Economic Alert | 30 September 2014

India – RBI reaffirms our extended pause view

- **The RBI keeps the repo rate unchanged; reiterates upside risks to January 2016 CPI target**
- **The Monetary Policy Report quantifies upside risk to Jan 2016 CPI target under base-line assumptions**
- **IGBs to trade range-bound amid stable policy rates; we maintain our *Neutral* IGB outlook**

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The Reserve Bank of India's (RBI's) September monetary policy meeting kept all rates unchanged – the repo rate at 8%, reverse repo at 7% and statutory liquidity ratio (SLR) at 22%. Although the rate decision was in line with expectations, the market focus was on the RBI's CPI inflation forecast. The RBI appears comfortable that the January 2015 CPI target of 8% is achievable but its model-based forecast suggests that there are upside risks to the January 2016 target of 6%. In the newly introduced Monetary Policy Report (separate from the Monetary Policy Statement), published for the first time, a model-based approach projects CPI inflation for Q4-FY16 (fiscal year ending March 2016) at 7%, with specified baseline assumptions (details below). This forecast is similar to our own projection, and initially led the market to believe that the RBI could become more hawkish going forward.

However, in the press conference after the policy meeting, Governor Rajan clarified that the RBI intends to overlay these model-based forecasts with a subjective assessment. Based on its subjective assessment, it is still possible to reach the 6% January 2016 CPI target with an unchanged monetary policy stance if the government takes the necessary action to reduce food inflation. Accurate forecasting of CPI over a longer horizon is difficult because food comprises almost half of the CPI basket. This is why Governor Rajan emphasised "data dependency" in the press conference; we believe this will be the operative phrase going forward. We have long maintained that the RBI will be on an extended pause (no rate cut in 2015) as the disinflation process takes shape and the government takes the necessary steps to improve food supply. The September monetary policy meeting reaffirms our view.

Figure 1: RBI's estimate of inflation sensitivities

	Inflation	GDP growth
Model-based forecast for FY16	**7.00%** *(end-Q4)*	**6.3%**
Sensitivities (bps)		
Slack in the global economy of 50bps	-10	-20
Increase in Indian crude oil basket by 10%	+20	Minimal
Below-normal monsoon and higher increase in MSP	+80	-40
Augmenting supply capacity	-90	+40
GDP growth 100bps higher than current forecast	+20	NA
INR weaker by 10%	+30	+10

Source: RBI Monetary Policy Report, Sep 2014

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The Monetary Policy Report

The RBI's new Monetary Policy Report includes long-term projections on GDP and inflation. We highlight three important elements of the report.

First, this report replaces the Macroeconomic and Monetary Developments report released until April 2014; that was a more backward-looking document and did not carry projections beyond a running fiscal year. In this respect the new Monetary Policy Report marks a significant departure: it provides model-based forecasts out to March 2016, almost six quarters ahead. The model explicitly assumes a normal monsoon, moderate increase in minimum support prices (MSP), gradual moderation in crude oil prices through 2015, FY16 GDP growth of 6.3%, no structural change in the economy, and continuance of similar macroeconomic policies into FY16. Under such a scenario, the model predicts CPI inflation at 7% by Q4-FY16.

Second, it is important to emphasise that the 7% model-based prediction should not be confused with the RBI's January 2016 CPI target of 6%, for reasons highlighted above. By providing a model-based forecast, the RBI has effectively quantified the "significant upside risk" to its January 2016 inflation target.

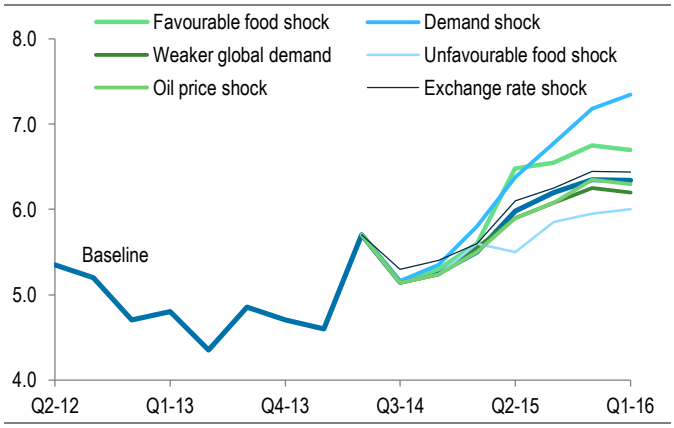
Third, in addition to providing model-based predictions for FY16 GDP and inflation, the report includes sensitivities of these forecasts to various factors. Such an approach could eventually help explain growth/inflation movements between different periods.

The model-based CPI prediction of 7% by Q4-FY15 quantifies "significant upside risk" to the RBI's CPI target of 6%

We have tabulated these sensitivities in Figure 1 and reproduced the risk scenarios for inflation and growth as outlined by the RBI (Figures 2 and 3). We believe that the RBI's estimate of +20bps impact on CPI if FY16 GDP growth is c.7.3% (+100bps higher than the base-line scenario) understates the risk. Interestingly, while the RBI provided an estimate of the positive impact of the augmentation of supply capacity on headline CPI and growth, a similar sensitivity estimate for any impact from interest rates was not mentioned.

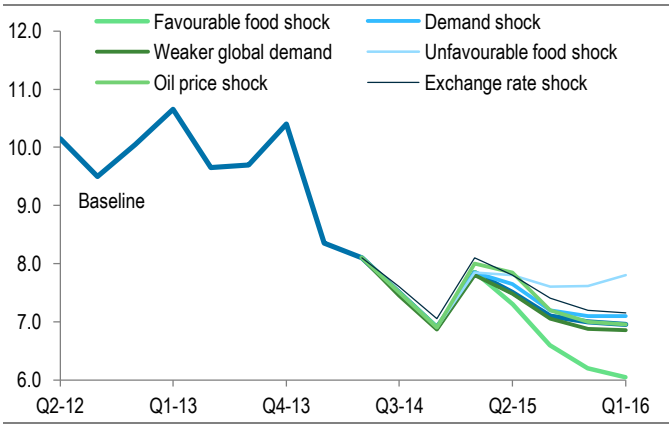
Also, even the model-based CPI forecast of 7% by Q4-FY15 incorporates a significant correction in food inflation. Average food inflation since this series began in January 2012 has been 10.6%, while FYTD it is 9%. In order to achieve the model-based 7% target, food inflation would have to slow to at least 8%. Under the scenario of augmentation of supply capacity, it would have to fall c.6%.

Figure 2: Risk scenarios on baseline GDP growth path



Source: RBI Monetary Policy Report, Sep 2014

Figure 3: Risk scenarios on baseline inflation path



Source: RBI Monetary Policy Report, Sep 2014

Rates market outlook

The status quo on policy rates was in line with expectations

The status quo on policy rates was in line with rates market expectations, but the RBI fine-tuned several other policy measures. The RBI will reduce the held-to-maturity (HTM) ratio gradually (50bps per quarter) to 22% from 24% starting on 10 January 2015. However, the SLR remains unchanged, which is a mild positive for Indian government bonds (IGBs). Banks' access to RBI liquidity via export credit refinance has been reduced to 15% from 32% of the outstanding export credit. With current utilisation at c.10%, we think any impact on overnight rates should be limited. IGB reaction to the policy announcement was muted and the OIS curve bear flattened by c.3bps.

We remain Neutral on the IGB outlook

We remain *Neutral* on the IGB outlook on stable monetary policy and a balanced demand-supply outlook. We expect the benchmark 10Y IGB to trade between 8.40% and 8.65% over next two months. Headline CPI inflation for the remainder of FY15 is likely to be a V-shape trajectory. However, the RBI is likely to maintain stable policy rates. Moreover, local demand-supply dynamics are balanced, and only an increase in the IGB quota for foreign investors can make them more favourable. The IGB quota utilisation for foreign portfolio investors stands at c.97% currently, and for long-term investors it is at c.66%.

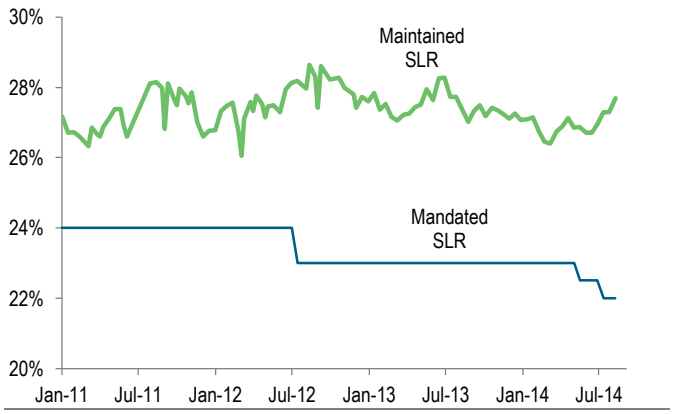
In today's monetary policy announcement the RBI also announced several other measures. From a medium-term perspective, there were two positives:

Government securities up to 5% of banks' NDTL can be included in the mandatory SLR requirement as Level 1 HQLA

1. Government securities up to an additional 5% of banks' net demand and time liabilities (NDTL) can be included in the mandatory SLR requirement as Level 1 High-Quality Liquid Assets (HQLA) to meet the liquidity coverage ratio (LCR) requirement. This is positive for banks, as it reduces the mandatory holding of government securities. From an overall banking system perspective, 5% of NDTL is equal to c.INR 4.38tn.

2. The RBI also announced two steps to address operational issues faced by foreign portfolio investors and long-term foreign investors. It decided to extend reporting timings on trade dates and an option for T+2 settlement for secondary market over-the-counter trades in government securities.

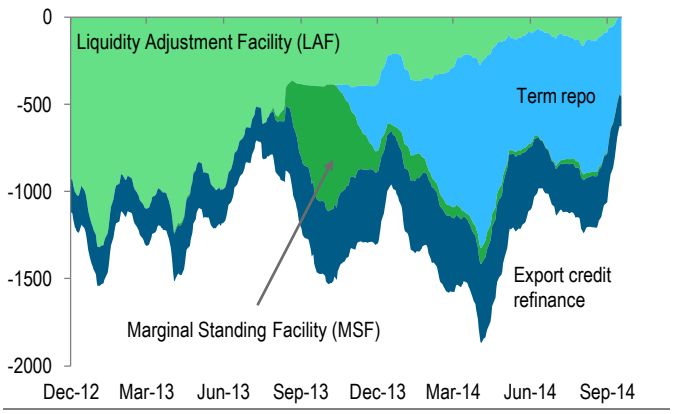
Figure 4: Banks holding excess SLR to meet LCR requirements *(% of NDTL)*



Source: RBI, Standard Chartered Research

Figure 5: Term repo is the main liquidity tool

30-day MA of amount in various liquidity facilities, INR bn



Source: RBI, Standard Chartered Research

Foreign investors can extend reporting timings on trade dates and settle IGBs on a T+2 cycle

In our previous reports highlighting these issues (see *Rates Alert, 27 September 2013, 'India – Index issues go beyond capital controls'* and *On the Ground, 25 July 2014, 'International settlement of IGBs would be positive'*) we noted that an RBI announcement to tackle them would be viewed positively by foreign investors. However, given the almost full utilisation of IGB securities, the near-term impact on them is likely to be limited. Moreover, given increasing foreign-investor interest in the INR corporate bond space, we think such steps should be extended to corporate bonds as well.

What investors think?

Investors view the RBI's anti-inflationary stance as a medium-term positive

Our conversations with international and domestic investors suggest that rate-cut expectations over the next six months are low. Investors think the RBI's strong anti-inflationary stance is a medium-term positive. While there are mixed views on whether the monetary mechanism works in India, all agree that the RBI's decision to keep rates unchanged over the short term sends a very powerful signal to market participants – and helps enhance the inflation-fighting credentials of the central bank. On the timing of the first rate cut, expectations range from Q2-2015 to Q4-2015. Investors expect the RBI to trail inflation – and keep real rates at healthy levels: as inflation comes down, the RBI will lower rates – but it is unlikely to be proactive. They believe the overall growth-inflation dynamics in 2015 will be favourable for IGBs and prefer duration exposure in IGBs. While rates are unlikely to be lowered over the short term, we expect IGB yields to decline as inflation starts to stabilise and then fall.

Investors welcome INR stability, especially in a strong USD environment

From a total-returns perspective, performance of the Indian rupee (INR) is also important. Investors appreciate the RBI's strategy of accumulating reserves and limiting INR appreciation. Although a range-bound FX market may not encourage hedging activity by locals, international investors welcome INR stability, especially in a strong US dollar environment. Over the medium term, investors remain constructive on IGB duration and the INR.

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