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# RBI to ensure repo mode

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## Bottom line: 25bp Feb 3 repo rate cut; Rs60-65/USD

We expect the RBI to anchor the money market to the repo rate during the March quarter. Our liquidity model shows that the money market deficit will seasonally widen to Rs1783bn in March from Rs972bn in end-December, aggravated by fiscal compression. This assumes maturity of Rs1000bn of FX forwards (~US$16bn) contracted earlier. In order to prevent the money market from jumping to MSF (=100bp + repo rate) mode, the RBI should step up repos. 3G telecom auctions remains a key swing factor. Note we continue to see a 25bp cut to 7.75% repo rate on February 3. Our call that the RBI will put up only token resistance at Rs62-63/USD to offset US Dollar strength is holding good. In 2015, we expect the RBI to try to hold Rs60-65/USD from Rs58-62/USD earlier. If the US Dollar peaks off at current levels, we think that the RBI will not have to exert itself too much to anchor INR expectations. Our Asia FX strategist, Adarsh Sinha, sees the INR at Rs62.50/USD in March 2015. Do read our India 2015 report here.

## Step up in repos, FX forwards to meet seasonal demand

We expect the RBI to anchor the money market to the repo rate during the March quarter. Our liquidity model shows that the money market deficit will seasonally widen to R1783bn in March from Rs972bn in end-December, aggravated by compression of public expenditure to meet the FY15 fiscal deficit target of 4.1% of GDP (Table 1). We expect the RBI to hold the money market in repo mode despite the liquidity shortfall rising to Rs1453bn in January, Rs1172bn in February on reduced government expenditures and Rs1783bn in March on tax outflows.

We expect credit demand growth to end the current fiscal year at 15%. This translates into a reserve requirement of Rs2282bn. Of this, Rs1500bn (~US$24.5bn) has already been provided via FX purchases until December (BAMLe). At the same time RBI has conducted an OMO sale of Rs600bn until December. Net-net, the economy still needs a reserve money flow of Rs1382bn to fund the 15% loan demand. Of this, we expect roughly Rs1000bn (~US$16bn) to come through maturity of FX forwards in the March quarter. The remaining gap will have to be met via a step up in repos and therefore, it is natural that the money market deficit will expand to Rs1783bn by March. Note we continue to see a 25bp cut to 7.75% repo rate on February 3.

## Swing factor: 3G auctions

The money markets will swing as corporates transfer funds to the treasury as they bid in the telecom auctions. Media reports suggest that the government will be able to raise ~Rs650bn in the upcoming 3G auctions that will start on February 25. Of this 1/3rd or roughly Rs220bn will be received in the current financial year.

Additionally, the government is planning to auction ~100 coal blocks in phase I of which ~45-50 coal block auctions could get completed by March and remaining by June. As only 5% of reserve price (roughly Rs10-15bn) is expected to be realized by March, these coal auctions are unlikely to impact our liquidity projections in any meaningful way.




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## MSF mode unlikely

We expect the RBI to step up liquidity to avoid the MSF mode. After all, Gov Rajan has already committed that "... if the current inflation momentum and changes in inflationary expectations continue, and fiscal developments are encouraging, a change in the monetary policy stance is likely early next year, including outside the policy review cycle..." It would be contradictory to let the money market shoot off 100bp to the MSF rate at the peak of the busy season because the government is compressing expenditure or holding 3G auctions.

On our part, we expect inflation to continue to come in at a benign 5.6% (5.3% consensus) for December today and 6.2% for January, well within the RBI's 8% January 2015 target (Chart 1). Table 2 shows that food prices are rising in December and January primarily on account of reversal of yoy base effects in vegetable prices. If November industrial production remains weak today (1% BAMLe, 2.4% consensus), then December quarter growth is likely to disappoint at a sub-5% level (5.3% in the September quarter).

## INR: Token resistance at Rs62-63/USD

Our call that the RBI will put up only token resistance at Rs62-63/USD to offset US Dollar strength is holding good. If the US Dollar peaks off at current levels, we think that the RBI will not have to exert itself too much to anchor INR expectations with seasonality turning in favor. Our Asia FX strategist, Adarsh Sinha, sees the INR at Rs62.50/USD in March.

We continue to expect the RBI to continue to mount a token defense at Rs62-63/USD levels, selling, say, US$500mn-US$1bn, as it is doing. It is only at Rs65/USD that we see full-scale FX intervention of, say, US$15bn. The RBI should ideally want to hold Gov Rajan's preferred Rs60-62/USD zone. At the same time, it will not spend too much of precious FX at a time the INR has outperformed most BRIC/TIM currencies (Chart 2).

## RBI to hike USD share of FX reserves

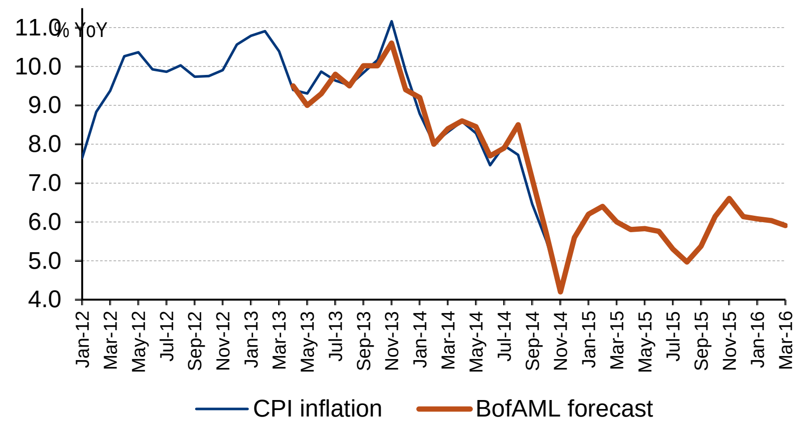
Media reports suggest that the RBI will likely hike the share of USD in FX reserves to 60+/-7% from 50+/-7% in view of the greenback's strength (Table 3). 85% of India's trade is denominated in USD. Note FX reserves currently stand at ~US$358.5bn (including short-term net forwards outstanding).

Table 1: RBI to provide temporary liquidity on year-end tax outflows

| | Jan-15 | Feb-15 | Mar-15 |
|---|---|---|---|
| 1. Opening balance | -972 | -1453 | -1172 |
| 2. Net flows (4-3) | -481 | 282 | -611 |
| 3. Outflows (= a+b+c+d) | 1691 | 1329 | 1039 |
| a.Currency in circulation | 183 | 214 | 187 |
| b. CRR | 19 | 65 | 62 |
| c.Gross Central issuance | 690 | 260 | 0 |
| d.T bill issuances | 570 | 560 | 560 |
| e. States (net borrowing) | 230 | 230 | 230 |
| 4. Inflows (=a+b+c+d+e+f) | 1210 | 1611 | 428 |
| a. G-sec coupon payments | 171 | 311 | 193 |
| b. Redemptions | 0 | 38 | 0 |
| c. T bill redemptions | 658 | 538 | 798 |
| d. Net govt .expenditure | 81 | 424 | -963 |
| e. Fx intervention | 300 | 300 | 400 |
| f. RBI OMO | 0 | 0 | 0 |
| 5. Closing balance (=1-3+4) | -1453 | -1172 | -1783 |

Source: BofA Merrill Lynch Global Research estimates, RBI.

Chart 1: CPI on track to meet 8% Jan-15 and 6% Jan-16 RBI targets




Source: BofA-ML Global Research Estimates, MoSPI

Table 2: Reversal of yoy base effects in veggie prices pushing up food inflation

| Retail food price inflation (% yoy) | Weight in CPI | Sep'14 | Oct'14 | Nov'14 | Dec'14 | Jan'15* |
|---|---|---|---|---|---|---|
| Rice | 7.1 | 7.0 | 5.6 | 2.3 | 1.6 | 1.4 |
| Wheat | 5.5 | 7.1 | 5.2 | 4.3 | 1.4 | -0.7 |
| Atta | 1.9 | 5.0 | 4.0 | 3.0 | 2.4 | -0.5 |
| Gram dal | 0.4 | -10.1 | -10.0 | -10.4 | -9.9 | -6.5 |
| Tur/Arhar dal | 1.5 | 7.0 | 6.6 | 7.0 | 7.4 | 9.1 |
| Urad dal | 0.1 | 31.4 | 25.6 | 20.2 | 20.3 | 19.9 |
| Moong dal | 0.5 | 21.7 | 20.5 | 23.7 | 25.3 | 23.7 |
| Masoor dal | 0.2 | 18.2 | 19.6 | 19.8 | 22.8 | 24.2 |
| Groundnut oil | 1.9 | -7.0 | -5.6 | -4.9 | -5.1 | -3.2 |
| Mustard oil | 0.1 | 0.8 | 1.5 | -0.9 | -1.0 | -0.7 |
| Vanaspati | 0.1 | 4.0 | 2.7 | 0.9 | 1.0 | 1.0 |
| Soyaoil | 0.7 | -0.4 | -0.3 | -1.5 | -2.3 | -1.1 |
| Sunflower | 0.3 | -5.4 | -4.7 | -5.8 | -3.4 | -2.5 |
| Palm oil | 0.8 | -5.2 | -3.6 | -6.3 | -6.9 | -4.0 |
| Potato | 1.8 | 62.8 | 54.5 | 18.9 | 12.5 | 9.8 |
| Onion | 1.8 | -51.2 | -55.1 | -52.5 | -23.8 | 13.2 |
| Tomato | 1.8 | 23.9 | -7.2 | -45.0 | -25.3 | 17.4 |
| Sugar | 1.8 | 0.2 | 0.5 | 0.6 | -0.3 | -2.1 |

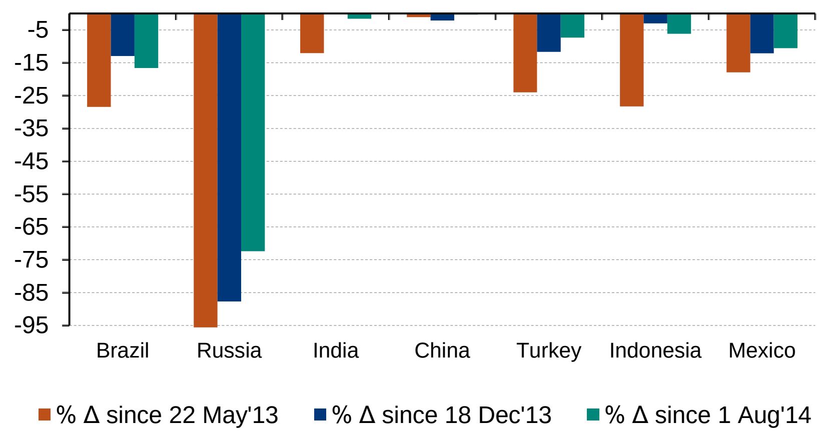
Table 2: Reversal of yoy base effects in veggie prices pushing up food inflation

| Retail food price inflation (% yoy) | Weight in CPI | Sep'14 | Oct'14 | Nov'14 | Dec'14 | Jan'15* |
|---|---|---|---|---|---|---|
| Gur | 0.1 | 0.2 | 1.6 | -0.2 | 0.0 | -2.3 |
| Milk | 7.7 | 9.4 | 9.8 | 10.1 | 9.9 | 9.0 |
| Tea loose | 1.8 | 3.5 | 3.2 | 0.8 | 0.8 | 0.2 |
| Salt pack | 0.2 | 7.4 | 6.8 | 7.9 | 7.0 | 5.8 |
| Vegetables inflation | 5.4 | -10.4 | -22.2 | -35.6 | -15.4 | 13.6 |
| Total/ Weighted Avg. | 38.2 | 2.1 | 0.7 | -2.1 | 0.7 | 2.9 |
| CPI food inflation | 49.7 | 7.6 | 5.7 | - | - | - |

*Avg prices until January 8th

Source: BofA-ML Global Research Estimates, Department of Consumer Affairs, PMC

Chart 2: INR: Stabilized since December 2013




Note: As on 12 January 2015

Source: BofA-ML Global Research Estimates, Bloomberg

Table 3: RBI to hike USD share of FX reserves

| Currency | Actual portfolio composition (%) | Existing composition (%) | Revised composition (%) | Currency movement** |
|---|---|---|---|---|
| USD | 57.82 | 50+/-7* | 60+/-7 | N.A. |
| Euro | 13.28 | 17+/-5 | 16+/-5 | -15.75 |
| GBP | 13.16 | 13+/-5 | 14+/-5 | -14.25 |
| AUD | 9.89 | 11+/-5 | 6+/-3 | -17.2 |
| CAD | 4.08 | 5+/-3 | 4+/-3 | -10.7 |
| Others | 1.77 | 4+/-3 | | N.A. |

*Emergency Leeway of +/-10%

**Change in exchange rate against dollar over last 6 months

Source: Financial Express

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