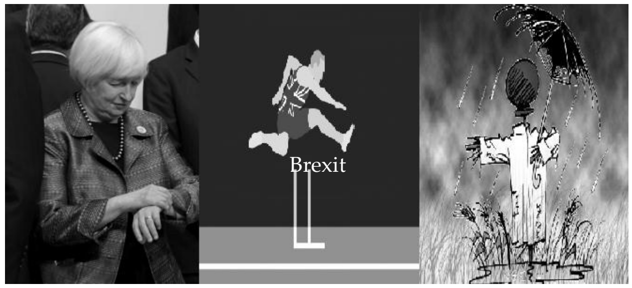
RBI Watch: Money, money, everywhere, but how much more?



In its second bi-monthly policy meet of FY17 (on 7th June), the RBI is likely to leave the Repo rate unchanged at 6.50%. We believe that the central bank will wait for the onset of monsoon to see its impact on both growth and inflation. Besides we are entering a period of increased global uncertainty, driven by factors ranging from the Fed's rate stance, UK's referendum on staying within the European Union in June and the possibility of adverse news flow from China. In our opinion, it would be rational for the RBI to be in a wait-and-watch mode for now.

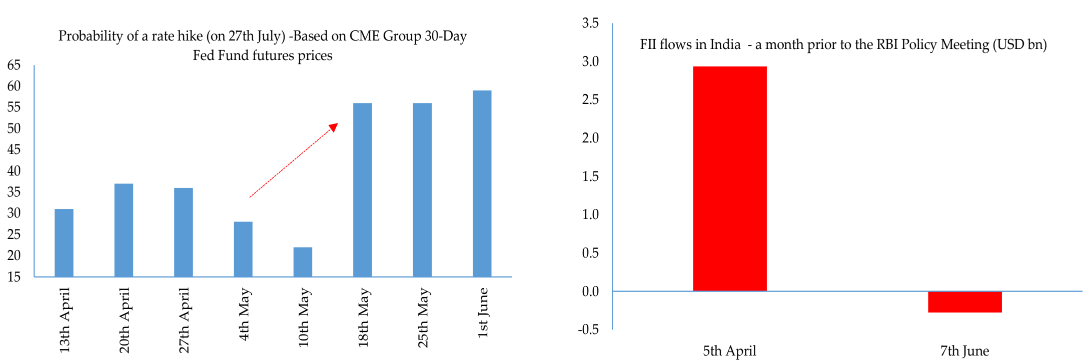
While the absence of a rate cut is factored into bond prices, what the markets would seek clarity on is the RBI's liquidity management policy - likely to be a crucial element for the upcoming meeting.

That said, we do not believe that the window for a rate cut is shut and expect another 25 bps cut in FY17, possibly after August, if the global environment is benign.

What has changed since the last meeting in April?

- On the global front, markets are now pricing-in a greater probability of interest rate hike from the US Federal Reserve in next one or two months. After a series of hawkish comments from the Fed officials, probability of a rate hike for the July meeting has gone up from around 30% in the beginning of April to around 59% now. The UK's referendum on 23rd June is likely to go on favor of those who want to continue in the EU but the polls have swung a little and one cannot ignore the risk of 'Brexit'. The impact of China's policy stimulus seems to be wearing off and this could mean some unsavory news, both on the real and financial economy.

Figure 1: US Fed officials decide their stance a week before UK's vote on membership, FIIs pull out



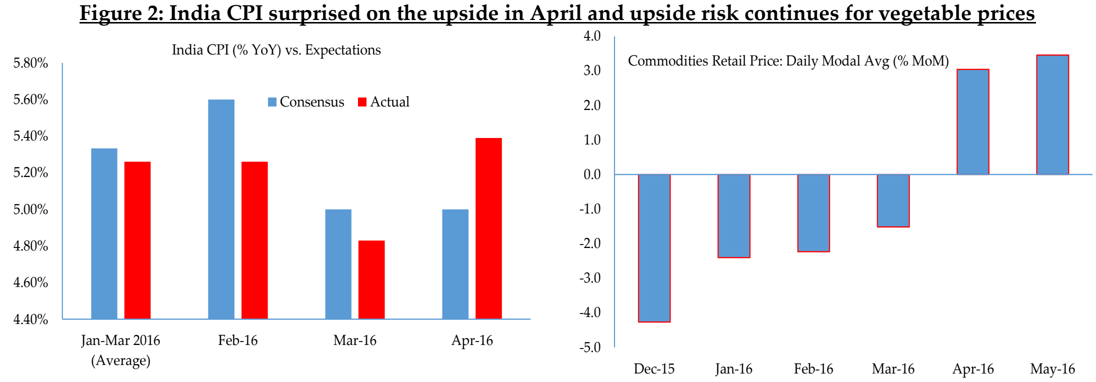
Source: CME Group, CEIC, Reuters and HDFC Bank

- On the domestic front, April CPI rose 5.4% YoY from 4.8% in March. The rise was higher than market expectations of 5.1% and was worryingly led by the food prices. Moreover, as per the high frequency data of Mandi prices, the uptick continued in the month of May, especially for heavy weight items like Potato, sugar and pulses (Figure 2).

  Thus, the statistics related to temporal and spatial distribution of rainfall becomes an important variable for the trajectory of food prices going ahead, and the RBI is likely to get clarity on this front only by July (Figure 3).

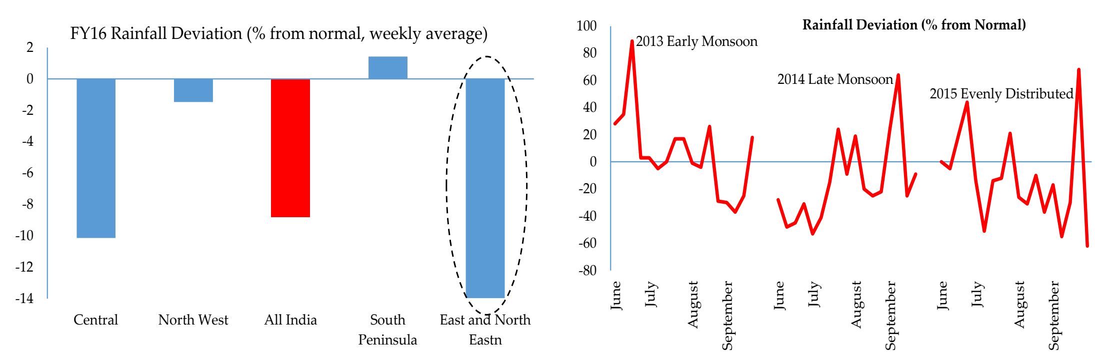
  Moreover, crude prices have gone up by 11% since the last monetary policy meeting (other commodity prices as well) and it would be important to note if this is a trend reversal or just a short-term rally. As of now, from the RBI's perspective, India's crude basket price is up from USD 36/barrel in March to USD 45/barrel in May.

Figure 2: India CPI surprised on the upside in April and upside risk continues for vegetable prices



Source: CEIC, Department of Consumer Affairs and HDFC Bank

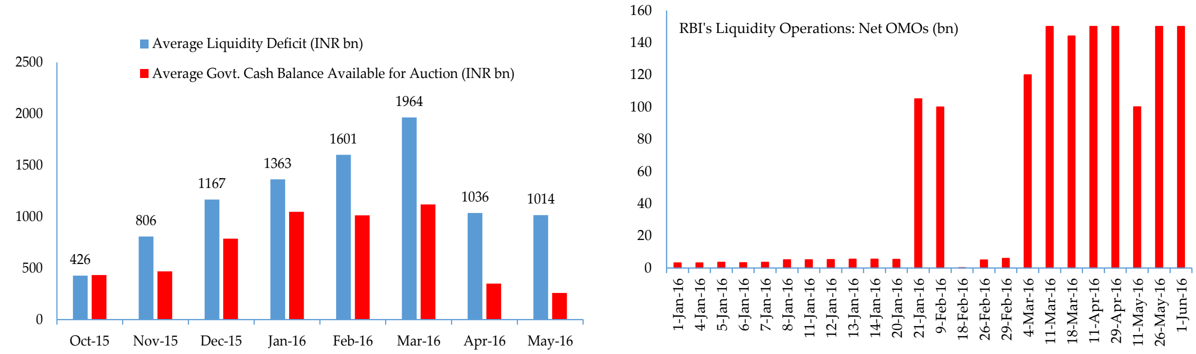
Figure 3: In FY16, despite deficient monsoon, the rainfall in North West and South Peninsula was close to normal. Moreover, the temporal distribution was more or less even. Hence, the output damage was less severe.



Source: CEIC, IMD and HDFC Bank

- On the liquidity front, after RBI's decision to gradually move the systemic liquidity from a deficit to neutral regime, the daily deficit has narrowed to around Rs.1 trillion in May from close to Rs. 2.0 trillion in March. Aggressive OMOs, to the tune of INR Rs.700 billion and increased government spending in the past two months have helped in this regard.

Figure 4: Banking liquidity has improved amidst OMOs and higher government spending



Source: CEIC, RBI and HDFC Bank

What to expect from the June Policy?

1. **Leaving room open for one more rate cut this year.** In our view, likelihood of one more rate cut in FY17 should remain on the table. For one, we believe that crude prices are likely to average around USD 50 per barrel in FY17. While the RBI is likely to highlight the risk of rise in crude prices, it could be reiterated that on average the import basket price for crude should remain subdued and comfortable. Two, while the US is not likely to hike rates in the June meeting, the RBI is likely to wait for its guidance on rate trajectory and reiterate that global risks remain more or less balanced for now. Three, on account of efficient management of food supply by the government, normal monsoon, restrained hike in the MSPs, and only partial implementation of 7th pay commission recommendations, the inflationary pressures are likely to remain muted. The RBI is likely to reiterate similar assumptions and a wait-watch stance for the fresh set of data.

2. **Clarification on Liquidity management:** The critical part of the statement could be clarification and guidance on liquidity infusion. Some basic questions arise. What exactly does the RBI mean by liquidity neutrality? How will the seasonal fluctuations in liquidity drivers like government spending (the analogue is liquidity draining cash balances with the RBI) affect its strategy? Does the RBI now have a more specific view on possible 'liquidity shocks'- the spectrum auction in next two-three months, and the maturity and outflow of dollar FCNR(B) deposits (contracted in the wake of the May taper tantrums) in 2H-2016? What exactly is the time frame over which the RBI will reach this 'neutral regime'? We hope the statement will shine some light on this.

How much OMOs are needed?

We try to assess the quantum of OMOs that are needed to reach what we perceive to be a 'liquidity neutral' regime. We assume that bond purchases by the RBI are a residual, derived post the impact of foreign capital inflows on domestic money-supply. These are tentative approaches that give a basic sense of the magnitudes involved.

i. **Approach 1:** With a simple model matching money supply and demand in the economy, RBI could be targeting around 16% growth in reserve money for FY17 (M=kPY, which has historically formed the basis of monetary targeting in India). This is assuming income elasticity of money demand at around 1.4 for India (1% increase in income requires 1.4%

increase in money supply). Thus, with a likely real GDP growth of 7.8% in FY17 and 5% inflation, the RBI could seek to create Rs. 3.5 trillion reserve money over FY17.

	HDFC Bank Estimate for OMOs in FY17 (average INR bn per month) Scenario Analysis			
	0% via Foreign Assets	25% via Foreign Assets	50% via Foreign Assets	75% via Foreign Assets
Approach 1	291	218	145	73
Approach 2	325	244	162	81
Approach 3	406	304	203	101
Average	**340**	**255**	**170**	**85**

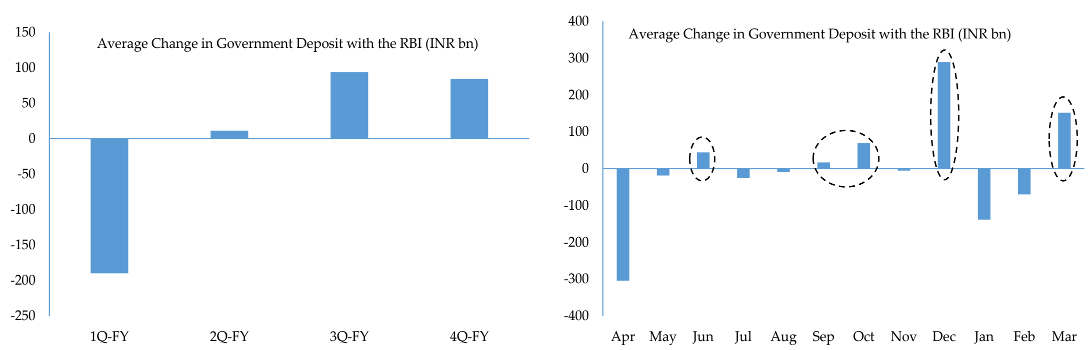
Source: CEIC, RBI and HDFC Bank. PB: Approach 1 is based on Cambridge equation of money demand, which says that a certain portion of the money supply will not be used for transactions. For approach 2: deposits are assumed to rise by 13% in FY17. Under approach 3, currency with public is assumed to rise at an average rate of Nov 15 –April 16, since leakage picked up Nov-15 onwards.

ii. **Approach 2:** A basic money demand model based on GDP/income growth does not capture RBI's explicit intent to move the banking system from a deficit to a neutral regime. If we assume reserve money growth for FY17 similar to the last year and take into account the incremental impact of removing the extant liquidity deficit (~1% of NDTL within one year), then the reserve money creation could be Rs. 3.9 trillion (+18%). This also takes into account the rise in bank deposits during the year.

iii. **Approach 3:** Both the above-mentioned approaches do not take into account the recent concern for the baking sector liquidity – currency leakage with the public. While there are theories talking about higher ATM withdrawals to save the hike in transaction tax, election related spending and hike in services tax among many others, we believe that if this becomes a structural problem, then RBI could be doing additional OMOs to encounter the problem. In this regard, assuming that the recent surge in currency with public persists through the year, the reserve money creation could be around Rs. 4.9 trillion in FY17 (+22%). This is an extended framework of approach 2 mentioned above.

Thus, depending on the extent of foreign capital inflows, combining all the above-mentioned approaches, OMOs could be in the range of Rs. 85 billion to 340 bn per month. At the current pace, RBI is largely relying on OMOs with average infusion of Rs. 350 billion per month. This of course, is in addition to the cyclical demands met through the repo window and term-repos, on the basis of government's cash balance with the RBI and other transitory factors.

Figure 5: Trends in government deposits with the RBI, 3Q and 4Q generally require more liquidity infusion



Source: CEIC, RBI and HDFC Bank

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