December RBI Monetary Policy Preview

December 2017

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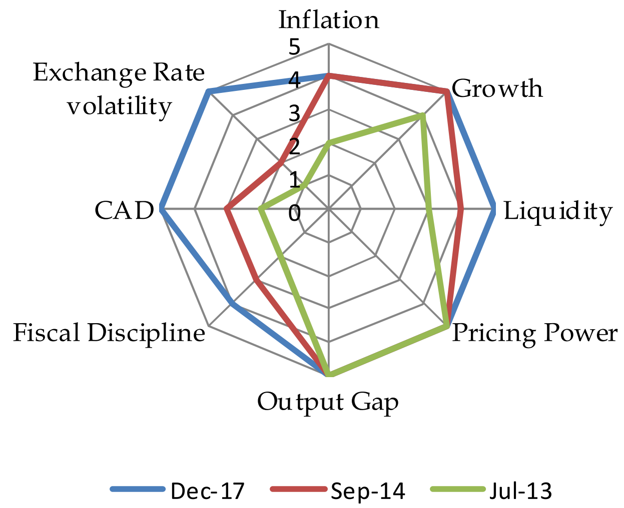
RBI Dashboard

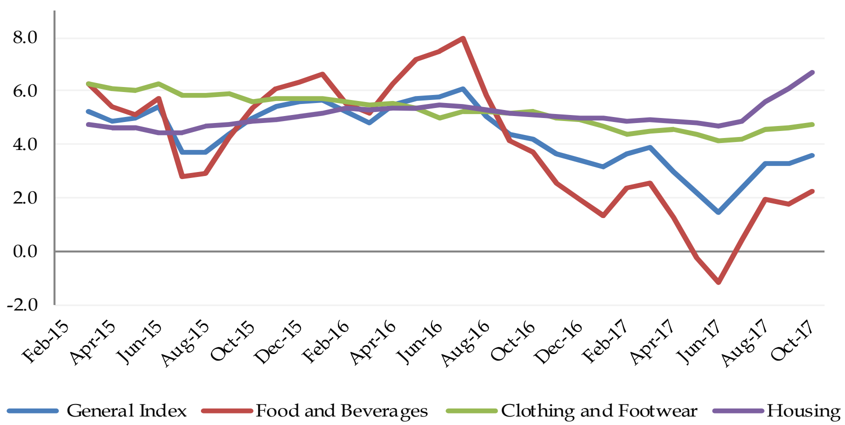
- RBI's objectives as set out in Urjit Patel Committee Report:
  - Headline CPI - nominal anchor for policy communication.
    - Target: 4% with a band of +/- 2% tolerance
  - Monetary Policy Committee (MPC) vested with Monetary Policy decision
    - Policy rule defined in terms of a real policy rate 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.
    - Inflation has ticked up but still remains below RBI's medium term target

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

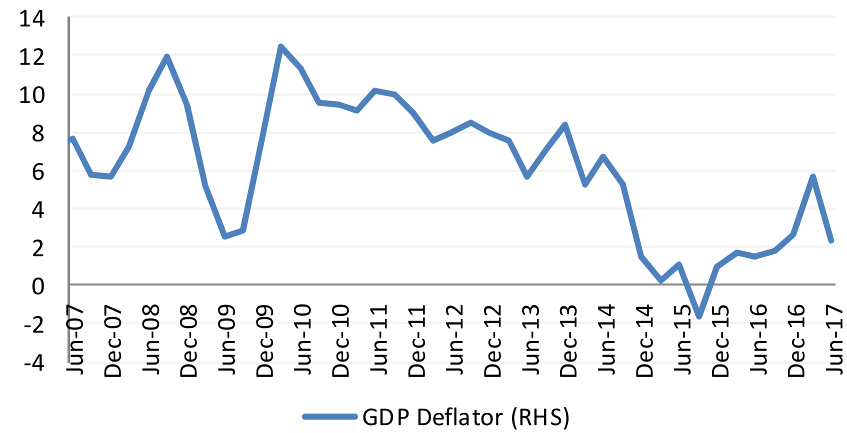


Inflation Picture: CPI has picked up from its recent record lows

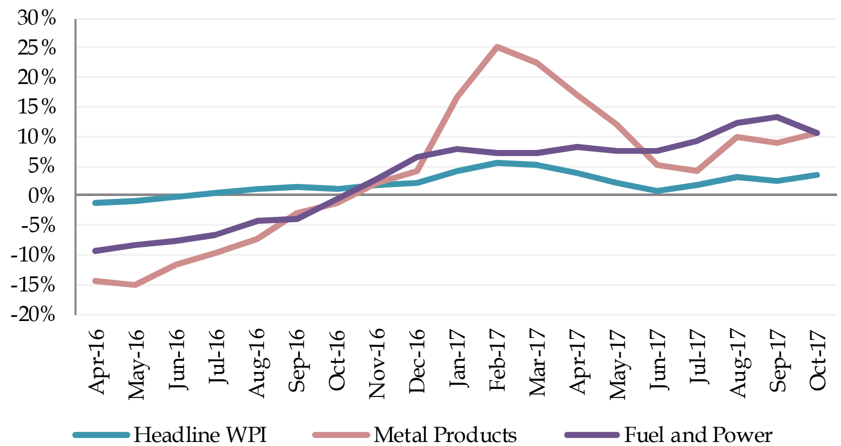
India CPI



GDP Deflator



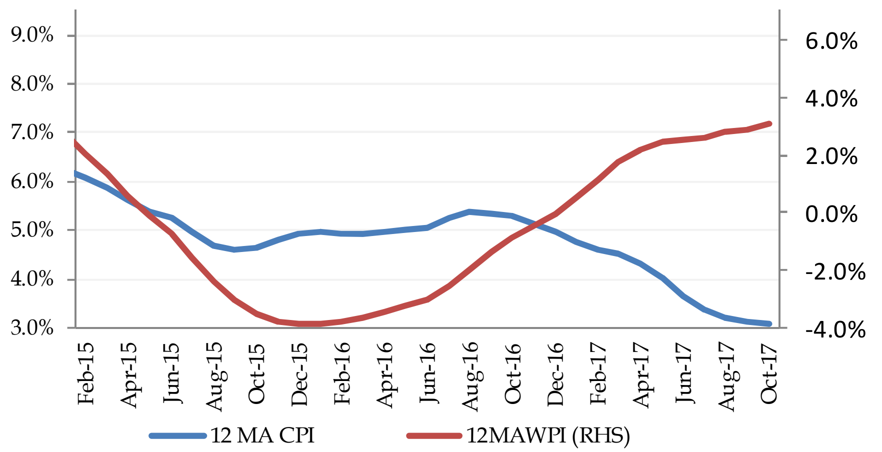
WPI



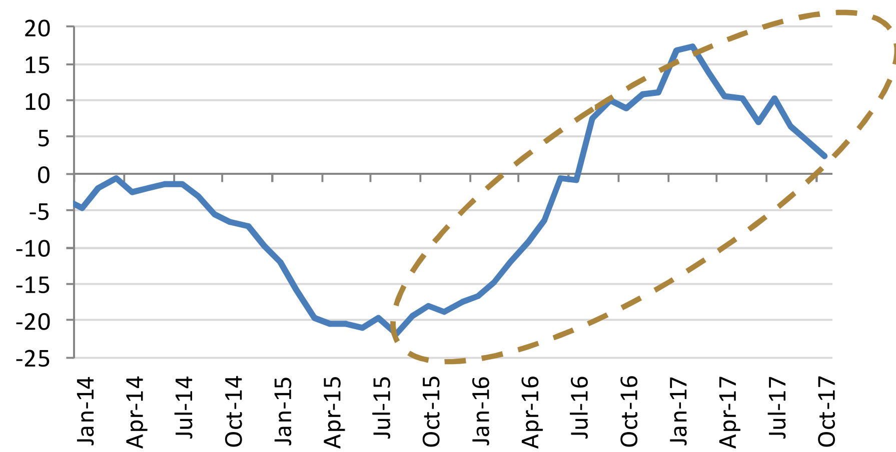
- After falling to record lows up to June, CPI inflation has picked up in the last few readings, although it remains below the RBI's medium term trajectory.
- We expect the inflation trajectory to continue to move up over the next several months. First demonetisation related factors that drove down inflation this time last last year are no longer in play. Second the inflation index will be impacted by an adverse base effect for the next few months. The combination of these factors could cause CPI to head to towards 5% by the January reading.
- WPI has also risen in the recent past driven by metal and petroleum products. The WPI and CPI divergence has reduced since the base revision to 2011-12.

Inflation Picture: WPI momentum has picked up CPI will follow

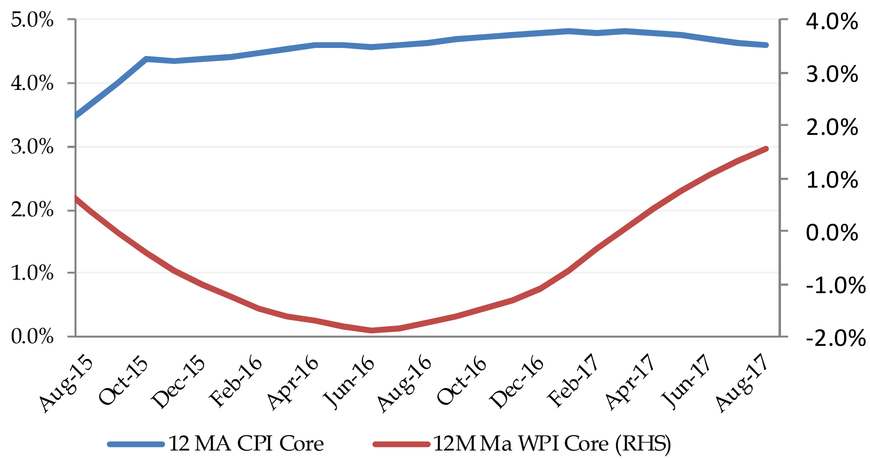
Twelve Month Moving Average Headline Inflation



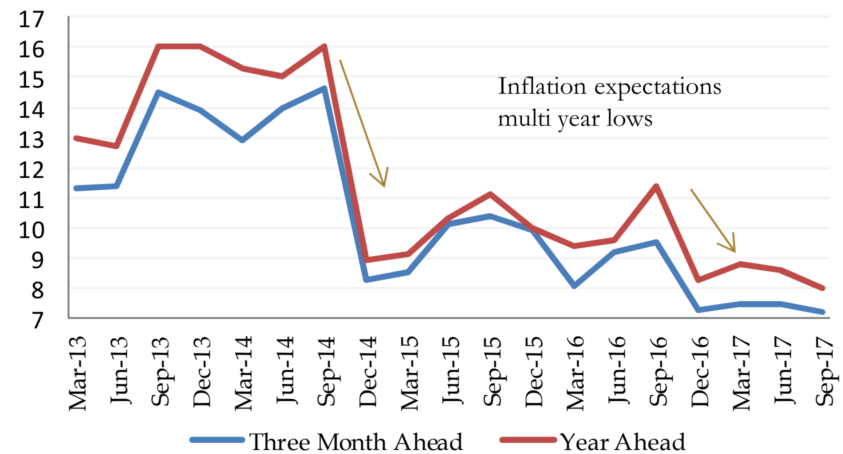
FAO Global Food Index (% Growth)



Twelve Month Moving Average Core Inflation

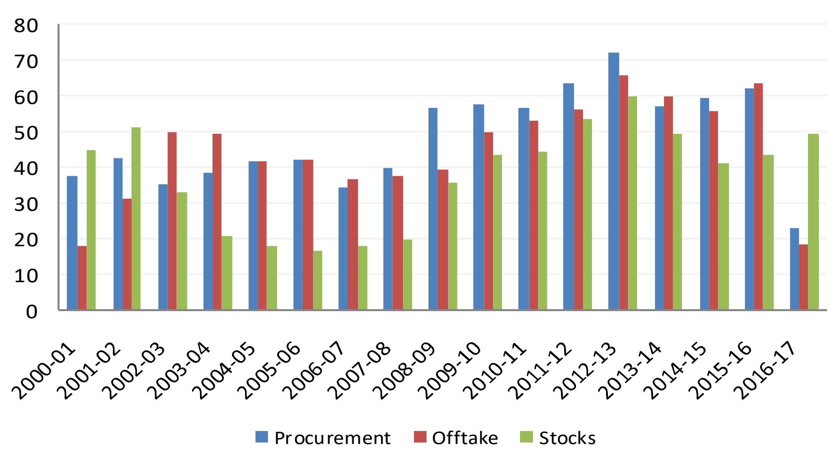


Inflation Expectations

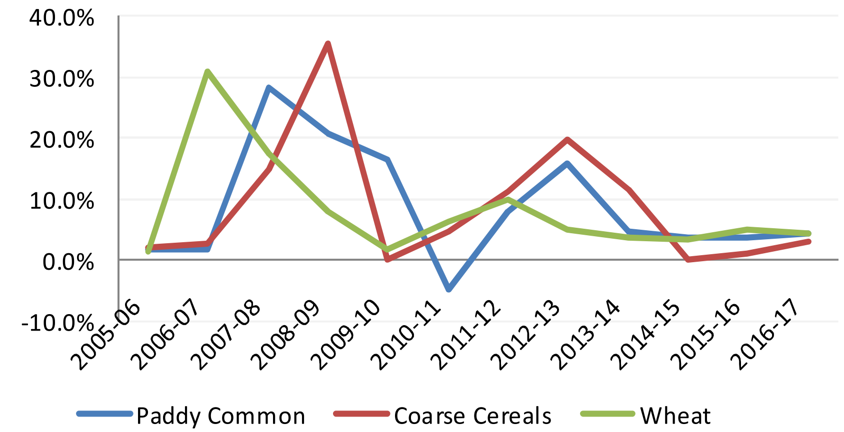


Inflation Picture: Adequate food stocks in conjunction with slower price growth and improved agricultural output

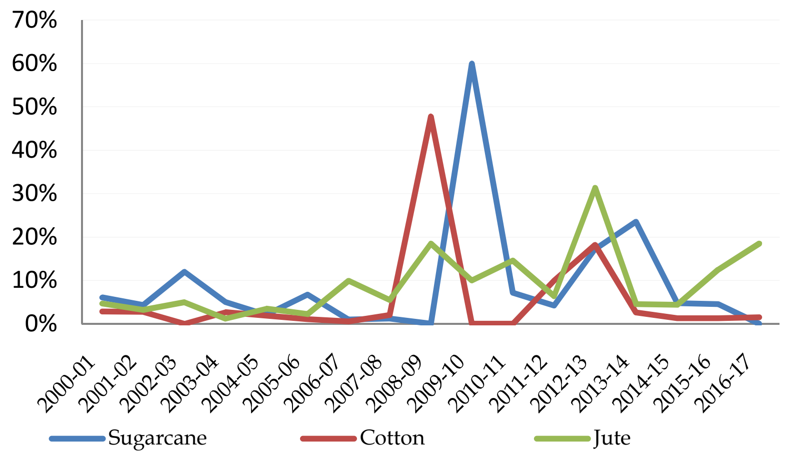
Public Distribution System (Million Tonnes)



MSP Prices – Food Grains (%chg)



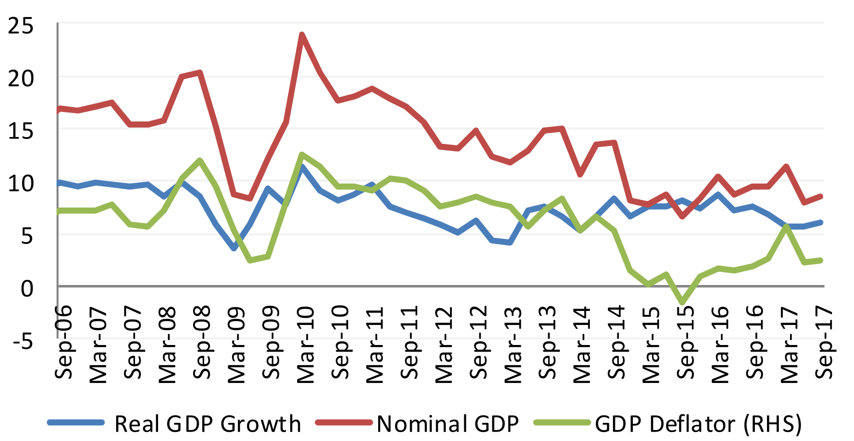
MSP Prices – Non Food Grains (%chg)



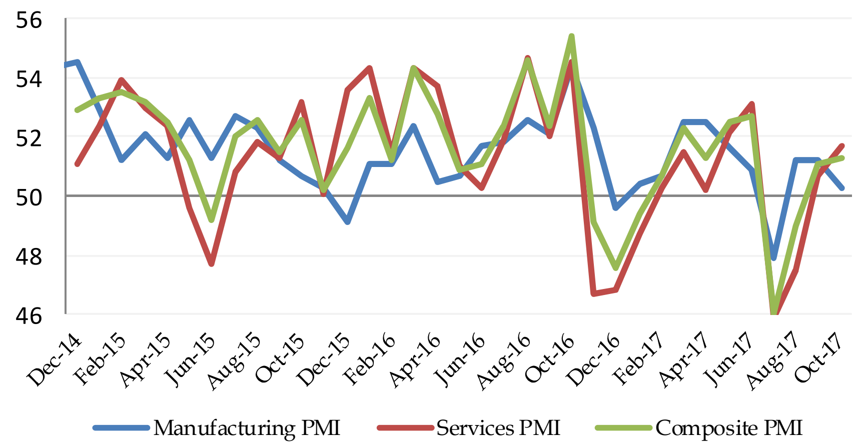
Rural Wage Growth

Growth Picture: economy working through multiple transitions

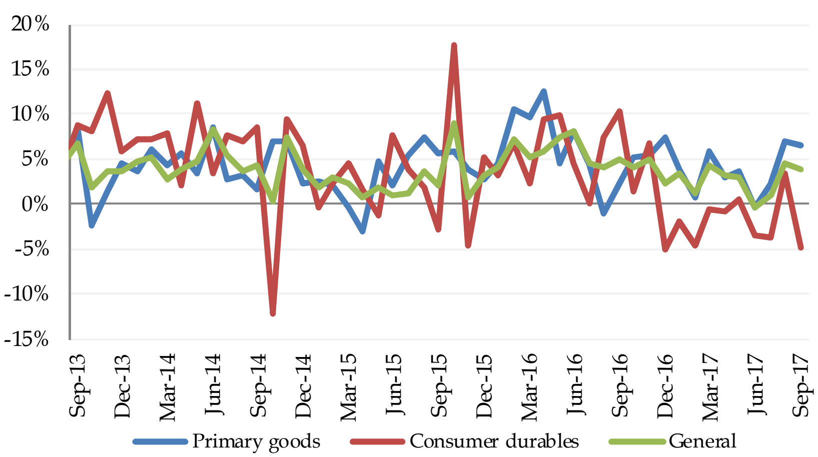
Real GDP Growth



India PMI



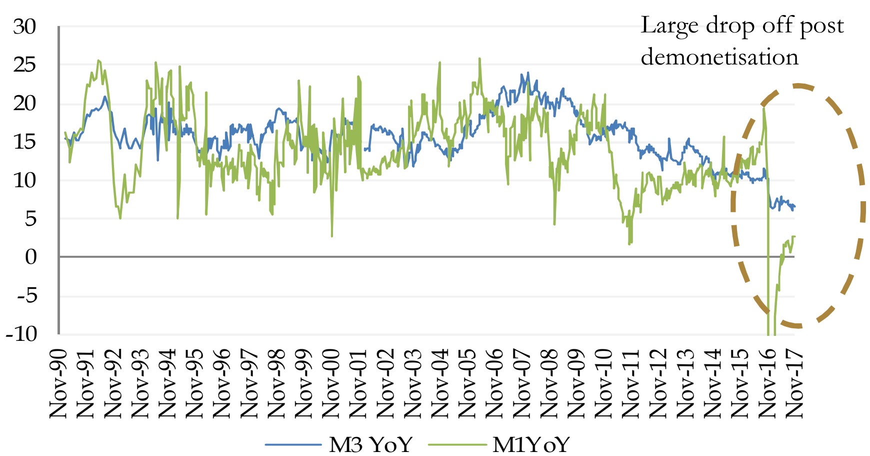
Index of Industrial Production



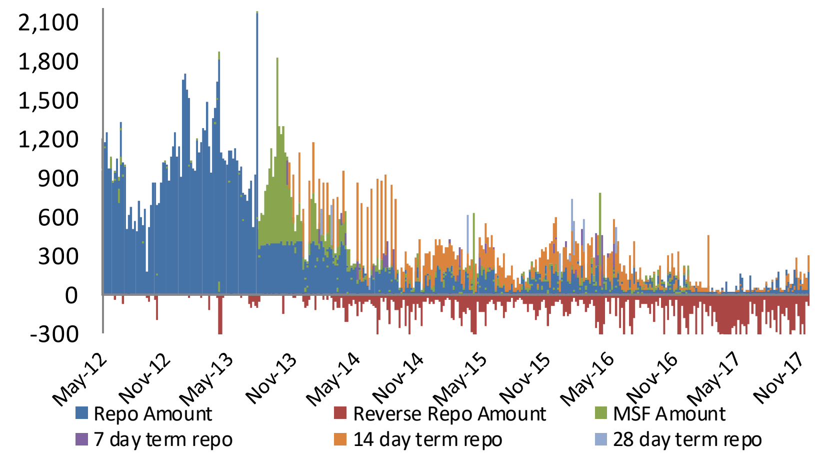
- The revised GDP figures indicate there has been a slowdown in GDP as the economy works through multiple transitions including the introduction of the GST and demonetisation.
- This transition was also visible in the industrial production data where the latest readings suggest that industrial production has been impacted by the uncertainty surrounding the introduction of GST and remaining residual impacts that arose out of the demonetisation exercise.
- However these impacts are fading as the economy adjust to the new environment as seen in the pick up in the Q2 GDP data.

Liquidity Picture: Comfortable liquidity conditions

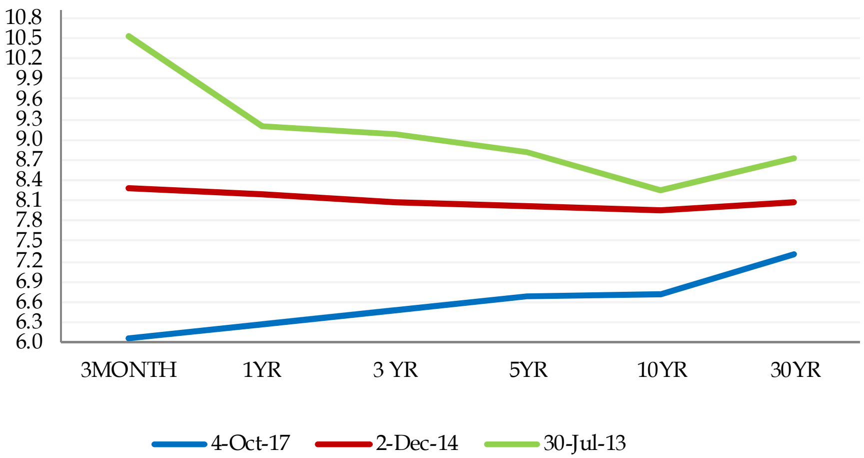
Money Supply Growth



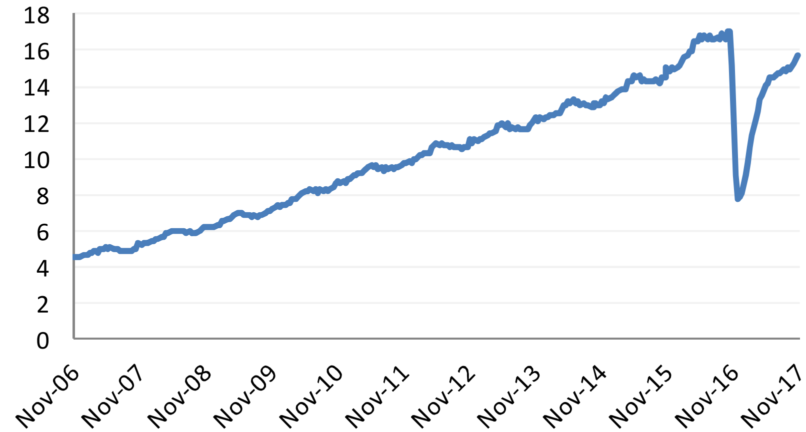
Liquidity Adjustment Facility (Rs. B)



Yield Curve

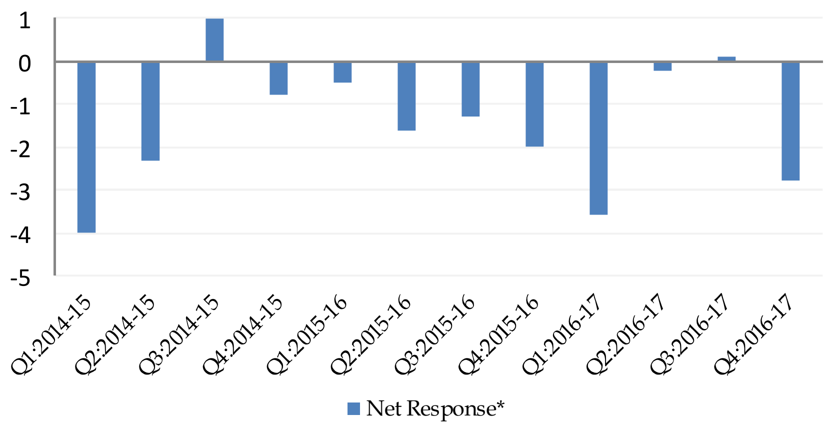


Currency in Circulation (Rs. TRN)

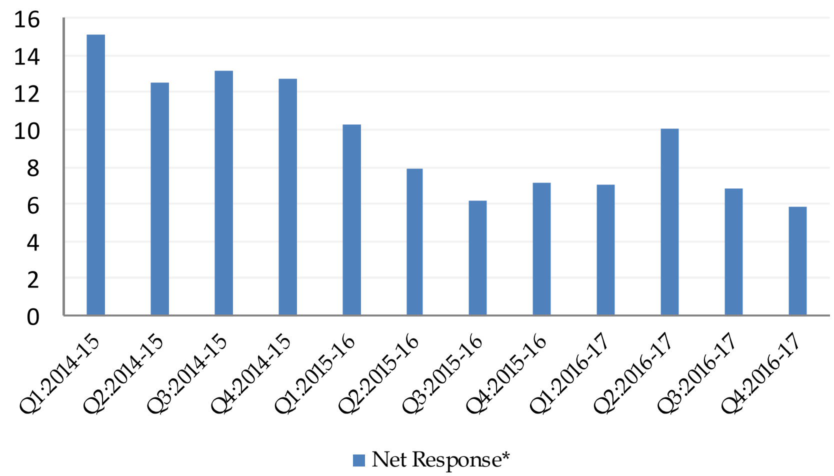


Pricing Power: Producer's pricing power compromised

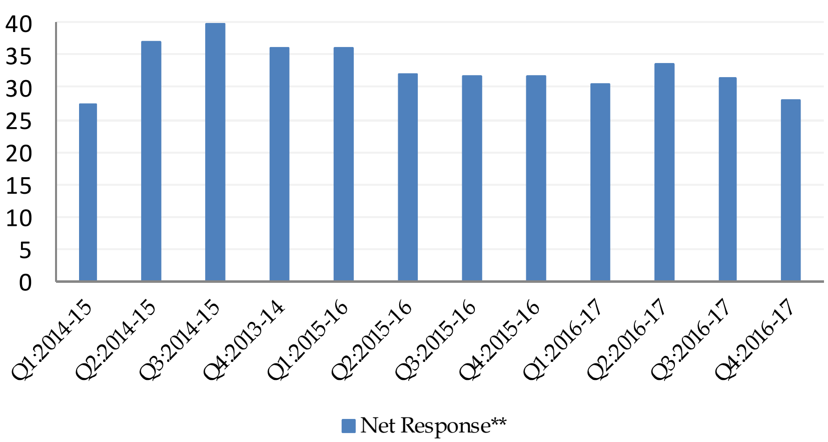
Expectations of Profit Margin – RBI Industrial Outlook Survey (% response)



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



Expectations of Overall Business Situation – RBI Industrial Outlook Survey

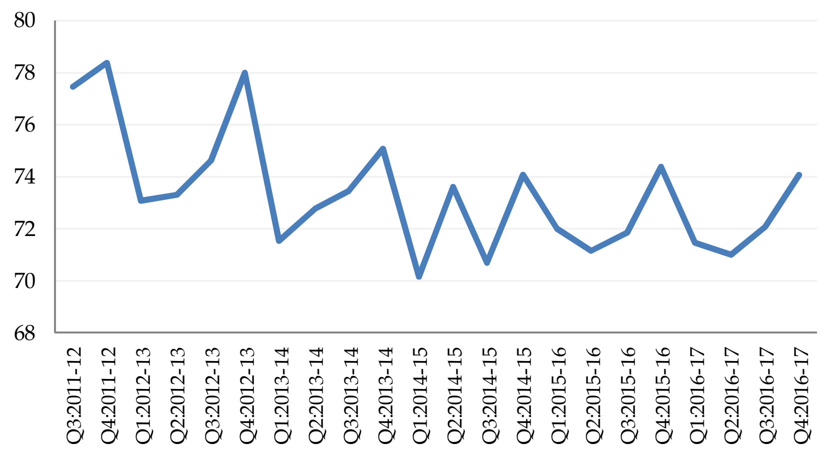


- FY17 saw a continued drop in operating profit growth indicating moderation in pricing power
- Companies highly impacted by high interest rates as interest costs as a percentage of operating profits increased
- RBI's Industrial Outlook indicates companies' expectation of selling price and profit margin 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

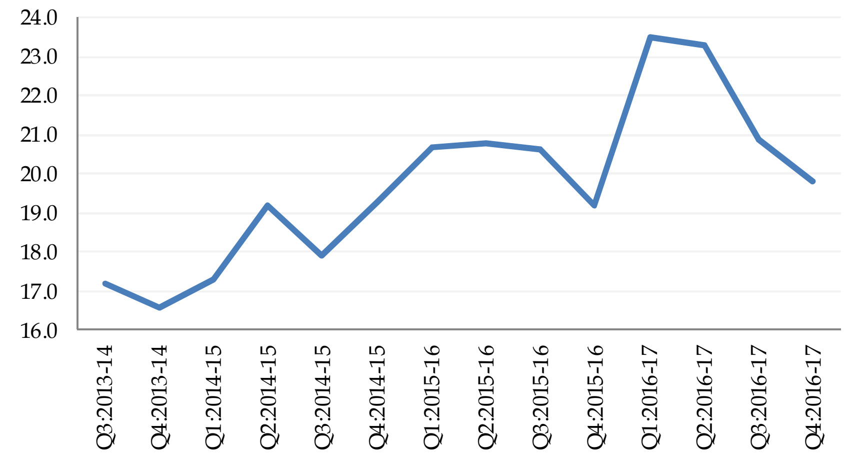
* The difference between % of respondents which indicated that profit margin and selling price will increase and those that answered it will decrease
** The difference between % of respondents which indicated that the overall business situation will improve and those that indicated it will worsen

Output Gap: Capacity Utilisation down, inventory build up

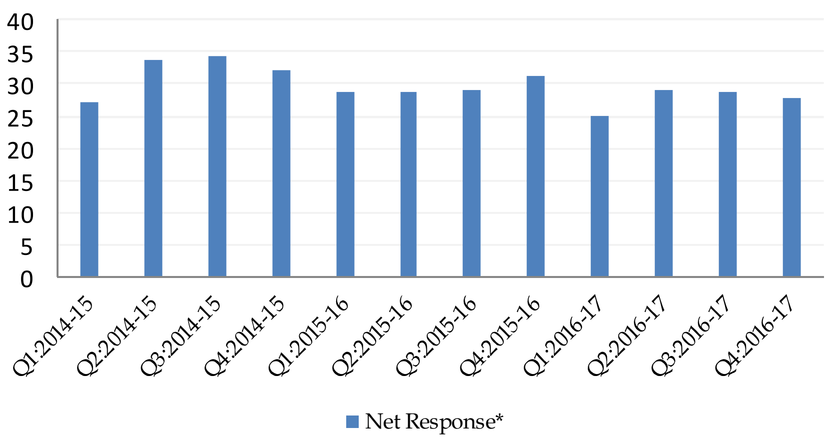
Capacity Utilization (OBICUS %)



Average Finished Goods Inventory / Sales Ratio (OBICUS)



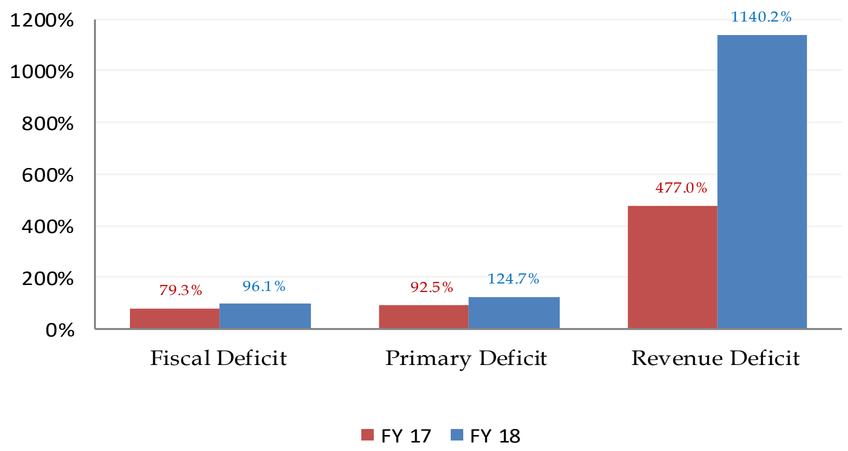
Expectation for Production (Industrial Outlook Survey %)



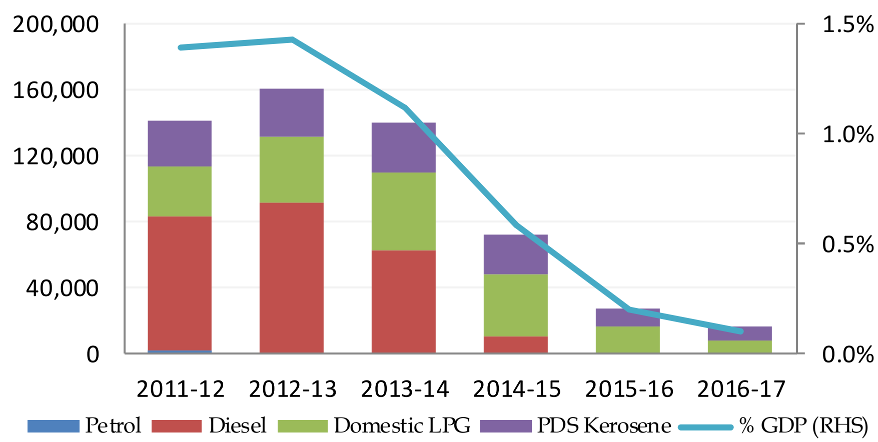
- The RBI's Order Books, Inventories, and Capacity Utilisation Survey (OBICUS) survey continues to show a decline in the level of capacity utilization
- The fall in capacity utilisation is visible across industry groups and especially pronounced in sponge iron and petroleum products
- Inventory levels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

Fiscal Discipline: Meeting fiscal deficit target may be difficult

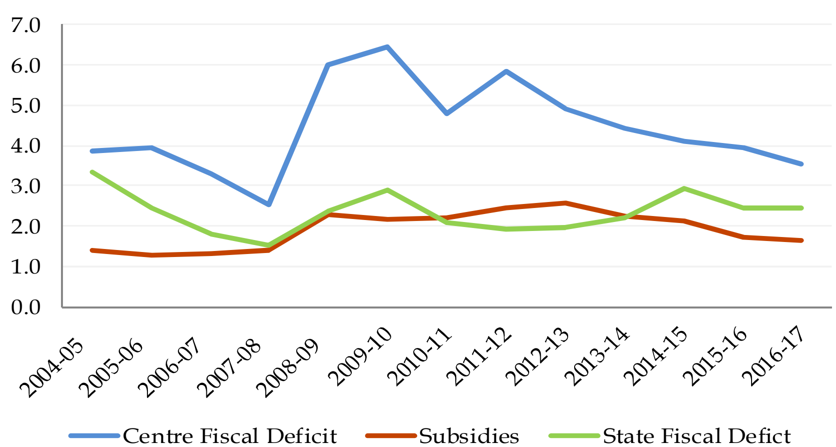
Fiscal Position up to October 2017 % actual to budget estimates



Public Sector Oil Marketing Companies Under recoveries



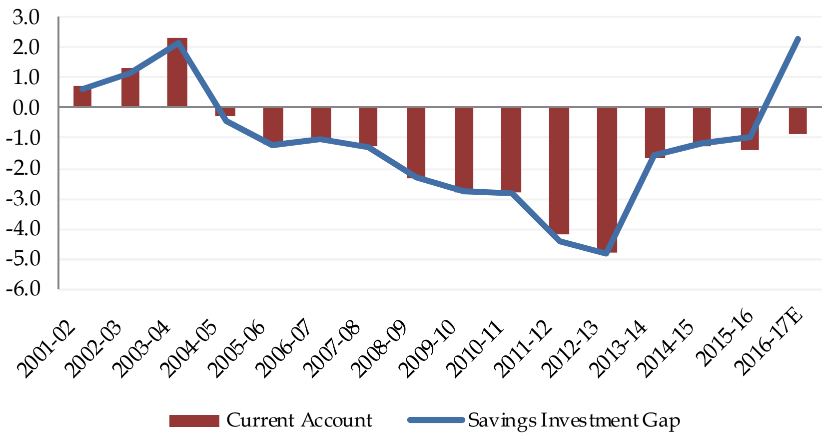
Fiscal Deficit (% of GDP)



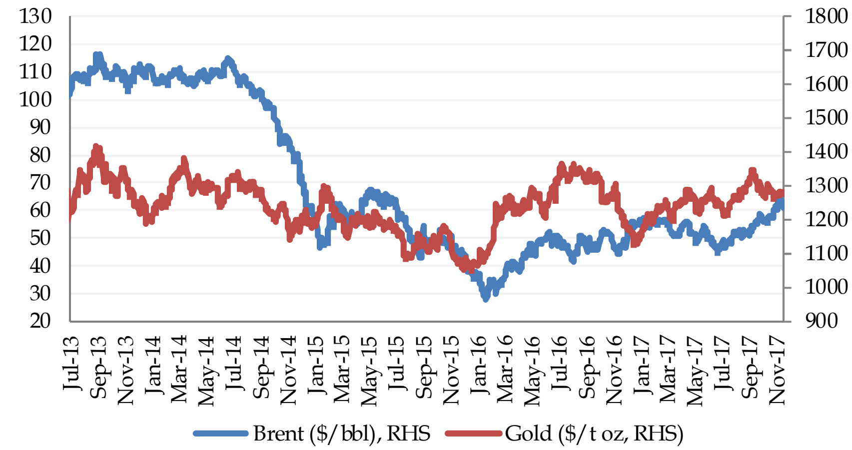
- The RBI has repeatedly stated that fiscal consolidation is very important.
- Last year the government has achieved its fiscal deficit target of 3.5% as forecasted by the budget for FY17 despite the aggressive front-loaded infrastructure spending.
- However for this year, while the government is making a concerted effort to widen the tax base, risks have arisen that could disrupt the fiscal math.
- Key risks that need to be monitored for fiscal targets are the pay commission increases, farm loan waivers, the success of GST implementation, plans for bank recapitalization and any impulses to loosen fiscal targets.
- At this point in the fiscal year, the deficit as a percentage of the budgeted deficit is alarming.

CAD: Substantial improvement over the last two years

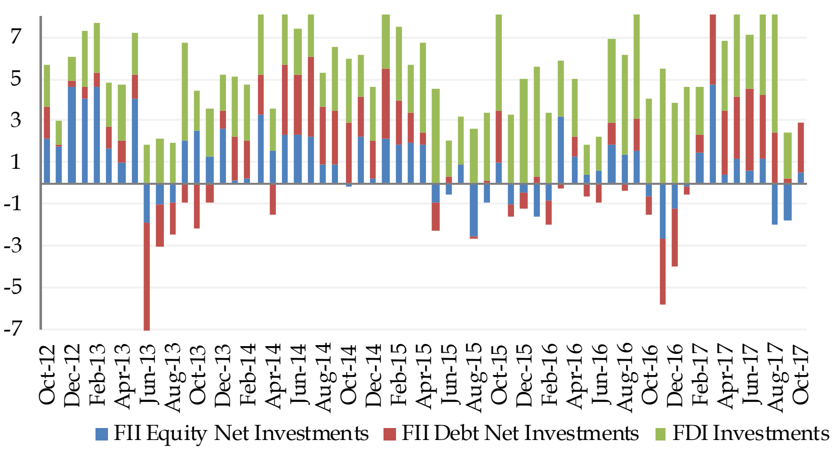
Current Account and Saving Investment Gap as % of GDP



Oil and Gold Prices



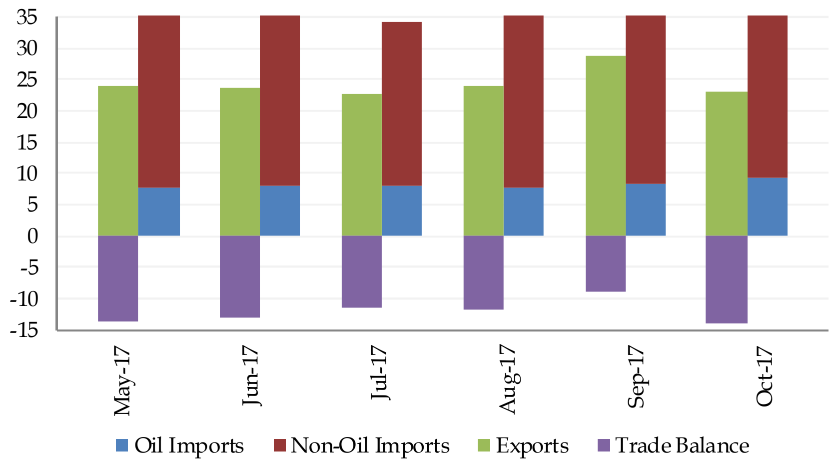
FII Investments



- 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.. Financing of the deficit has also become easier due to significant FII inflows.
- An improving CAD situation has reduced India's vulnerability to external shocks.
- However the trade deficit is widening in the latest readings and should be monitored closely.

Trade: Trade deficit higher than recent lows

Trade ($B)



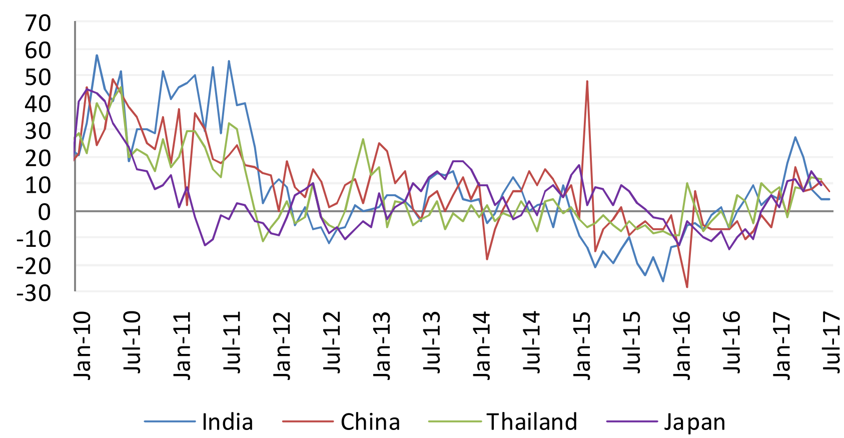
Top 10 Imports ($M)

Commodity Group	Apr-Sep 2016	Apr-Sep 2017(P)	%Growth	%Share
Pertoleum Crude & Products	39,527	46,506	18	21
Gems & Jewellery	20,931	38,508	84	17
Electoronics Items	19,139	25,949	36	12
Machinery	17,586	19,512	11	9
Chemicals & Related Products	15,802	18,409	17	8
Ores & Minerals	9,112	14,079	55	6
Base Metals	10,703	13,344	25	6
Agri & Allied Products	10,088	12,227	21	6
Plastic & Rubber Articles	7,157	8,517	19	4
Transport Equipments	7,448	6,913	-7	3
Total	**175,340**	**220,553**	**26**	**100**

Top 10 Exports ($M)

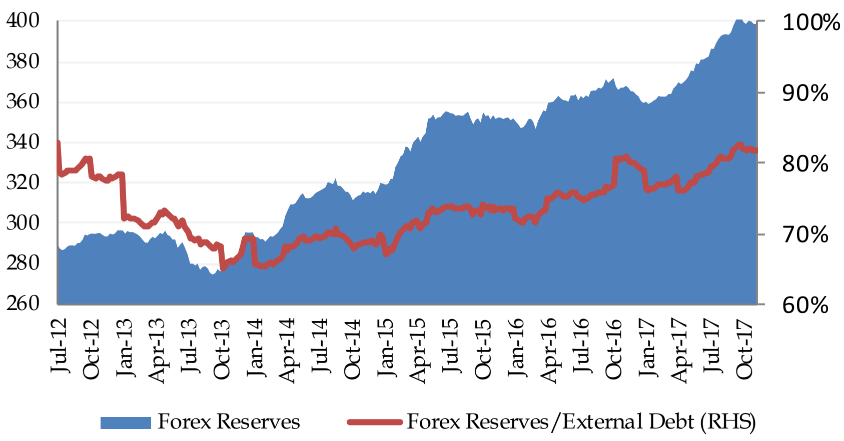
Commodity Group	Apr-Sep 2016	Apr-Sep 2017(P)	%Growth	%Share
Gems & Jewellery	22,220	21,341	-4	15
Chemicals & Related Products	15,937	17,472	10	12
Pertoleum Crude & Products	14,410	16,929	17	12
Agri & Allied Products	11,665	13,229	13	9
Base Metals	9,108	13,110	44	9
Machinery	9,899	11,371	15	8
Transport Equipments	11,026	11,827	7	8
Plastic & Rubber Articles	3,161	3,511	11	2
Electoronics Items	2,812	2,917	4	2
Leather & Leather Manufactures	2,731	2,796	2	2
Total	**131,984**	**146,286**	**11**	**100**

Export Growth

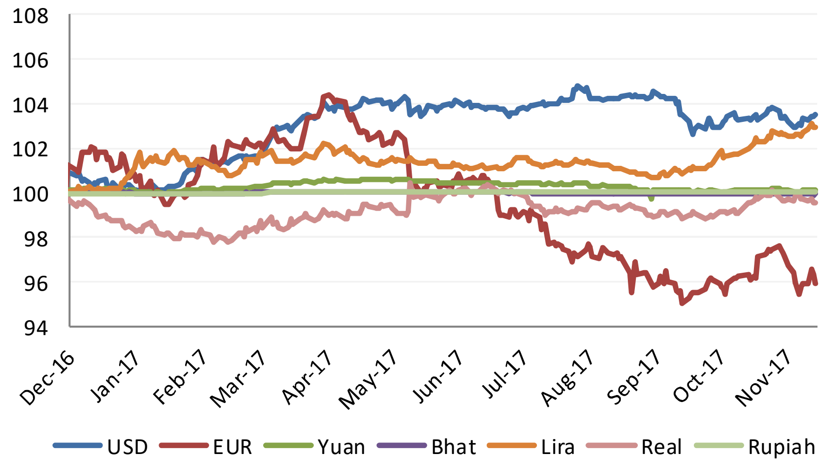


India's forex reserves have grown in absolute and relative terms

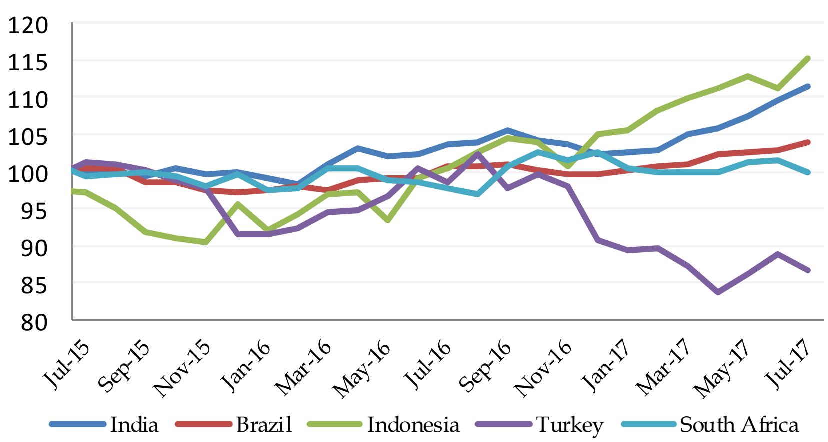
Foreign Exchange Reserves (SB)



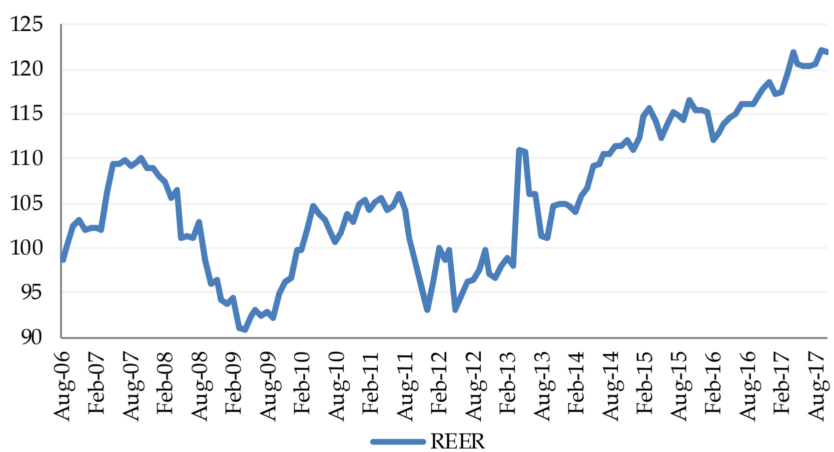
Rupee vs Selected Currencies



Foreign Exchange Reserve Additions

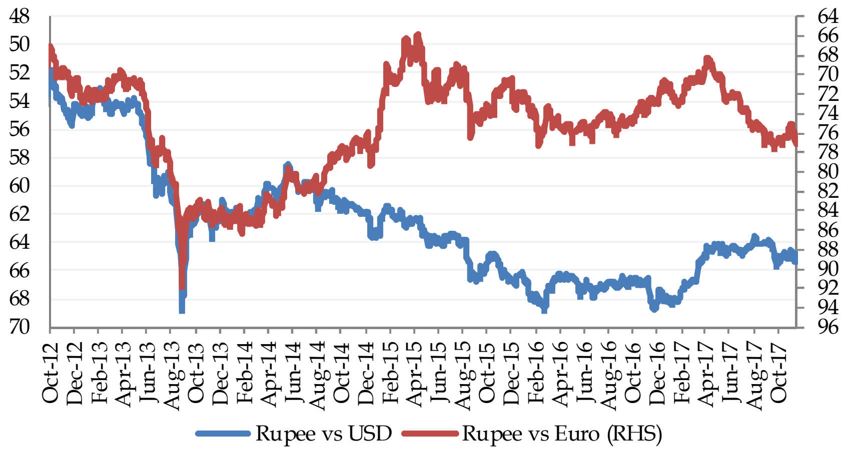


Real Effective Exchange Rate



RBI constrained by excess liquidity in intervening in FX markets

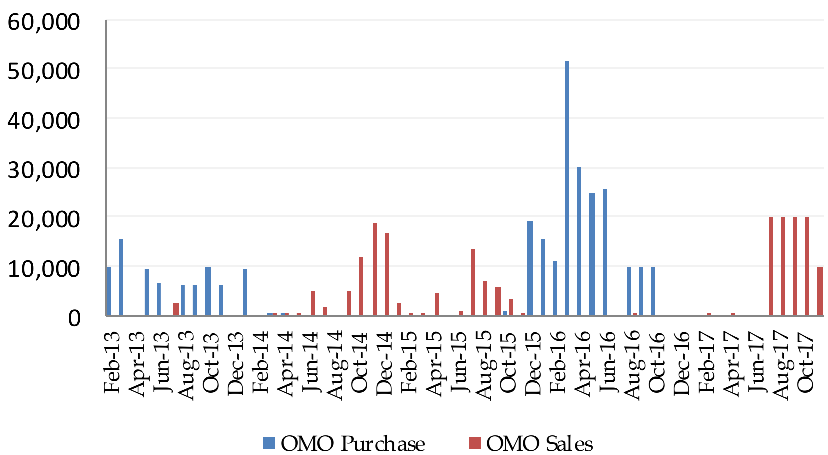
Rupee Performance



Sale/Purchase of Dollars by RBI

Period	RBI Gross Sale $	RBI Gross Purchase of $	RBI Net Purchase of $	Outstanding Forward Sales (-)/Purchase (+)
Sep-17	2,529	3,788	1,259	31,131
Aug-17	1,330	4,556	3,226	32,823
Jul-17	1,940	4,893	2,953	26,450
Jun-17	1,680	4,971	3,291	17,081
May-17	2,014	7,020	5,006	13,601
Apr-17	1,185	1,751	566	13,553
Last 12 Months	**51,269**	**69,211**	**17,942**	

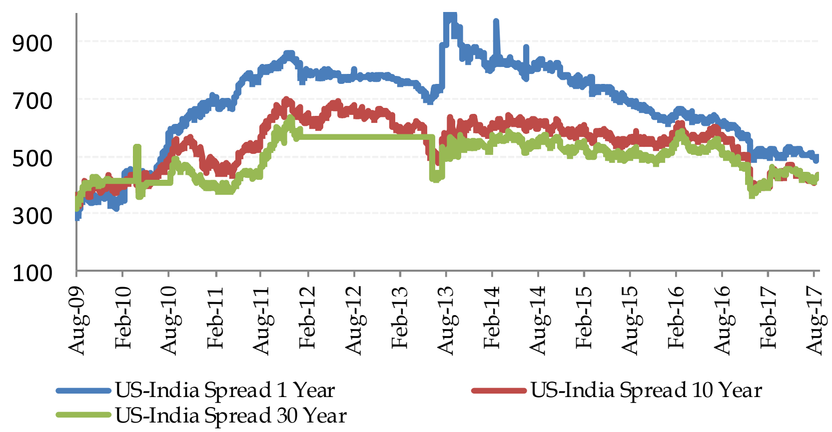
Net RBI OMO Sale/Purchase



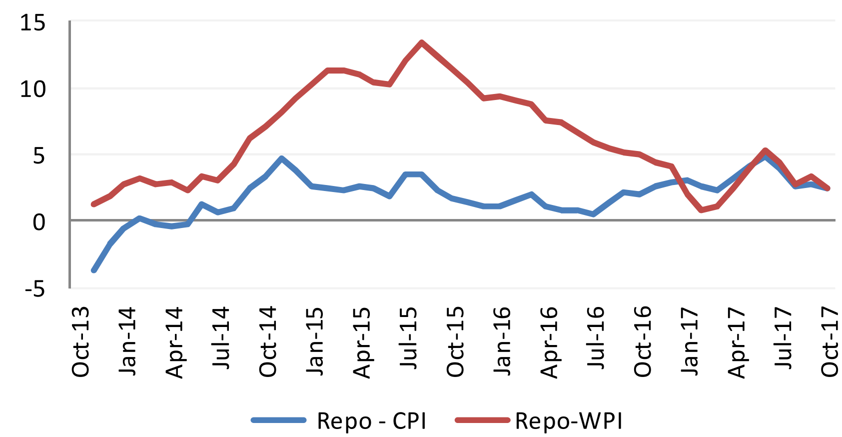
- The Rupee has had an appreciating bias as FII interest in INR assets has been very strong and macro economic fundamentals have been performing well relative to other Asian markets.
- While the RBI continues to intervene in FX markets ,its ability to slowdown the INR appreciation has been constrained 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

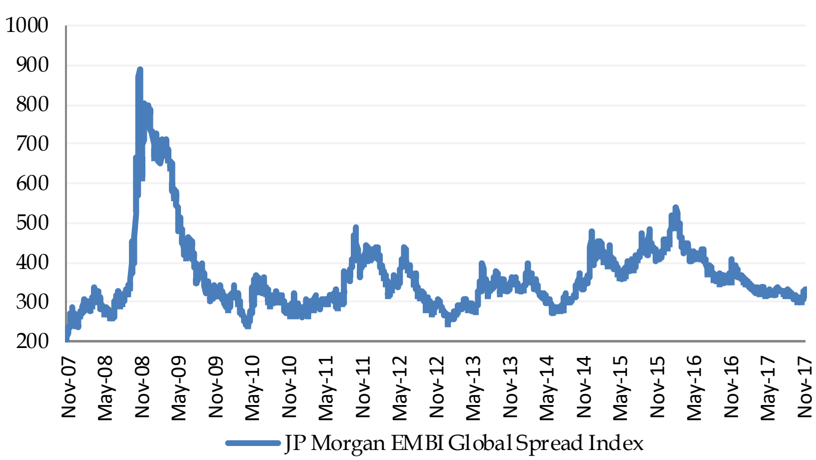
U.S Treasury-India G-sec Credit Spreads



Real Rates*



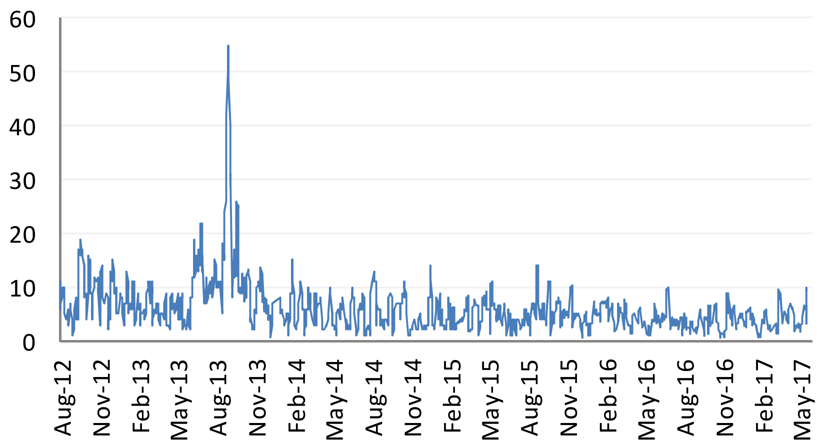
JP Morgan EMBI Spread Index



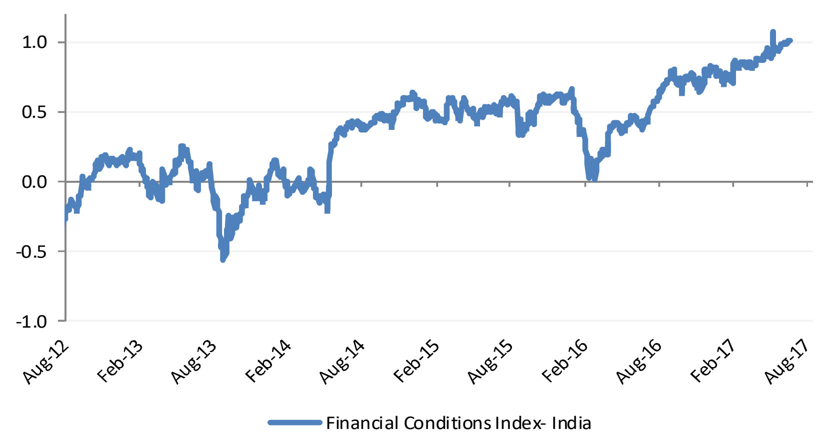
- As the U.S yields have risen and Indian yields moving down, the U.S India spread has come down from its highs
- India is also currently experiencing positive real rates. The real rate as measured by the Repo-CPI has moved up CPI has fallen faster than the policy rate. The real rates for producers is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

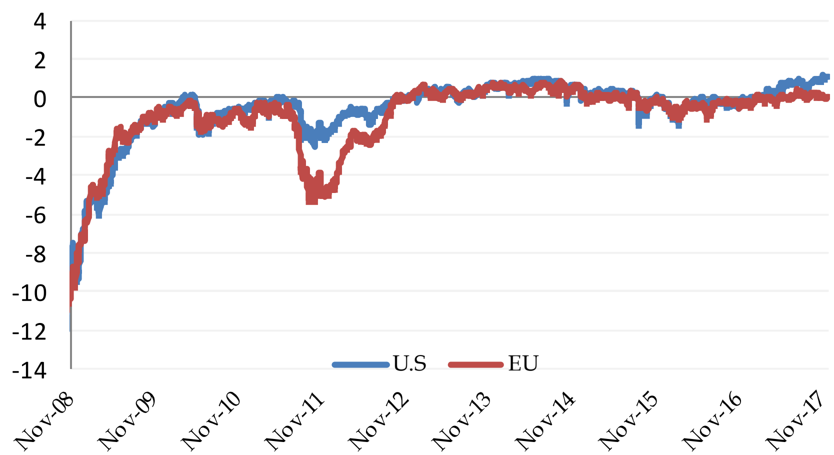


Trust India Financial Conditions Index



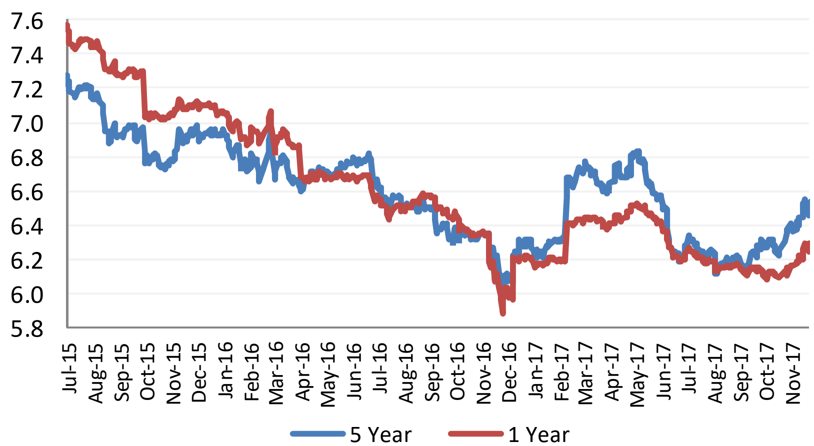
Bloomberg Asia Ex-Japan Financial Conditions Index

Bloomberg U.S EU Financial Conditions Index

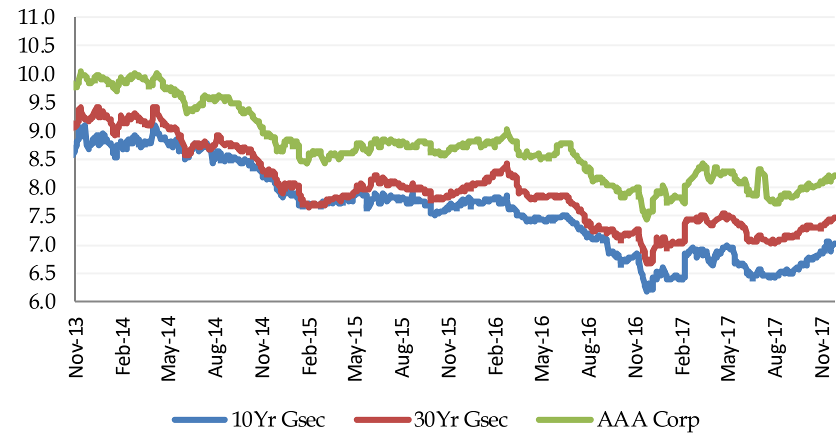


The Indian yields have moved up as inflation worries set in

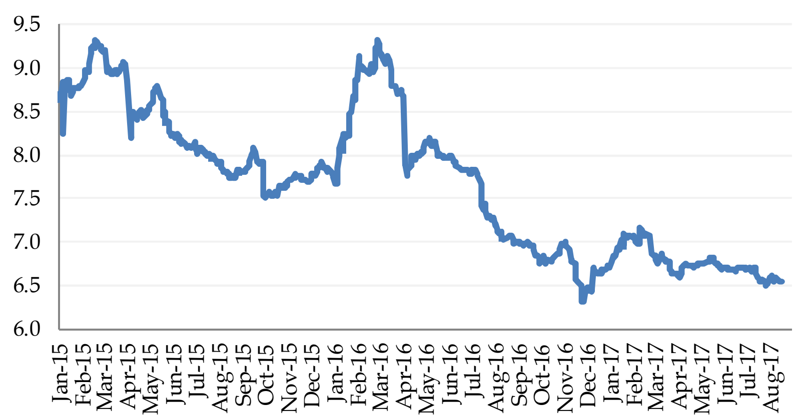
On-shore Swap Rates



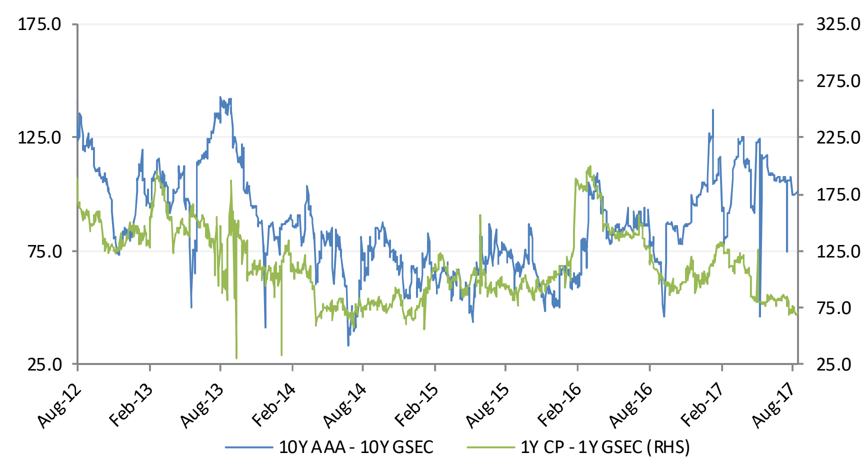
Selected Yields



3 Month CP Rates



10 Year and 1 Year Corp AAA Spreads (bps)



Our View: On hold for now

- After the observing the deceleration in the inflation trajectory over the last several months the RBI in its August policy meeting finally decided there is room for policy rates to come down. However in that policy, the RBI maintained its neutral policy stance and chose to remain on hold in its October policy and stated that it remains concerned with various upside risks to inflation. The RBI has always maintained the neutral stance gives it flexibility to respond to incoming data.
- In the August and October policies the RBI highlighted several factors contributing the uncertainty around inflation projections including:
  - Implementation of farm loan waivers by States may result in possible fiscal slippages and undermine the quality of public spending, entailing inflationary spillovers.
  - The timing of the States' implementation of the salary and allowances award. For example if States choose to implement salary and allowance increases similar to the Centre in the current financial year, headline inflation could rise by an additional estimated 100 basis points above the baseline over 18-24 months.
  - Price pressures are building up in vegetables and animal proteins in the near months.
  - A conclusive segregation of transitory and structural factors driving the disinflation is still elusive.
- Since the last policy decision, some of these risks have materialized and the inflation reading has moved up due to vegetable and protein items, although it remains below the RBI's medium term target of 4%.
- In addition the farm loan waivers the implementation of HRA increases continue to put pressure on the fiscal math.
- Given this backdrop, with the RBI's neutral stance, inflation moving up in the last few readings, and possible fiscal slippages the RBI is likely to feel the room for more monetary accommodation is limited. The RBI will also be comforted by the pickup latest GDP readings which will give it confidence that its current neutral stance is appropriate. We therefore expect the RBI to keep its policy Repo rate unchanged while maintaining its neutral stance and remaining data dependent.

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Thank You

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