PhillipCapital

Monetary Policy

RBI threw an unwanted surprise, Rupee on its way to 75+

5 October 2018

INDIA | INDOMOMICS | Update

Measures announced	**Unchanged interest rates; Stance changed to 'calibrated tightening'**
Our expectation	**25bps hike in repo and reverse repo rate**
Consensus	**25bps hike in repo and reverse repo rate**

RBI again surprised, this time by leaving repo/reverse repo rate unchanged at 6.5%/6.25%; policy stance is altered to 'calibrated tightening' from 'neutral'. Five of six members favoured this stance. Dr. Dholakia voted for policy stance to remain 'neutral' and Dr. Ghate voted for 25bps rate hike. GDP growth projection for FY19 is retained at 7.4%; Q1FY20 marginally lowered (by 10bps) to 7.5%. RBI's inflation guidance was further lowered (third time) for 1HFY19, retained for 2HFY19, and lowered for 1QFY20 – Q2FY19 CPI guidance at 4% (vs. 4.6% in the last policy, 4.8%-4.9% in the earlier policy, and 4.7%-5.1% in the policy prior to that), 3.9-4.5% in 2HFY19 (retained as last policy, vs. 4.8% in the earlier policy; 4.5-4.6% in the policy prior to that), and 4.8% in Q1FY20 (vs. 5% in the last policy). CPI guidance is almost similar after excluding HRA impact. Inflation uncertainties persist from oil prices, MSP hike, global financial markets, rising input cost, centre and state fiscal slippage, and states HRA impact. MPC remained positive on growth outlook.

<u>Our analysis:</u> We are surprised with the following: (1) why were the rates raised consecutively by 50bps when inflation was trending lower (also evident in RBI's lowered CPI forecast to 4%, which is their comfort zone); RBI's Q2 estimate has been lowered by 1% over the last two policies. (2) RBI's H2 inflation projection remains unchanged. Thus, where is the inflationary impact of rising oil prices and Rupee weakness? This will imply following scenarios – (1) Likely rate hike in the coming policies as inflation moves beyond guidance, (2) More oil price absorption by OMCs and upstream companies, thus non inflationary, (3) RBI expecting oil prices to move lower.

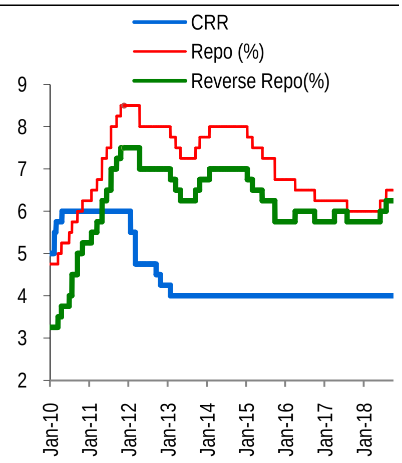
RBI's today's rate decision is justified on three accounts (1) purely from inflation point of view as their guidance has remained soft to unchanged; sticking to their mandate of nothing but inflation management, (2) the previous two rate hikes were pre-emptive (being proven now, we don't think decision was anticipating so), (3) RBI could announce Rupee measures separately (if/when they deem appropriate).

We retain our expectation of 25-50bps more rate hike in FY19. Liquidity will likely remain tight to neutral. RBI's stance of status quo (along with previous policy measures by RBI and government) is a clear reflection of RBI's sticking with their long-followed stance/mandate to allow currency to find its own levels while managing volatility, irrespective of quantum and contagion of Rupee weakness. With this as background and expectation of further international oil price rise, we further raise our top-end of the Dollar-Rupee estimate to 75 (from 73 earlier) and worst case scenario of 77-78 in the coming months.

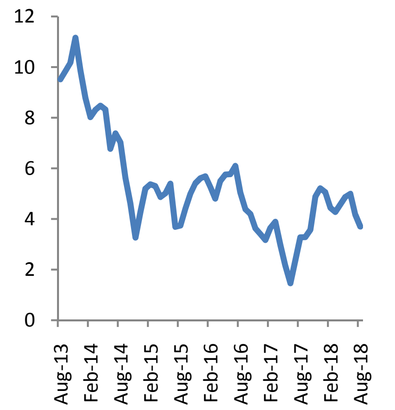
Key takeaways from RBI's statement:

Global economic activity continued to remain resilient, however growth outlook has become uneven amidst several uncertainties. Amongst AEs, US continued its growth trajectory while EU remained subdued. Japan continues to maintain its growth momentum. EMEs have been facing headwinds from global and domestic factors. Growth in Russia and Brazil is showing signs of revival. However, China has moderated while South Africa slipped into recession. Global trade has started showing signs of weakening due to intensification of trade wars. While oil and gold trend higher, base metal prices have softened due to weak demand from major economies. Global financial markets remain under pressure from trade tensions, tightening monetary policies and risks of contagion from specific EMEs. Bond yields in the US have softened while the Euro area has seen bond yields hardening. EMs have seen yields rise due to stress from domestic as well as global factors. Capital flows to EMs continue to decline.

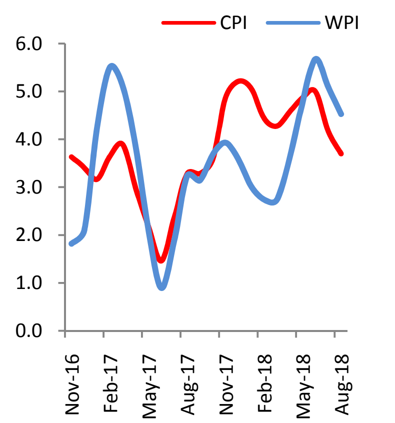
Policy rates left unchanged



CPI growth rate (yoy, %)



WPI remains above CPI (yoy, %)



Source: RBI, CSO, Phillip Capital India Researc

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FY19 GDP growth retained at 7.4%, outlook robust: Domestic economic activity has sustained momentum and the output gap has virtually closed. Macro economic data is indicating a pick-up in demand led by consumption and investment. Investment activity is boosted by FDI inflows, and increased financial resources to the corporate sector. Corporate margins, however, may be impacted by rising oil prices and dent investment activity, going ahead. Capacity utilization has declined to 73.8% in Q1FY19 from 75.2% in Q4FY18. RBI's business outlook for Q2FY19 shows optimism led by improving output, order books and exports. IOS indicates that activity in the manufacturing sector is expected to remain robust in Q2FY19. RBI's FY19 GDP projection is maintained at 7.4%, Q2FY19: 7.4%, 2HFY19: 7.1-7.3%, Q1FY20: 7.4%.

Inflation outlook calls for vigilance: June inflation fell to 3.7% (from 4.9% in June). Food inflation remained lower than seasonal usual. Inflation expectations are up by 50bps for next 3-months and moderated by 30bps for 12months (vs. previous survey). Manufacturing and services PMI also reflected rising input price pressures. Going ahead, inflation will be guided by (1) implementation/procurement operations post MSP hike, (2) Oil prices, (3) global financial markets, (4) input prices, (5) staggered impact of HRA revision by state governments, (6) Fiscal slippage at center/state levels. MPC remains committed to keep headline inflation near 4% on a durable basis.

The MPC notes that global headwinds in the form of escalating trade tensions, volatile and rising oil prices, and tightening of global financial conditions pose substantial risks to the growth and inflation outlook. It is, therefore, imperative to further strengthen domestic macroeconomic fundamentals.

In favour of No rate change:

- Dr Ravindra H. Dholakia
- Dr Pami Dua
- Dr Viral V. Acharya
- Dr Urjit R. Patel
- Dr Michael Debabrata Patra

In favour of change in stance:

- Dr Chetan Ghate
- Dr Pami Dua
- Dr Viral V. Acharya
- Dr Urjit R. Patel
- Dr Michael Debabrata Patra

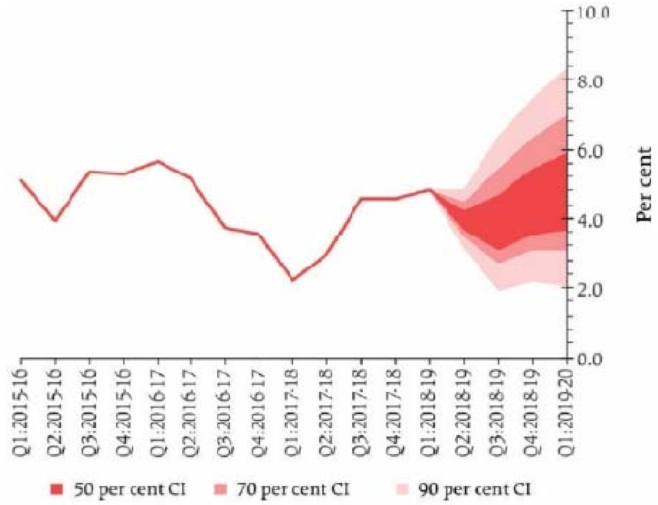
In favour of 25bps rate hike:

- Dr Chetan Ghate

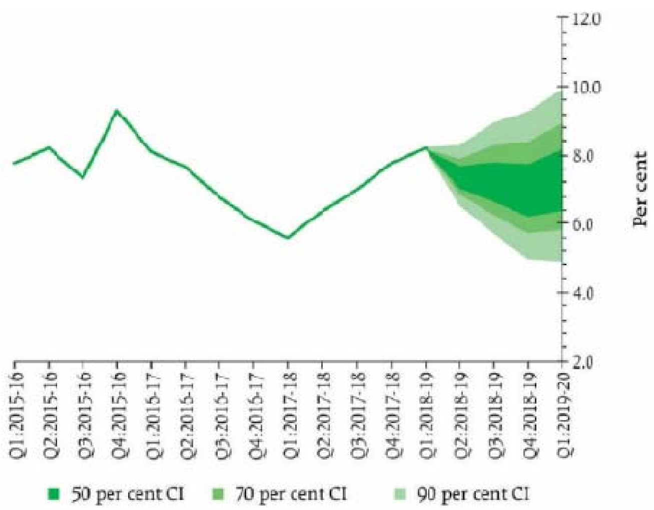
In favour of no change in stance:

Dr Ravindra H. Dholakia

RBI's quarterly projection of CPI inflation



RBI's quarterly projection of real GDP growth



Note: CI=Confidence Interval. Source: RBI, PhillipCapital India Research

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