

RBI Watch: Easy does it!

"Life was always a matter of waiting for the right moment to act."

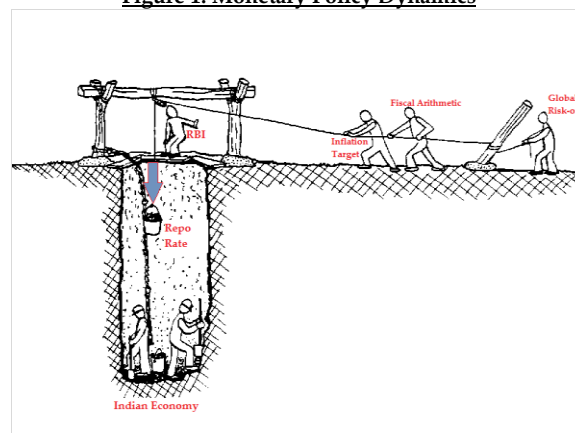
-Paulo Coelho

Just about every analyst in the market now believes that the right moment to act has come, and that the RBI shall cut policy rate (25bps at least) in its next monetary policy review on 5th April 2016.

After all, the latest inflation reading has been lower than expected and could presage a trend. The 'headline message' from the government with respect to fiscal consolidation has been assuring. To top it all, the government has even slashed interest rates on small saving schemes, a politically difficult move, but one that ticks an important box on the RBI's checklist.

In this note, we highlight our expectations for the upcoming monetary policy review. We believe that a cut on 5th April, although imminent could be of just 25 bps and disappoint those that are expecting more accommodation.

Figure 1: Monetary Policy Dynamics



Source: HDFC Bank

What has changed since then?

In its first monetary policy review of 2016, just before the union budget, the RBI decided to keep policy rates unchanged - to seek clarity on the plans for fiscal consolidation, work out the borrowing math of the government, and to gauge progress on structural reforms. Back then, although RBI maintained its dovish outlook in its statement, it highlighted that "structural reforms in the Union Budget that boost growth while controlling spending will create more space for monetary policy to support growth."

On the inflation front, while the RBI seemed somewhat certain on accomplishing the January-2016 target (6%), it highlighted marginal upside risk to the 5% inflation target for FY17. In this regard, assuming normal monsoon and subdued level of oil prices, the policy

statement cautioned that the impact of 7th Pay Commission could impact “upward momentum” to inflation trajectory for one to two years.

How have things panned out thus far? Has the government and evolving macro-economic conditions given the RBI enough reason to offer a more aggressive rate cut than expected earlier? Or, are there risks that the central bank is likely to consider and take a measured, calibrated approach?

- **Fiscal consolidation:** We believe that the government’s decision not to renege on the commitment to keep fiscal deficit at 3.5% of GDP (FY17), coupled with the weak industrial growth and softer-than expected inflation print does give the RBI some room to reciprocate. We would be surprised if the RBI does not cut the repo rate by 25 bps.

However there is some unsettling arithmetic and this could keep the RBI on guard and hold it from offering a 50 bps bonanza. As per our analysis, only 30-40% of the 7th Pay Commission burden has been accounted for in the union budget. Only after the announcement of the actual award of increments can the RBI assess the demand and inflation implications. This seems likely only in 2H-FY17. Similarly, expectations from telecom spectrum and divestment seem a tad stretched, the credibility of these targets (and hence the ability of the government to deliver on its fiscal promise) could only emerge later. The five state assembly elections due over the next few months queer the pitch further as it raises the risk of ‘populist spending’ and this includes a full implementation of the government’s pay-hike recommendations. Our sense is that the central bank would wait for greater clarity on these fronts before turning further accommodative.

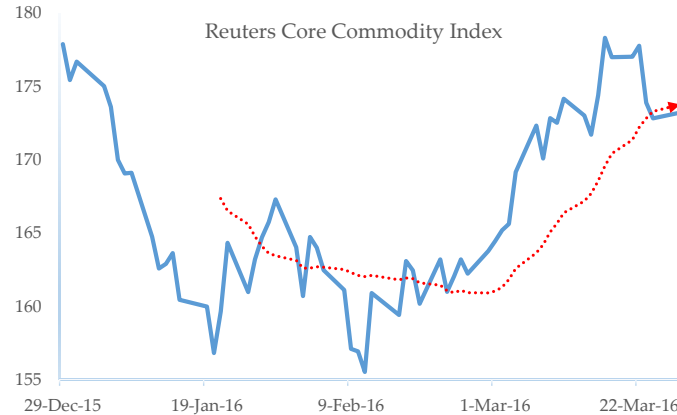
Figure 2: Upcoming State Elections

Schedule for the Legislative Assembly Elections	
State	Date of Poll
West Bengal	4th April to 5th May, 2016
Assam	4th April to 11th April, 2016
Kerala	16th May, 2016
Tamil Nadu	16th May, 2016
Pondicherry	16th May, 2016

Source: Elections.in, HDFC Bank

- **Inflation has eased but it still remains a challenge:** In its avatar as a flexible inflation targeter, the RBI is guided solely by CPI inflation in its policy decisions. In this regard, latest reading for the month of February has been lower than expectations- at 5.18% YoY vs. 5.69% in January. While this should provide room to cut rates, we believe that there still lies upside risk to 5% target for March-2017. For one, international commodity prices have moved up by 7.8% (Reuters Core Commodity Index) since the last monetary policy review and the central bank might not wish to ignore this altogether.

Figure 3: Reversal in trend for commodity prices?



Source: Reuters, HDFC Bank

Two, the monsoon could yet again turn out to be a party-pooper and challenge the efficacy of food supply management skills of the government. It is important to recognize the fact that some states are severely stretched in terms of critical inputs like irrigation. In Maharashtra for example, the second largest producer for agricultural output, successive years of low rainfall have resulted in falling groundwater levels and early drying of water streams. Another bad monsoon could lead to severe problems. While early forecasts predict a normal monsoon in FY17, these early forecasts have had a history of going awry. Thus, the RBI could want to watch this space instead of turning too aggressive.

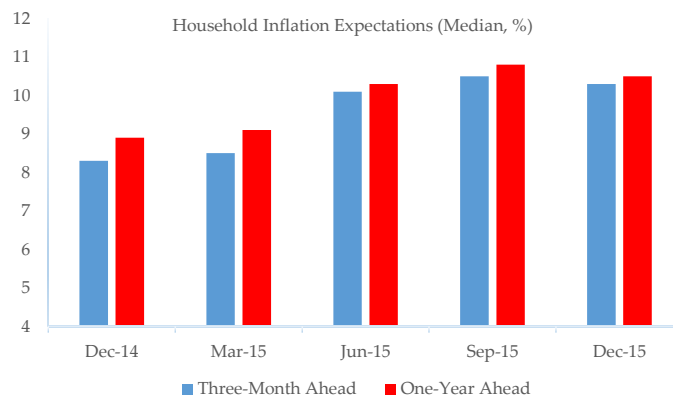
- **Global sentiment turned positive:** Internationally, while accommodation continues in EU and Japan, the US Fed has toned its communication down. With the Fed's decision to keep rates on hold in its last monetary policy review and indicating a relatively dovish stance, capital flows into emerging markets have once again picked-up (For India, FII flows touched a 34-month high in March). This should provide support to the RBI in cutting rates in April as it does not have to worry too much about a fall in debt yields turning the spigot off.

However things could be different and far more volatile going forward. Its current 'dovishness' notwithstanding, we still expect Fed to start tightening in 2H-2016. There are specific event risks such as the 'Brexit' referendum and the US presidential elections. Concerns about EM growth prospects and China might have receded a little but the tide could turn, leading to another bout of global risk aversion. This is clearly something the RBI needs to be watchful about. It does not necessarily preclude another rate cut (a cut could help growth driven flows such as stock-market inflows) but a looming storm risks does call for caution.

Therefore, no bazooka for now...

In September-2015, alongside the 50bps cut in policy rate, the Reserve Bank of India underlined inflation-adjusted interest rate of about 1.0-1.5% - as appropriate for the current phase of Indian economy. Based on the one-year Treasury bill rate and one-year inflation expectation, the real interest rate was 1.9% back then, and remains the same as of today. Thus, there exists room for further monetary easing, and this is a scenario that bond markets have been factoring-in post the union budget announcement. However, a cut beyond 25bps could not only lower the real rate of return below RBI's comfort range, but given the variety of risks and cautions that the central bank needs to consider, will not in our opinion, be the prudent thing to do.

Figure 4: Inflation expectations remain high



Source: RBI, HDFC Bank

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