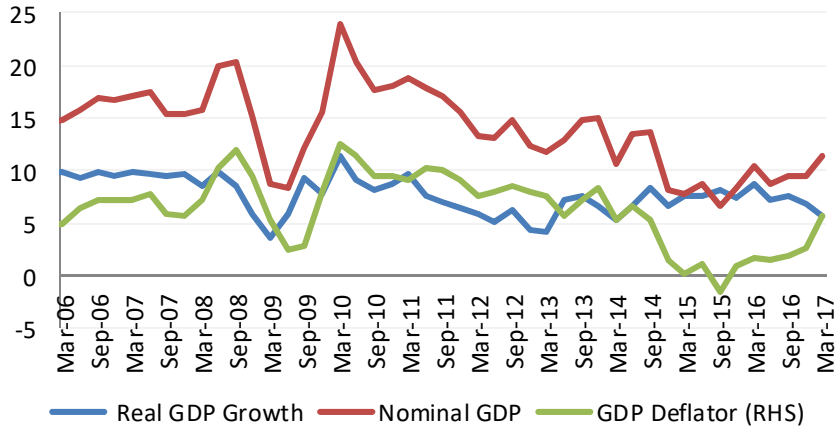


Rural Wage Growth

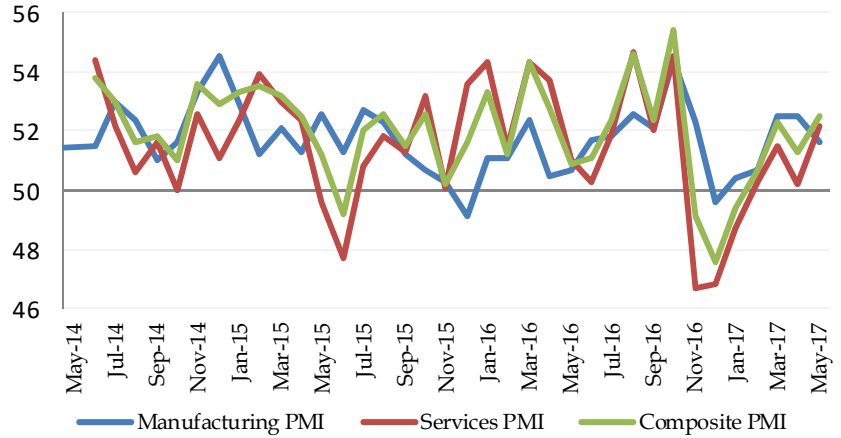


Growth Picture: PMI has recovered post the demonetisation slump

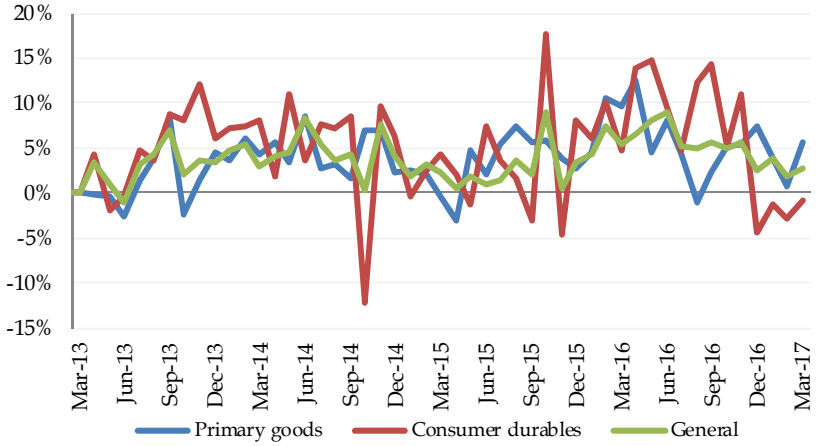
Real GDP Growth



India PMI



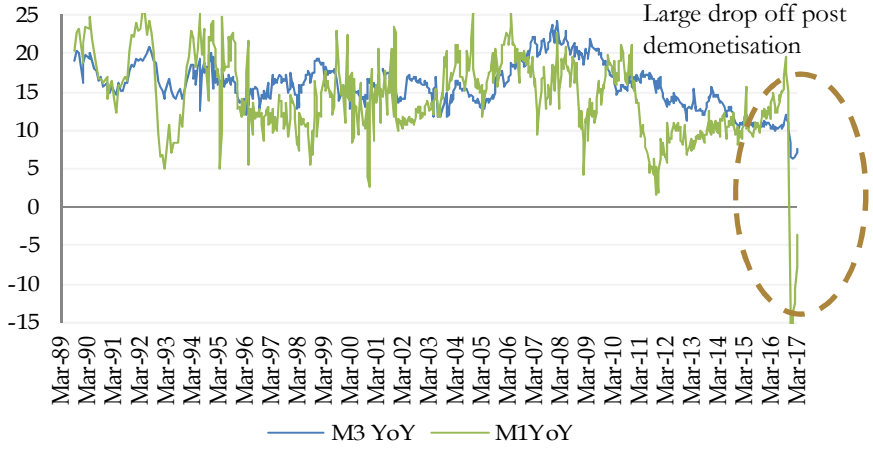
Index of Industrial Production



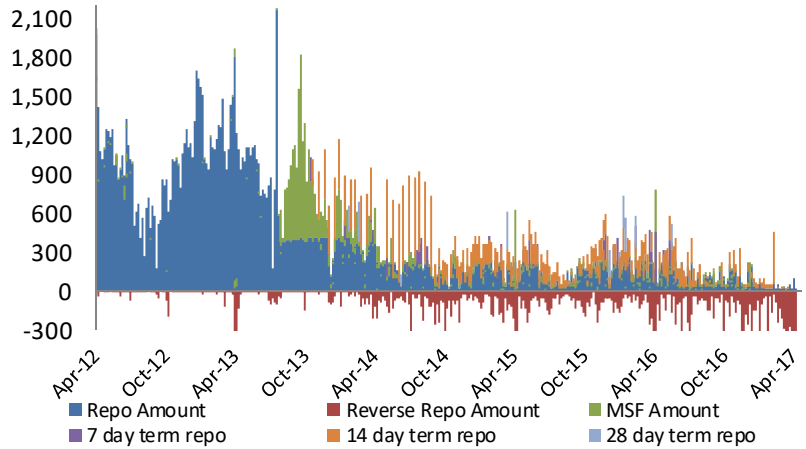
- The revised GDP figures indicate there has been a slowdown in GDP as the market has suspected all along
- Muted industrial production across all sectors. The consumer sector had slumped after the demonetisation but is now showing signs of recovery.
- We expect the IIP to be less volatile under the 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

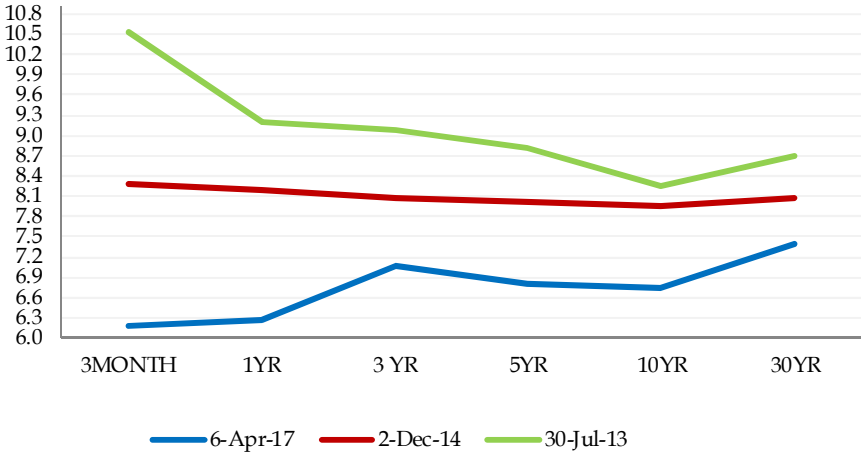
Money Supply Growth



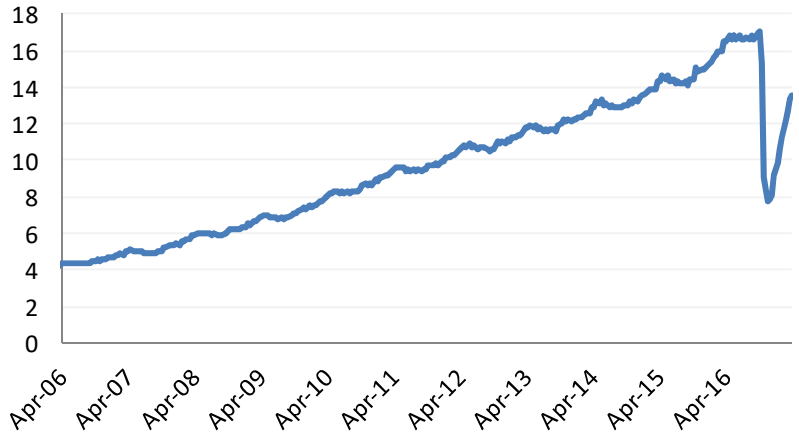
Liquidity Adjustment Facility (Rs. B)



Yield Curve

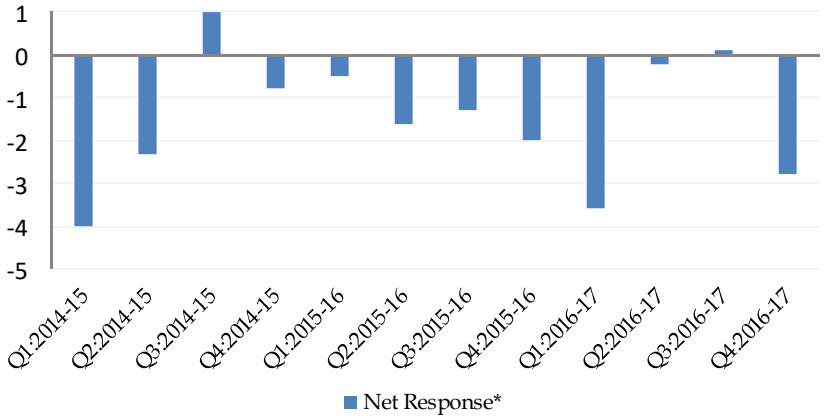


Currency in Circulation (Rs. TRN)

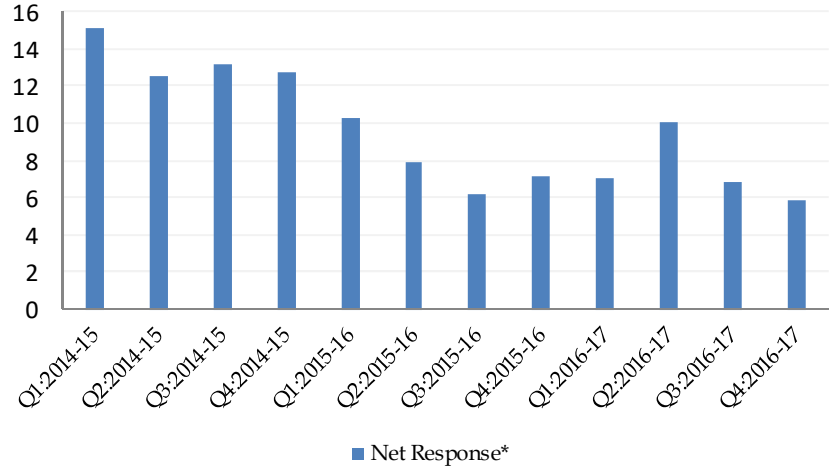


Pricing Power: Producer's pricing power compromised

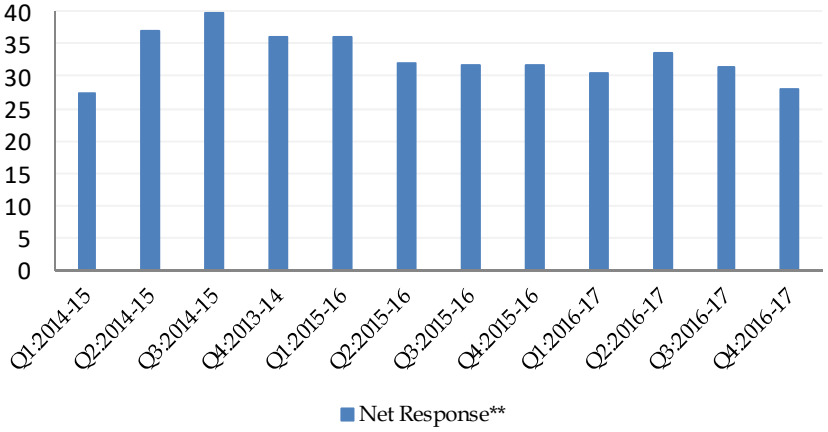
Expectations of Profit Margin – RBI Industrial Outlook Survey (% response)



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



Expectations of Overall Business Situation – RBI Industrial Outlook Survey

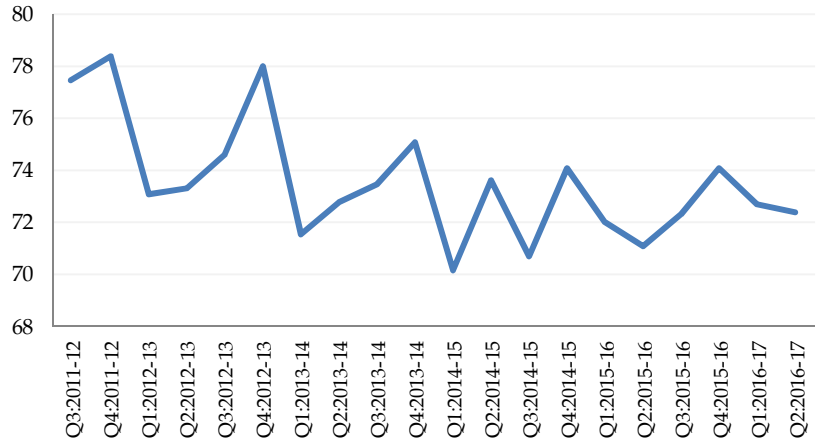


- FY16 saw a continued drop in operating profit growth indicating moderation in pricing power
- Companies highly impacted by high interest rates as interest costs as a percentage of operating profits increased
- RBI's Industrial Outlook indicates companies' expectation of selling price and profit margin 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

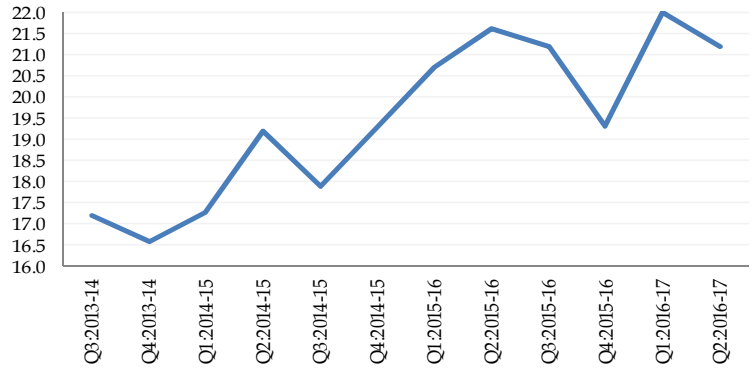
* The difference between % of respondents which indicated that profit margin and selling price will increase and those that answered it will decrease
** The difference between % of respondents which indicated that the overall business situation will improve and those that indicated it will worsen

Output Gap: Capacity Utilisation down, inventory build up

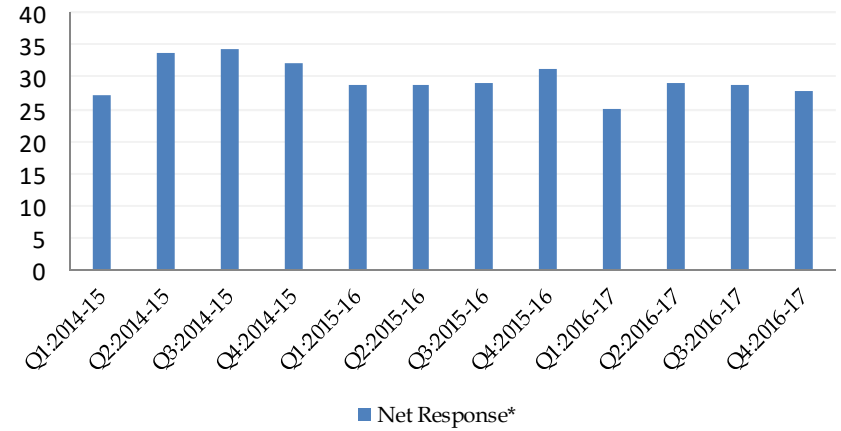
Capacity Utilization (OBICUS %)



Average Finished Goods Inventory / Sales Ratio (OBICUS)



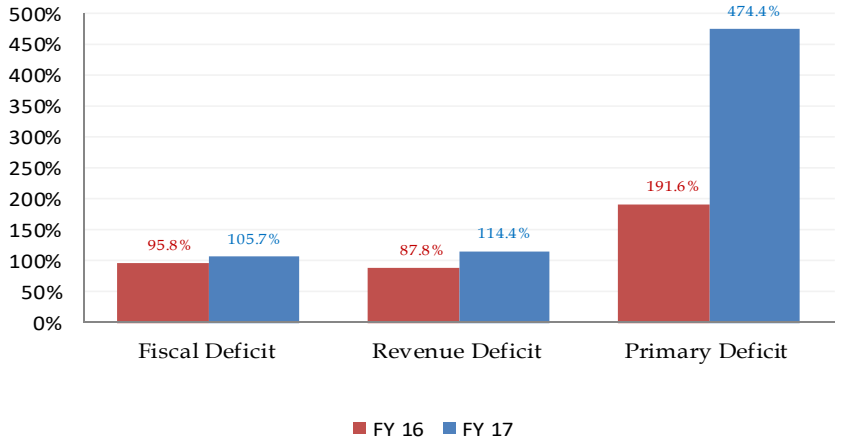
Expectation for Production (Industrial Outlook Survey %)



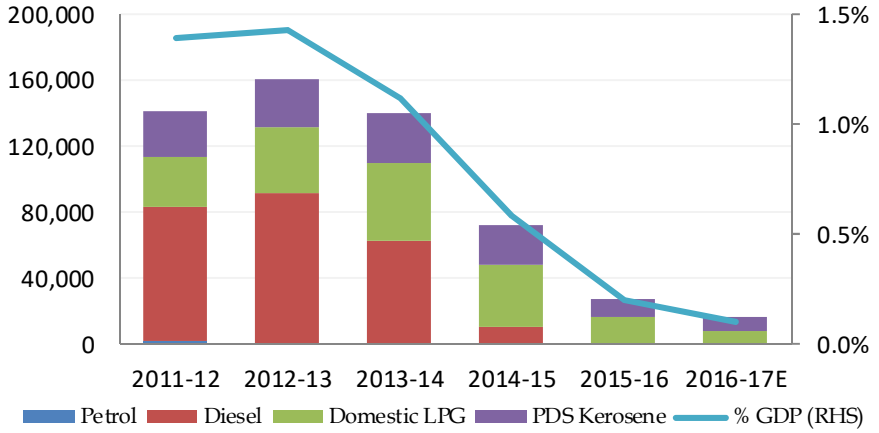
- The RBI's Order Books, Inventories, and Capacity Utilisation Survey (OBICUS) survey continues to show a decline in the level of capacity utilization
- The fall in capacity utilisation is visible across industry groups and especially pronounced in sponge iron and petroleum products
- Inventory levels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

Fiscal Discipline: Budget has outlined a prudent consolidation path

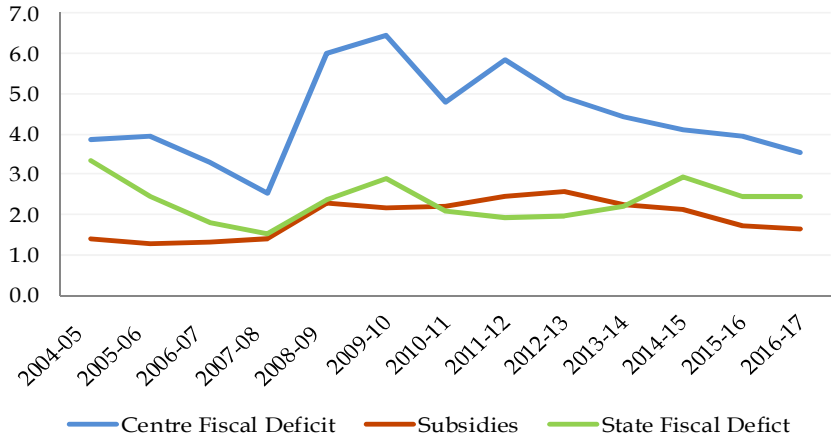
Fiscal Position up to January 2017 % actual to budget estimates



Public Sector Oil Marketing Companies Under recoveries



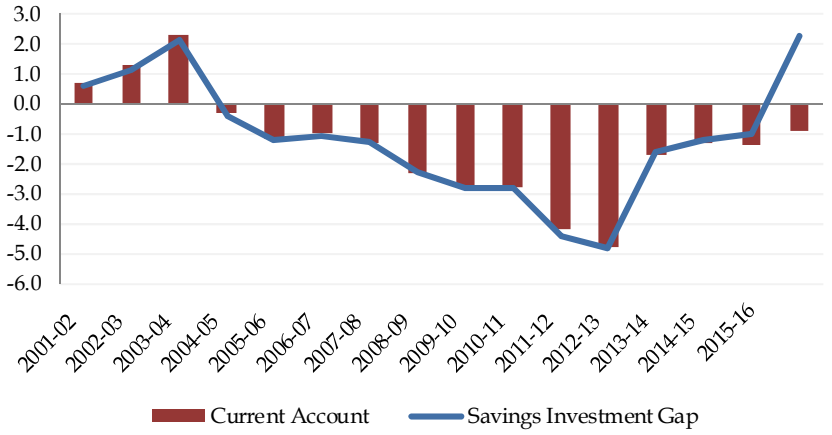
Fiscal Deficit (% of GDP)



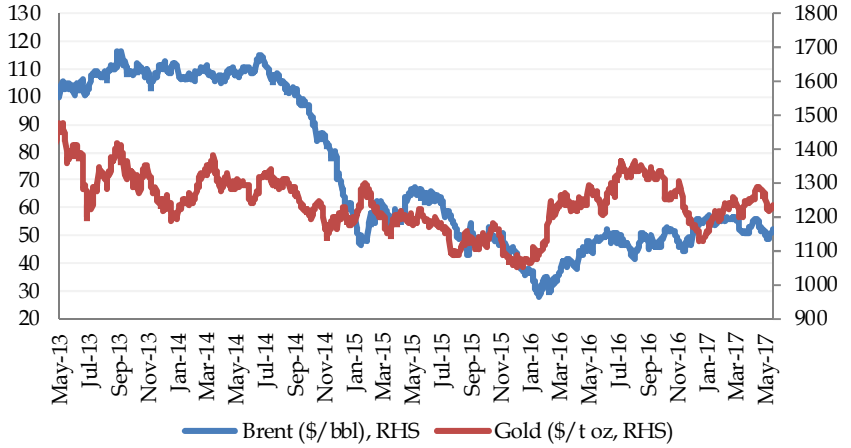
- The RBI has repeatedly stated that fiscal consolidation is very important.
- The government has made deep commitment to fiscal discipline at 3.5%, and lowered structural impediments to lower rate transmission by reducing PF, small savings and Kisan Vikas Patra rates. Moreover these rates are now revised more frequently to reflect market conditions.
- Given all the improvements the government will achieve its fiscal deficit target of 3.5% as forecasted by the budget for FY17 despite the current 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.

CAD: Substantial improvement over the last two years

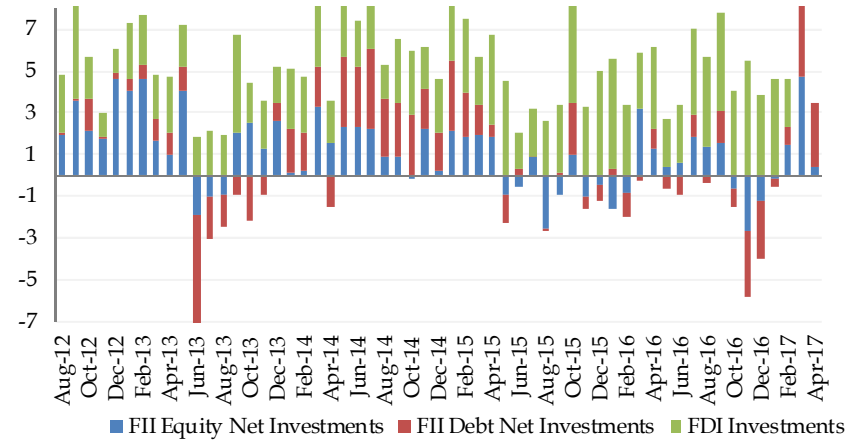
Current Account and Saving Investment Gap as % of GDP



Oil and Gold Prices



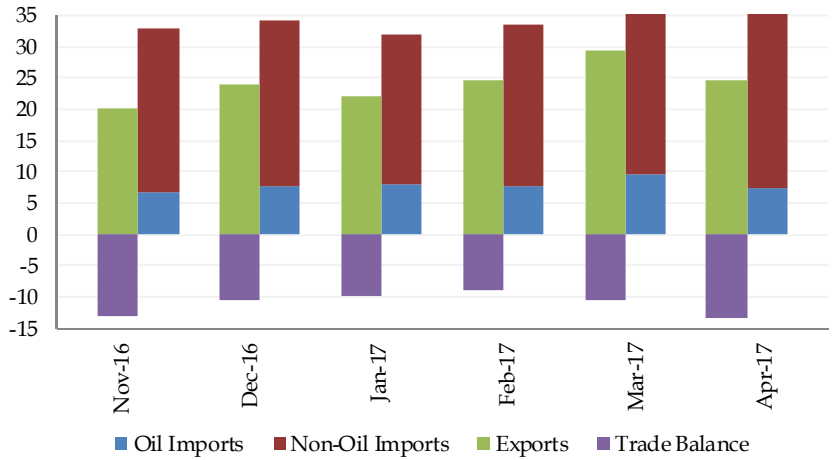
FII Investments



- The current account deficit (CAD) had emerged as a major source of concern for both monetary policy and financial stability
- The CAD has come in at 1.4% in Q3 FY17 vs 0.6% in Q2 FY17. 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)



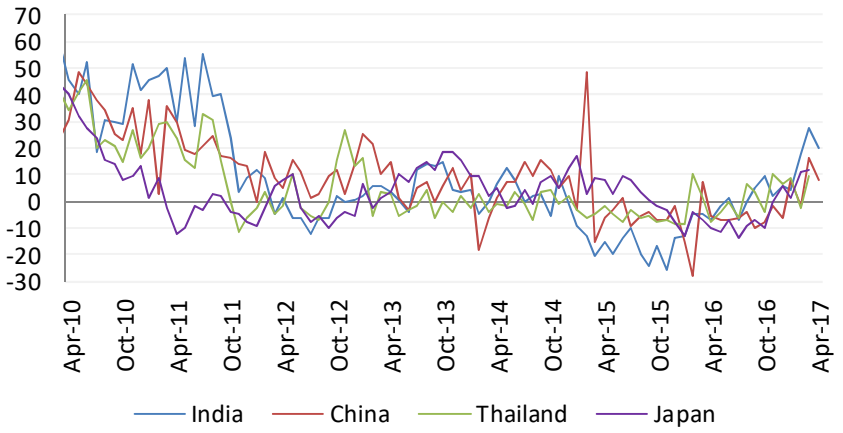
Top 10 Imports ($M)

Commodity Group	Apr-Mar 2016	Apr-Mar 2017(P)	%Growth	%Share
Pertoleum Crude & Products	82,944	86,866	5	23
Gems & Jewellery	56,509	53,816	-5	14
Electoronics Items	40,022	41,947	5	11
Chemicals & Related Products	36,888	33,658	-9	9
Machinery	33,217	32,987	-1	9
Base Metals	24,704	21,557	-13	6
Ores & Minerals	20,684	21,559	4	6
Agri & Allied Products	20,674	23,204	12	6
Transport Equipments	15,394	18,070	17	5
Plastic & Rubber Articles	13,761	14,019	2	4
Total	**381,007**	**382,741**	**0**	**100**

Top 10 Exports ($M)

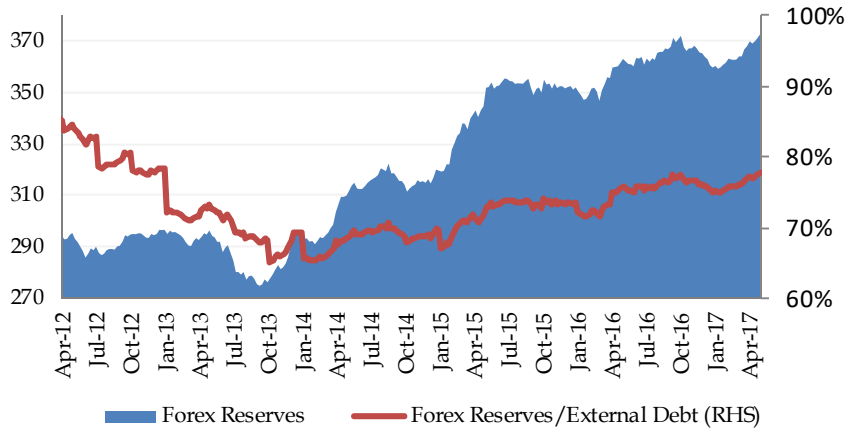
Commodity Group	Apr-Mar 2016	Apr-Mar 2017(P)	%Growth	%Share
Gems & Jewellery	39,283	43,551	11	16
Chemicals & Related Products	32,169	32,932	2	12
Pertoleum Crude & Products	30,583	31,622	3	11
Agri & Allied Products	24,522	24,657	1	9
Transport Equipments	21,336	23,144	8	8
Base Metals	18,498	21,985	19	8
Machinery	18,922	20,033	6	7
Plastic & Rubber Articles	6,416	6,463	1	2
Leather & Leather Manufactures	5,554	5,326	-4	2
Electoronics Items	5,690	5,687	0	2
Total	**262,290**	**276,547**	**5**	**100**

Export Growth

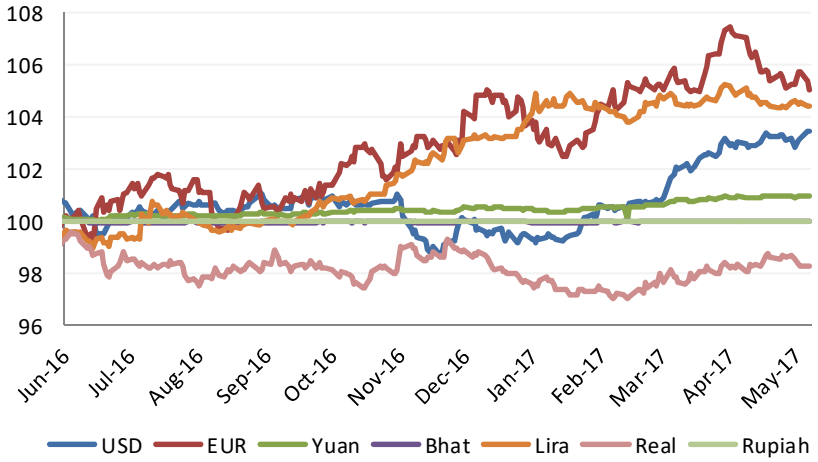


India's forex reserves have grown in absolute and relative terms

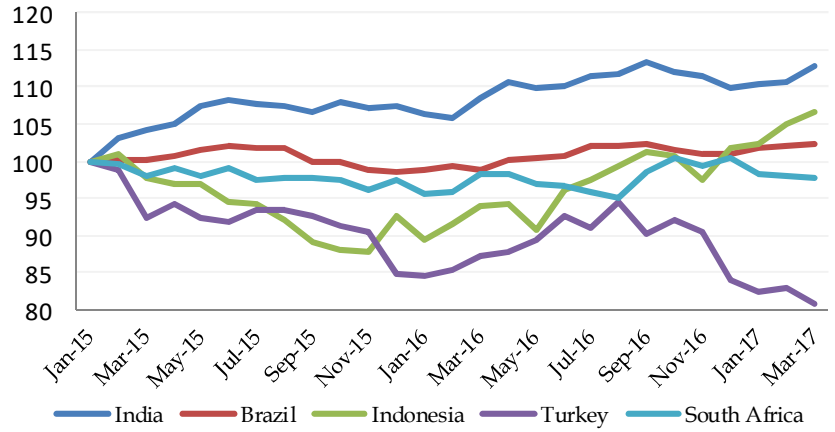
Foreign Exchange Reserves (SB)



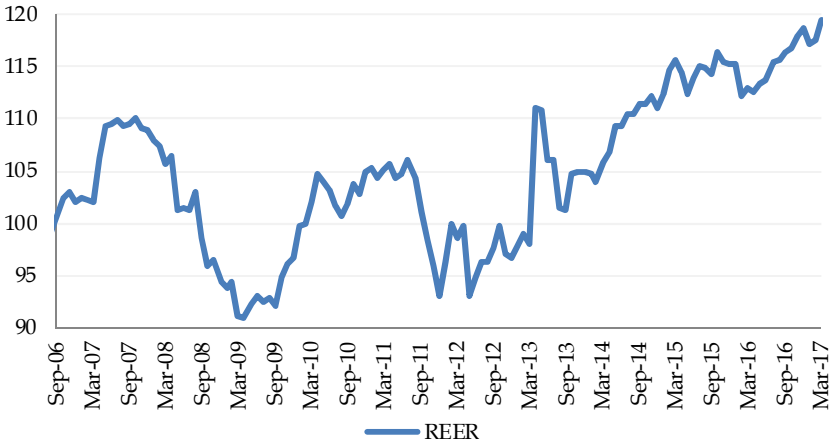
Rupee vs Selected Currencies



Foreign Exchange Reserve Additions

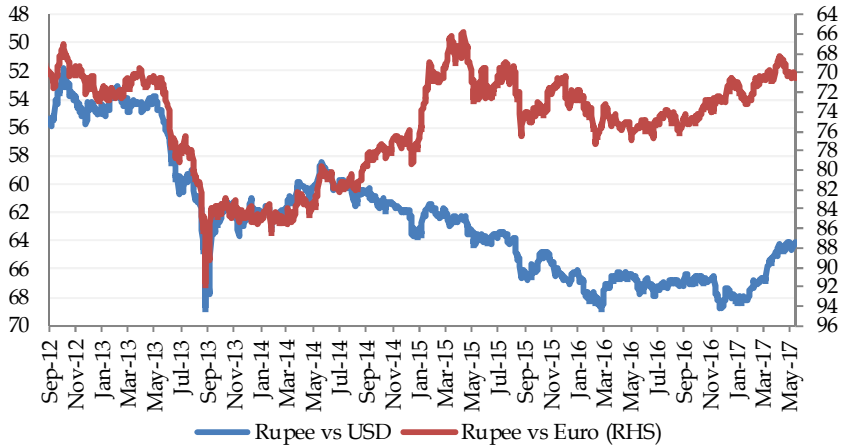


Real Effective Exchange Rate

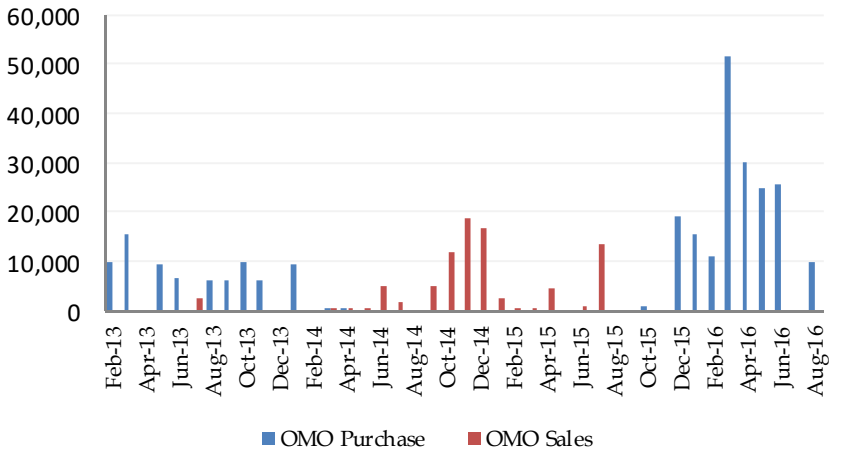


RBI constrained by excess liquidity in intervening in FX markets

Rupee Performance



Net RBI OMO Sale/Purchase



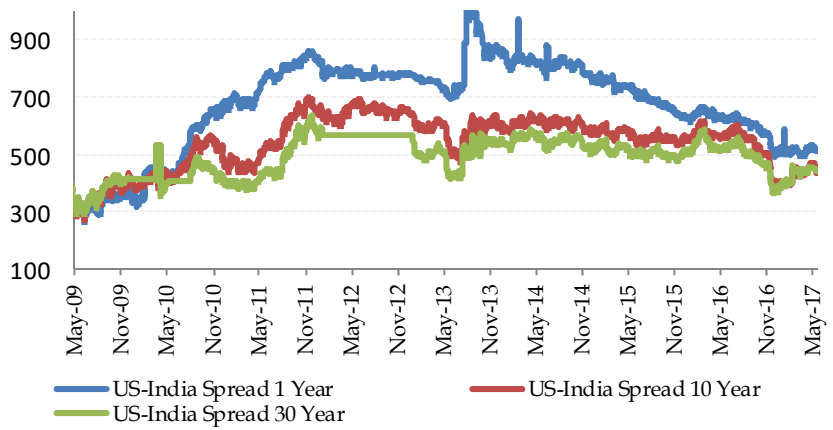
Sale/Purchase of Dollars by RBI

Period	RBI Gross Sale $	RBI Gross Purchase of $	RBI Net Purchase of $	Outstanding Forward Sales (-)/Purchase (+)
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
Nov-16	21,845	19,127	-2,718	2,944
Oct-16	9,966	9,548	-418	5,632
Last 12 Months	**59,413**	**71,764**	**12,351**	

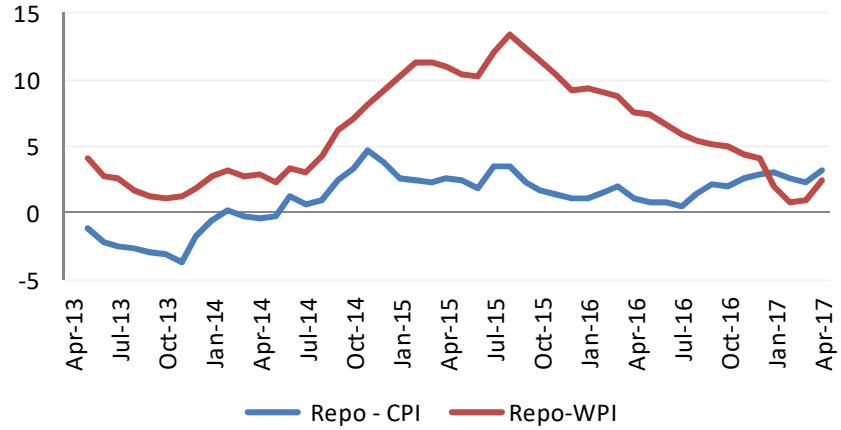
- The Rupee has actually appreciated against the dollar after the state assembly election to a 11 months high. The results of the election has increased the governments ability to carry out reforms.
- While the RBI continues to intervene in FX markets ,its ability to slowdown the INR appreciation has 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

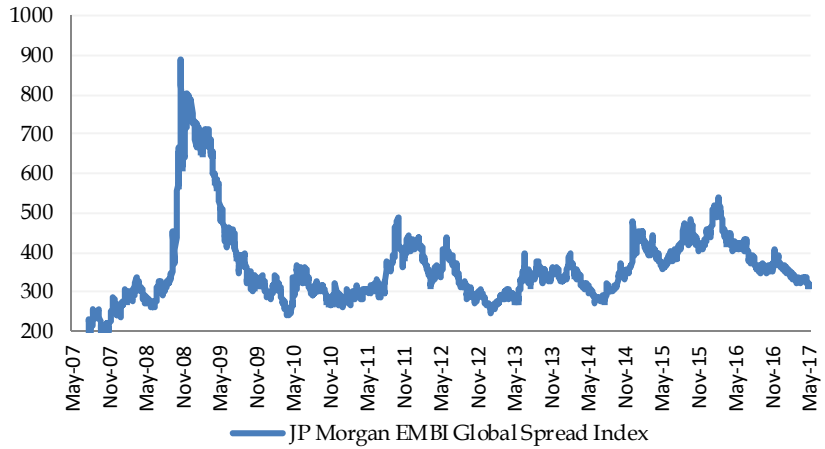
U.S Treasury-India G-sec Credit Spreads



Real Rates*



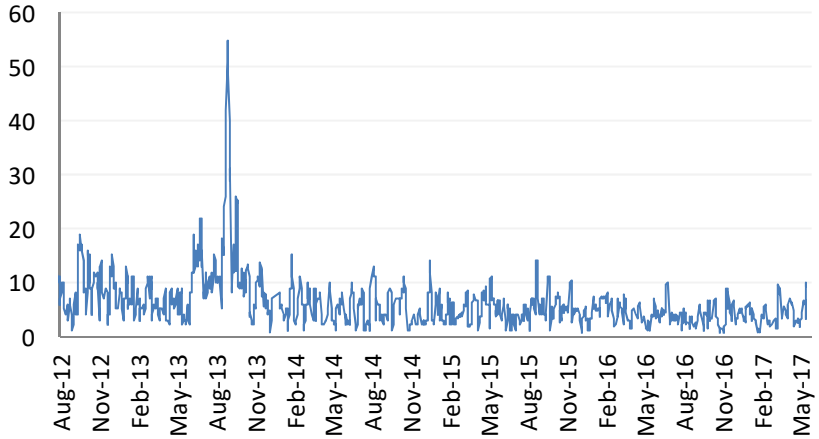
JP Morgan EMBI Spread Index



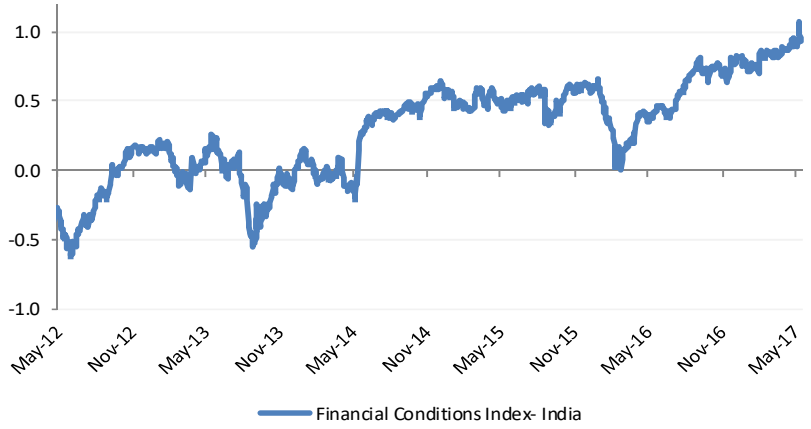
- As the U.S yields have risen and Indian yields moving down, the U.S India spread has come down from its recent highs
- India is also currently experiencing positive real rates. The real rate as measured by the Repo-CPI has moved down as the RBI has increased CPI has fallen faster than the policy rate. 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



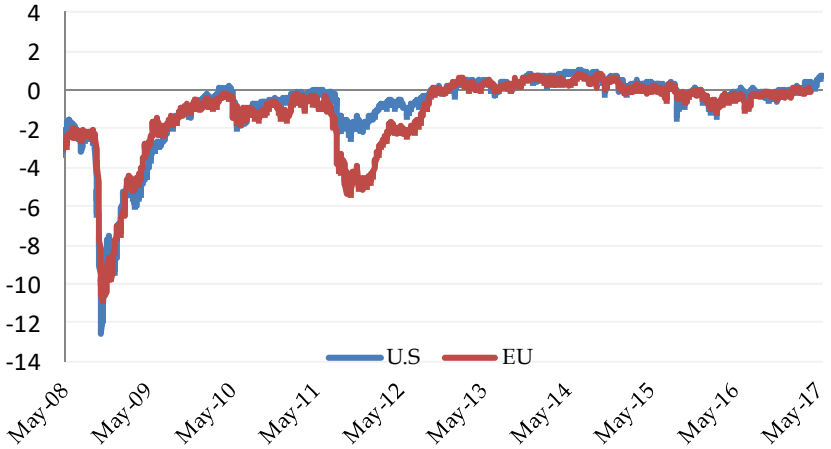
Trust India Financial Conditions Index



Bloomberg Asia Ex-Japan Financial Conditions Index

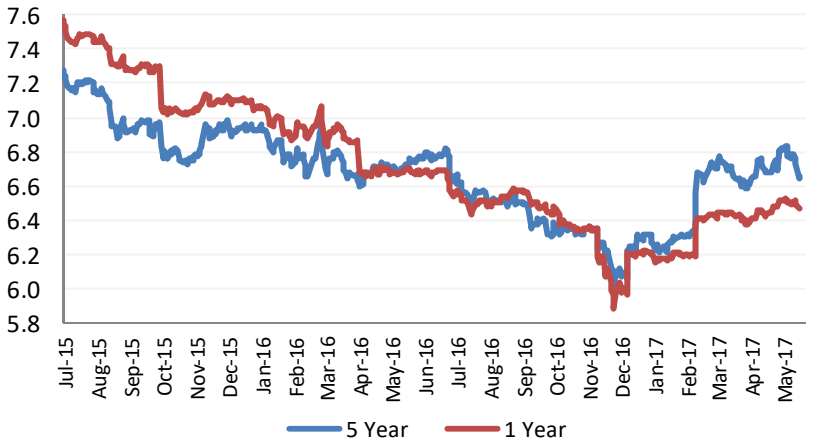


Bloomberg U.S EU Financial Conditions Index

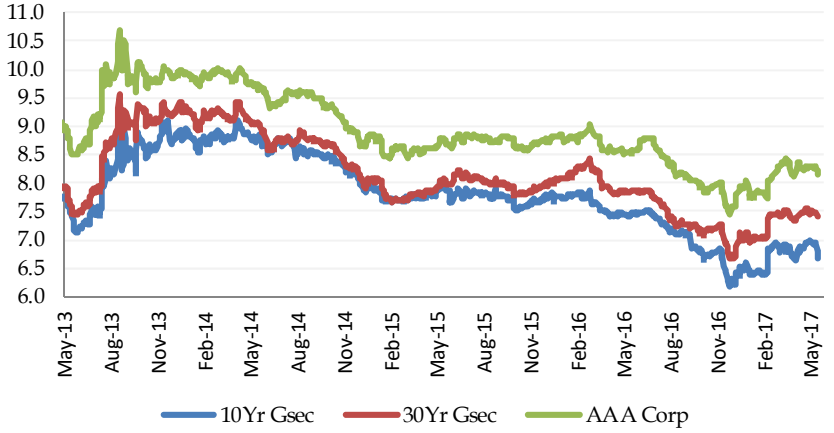


The rally in Indian bond markets was reversed with the change in stance

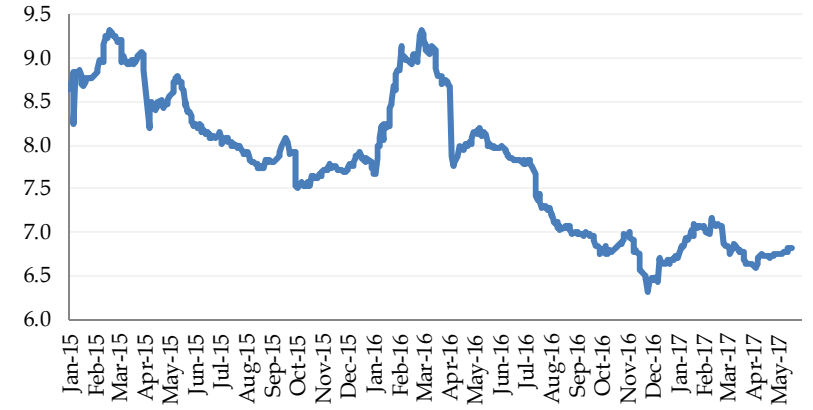
On-shore Swap Rates



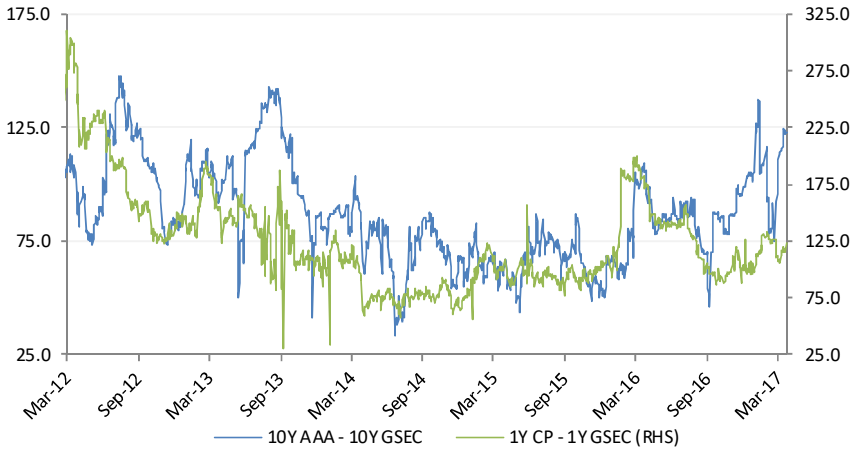
Selected Yields



3 Month CP Rates



10 Year and 1 Year Corp AAA Spreads (bps)



Our View: Rates to remain on hold consistent with neutral stance

- In its February policy the RBI surprised the market by shifting its stance from accommodative to neutral.
- In that policy the RBI had 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 since the policy, the Rupee has appreciated to four year highs.
- The RBI is actually in a corner in its efforts to stem the rapid appreciation of the Rupee. In some respects the Rupee appreciation is helpful as it reduces the risk of imported inflation however the RBI does not desire such a rapid appreciation. Intervention to weaken the Rupee ends up boosting domestic liquidity at a time where the banking system is awash with surplus liquidity. If the RBI does not intervene the Rupee could continue appreciating setting it up for future volatility of the currency.
- Furthermore inflation has been below RBI's medium target and we expect to remain below 4% for the next few months.
- Therefore the RBI may be forced to recalibrate its monetary stance given the persistent strength of the Rupee and inflation undershooting RBI's projections. The revised GDP with the new CPI/WPI series would also imply that the RBI should soften its stance.
- However the RBI's prior statements seem to indicate that it is currently committed to its neutral stance and hence will maintain the status quo while softening its tone and remaining data dependent.
- In terms of inflation, the trend in WPI should be monitored closely as it impacts the CPI with a lag. The recent rise in WPI partly represents a rise in cost inflation and this cost inflation has so far not been passed on to end products. As the economy revamps post demonetisation this cost inflation will feed into headline CPI inflation.
- Looking forward, the RBI expects that surplus liquidity should decline with progressive remonetisation. Nonetheless, the currently abundant liquidity with banks has persisted into 2017-18. The RBI is currently attempting to tackle the liquidity surplus problem which should give it more flexibility in managing Rupee volatility in the medium term. Meanwhile the stable currency continues to attract FII inflows into Indian debt as it presents an attractive carry opportunity.

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Thank You

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