

Monetary Policy Preview

27 July 2017

Tread With Caution: MPC Will Be A Divided House On Rate Cut

We see 50% chance of a rate cut in August 2017, if the Reserve Bank of India or RBI goes by the inflation data of the past couple of months. However, we are not taking a rate cut for granted, as an inflation-targeting central bank should ideally be forward-looking. Going forward, we see inflationary pressure from the increase in house rent allowance under the Seventh Central Pay Commission, upturn in food prices - particularly vegetables, formalisation effect of Goods and Services Tax or GST, increase in rural wages and minimum support price (MSP) for crops and farm loan waivers. Therefore, we believe it will be a close call given the differences in views within the Monetary Policy Committee (MPC). If the RBI waits till October 2017, the probability of a rate cut falls to 20% as global factors including gradual reduction in the balance sheet by the US Federal Reserve may also come in the way of the RBI. Moreover, if the RBI refrains from cutting rates in response to the soft patch of inflation, we believe it will also be able to push back a rate hike as inflation rises. In our view, the June 2017 inflation reading is likely to be the bottom, and we expect an uptick from July 2017 onwards. We also believe that inflation is likely to be slightly above the RBI's 4.5% upper bound forecast in 2HFY18. In any case, we see only limited room for policy easing, and do not believe that rates can be cut by more than 25bps. The only time since 1970 that benchmark interest rates in India have been lower than 6% was between January 2009 and August 2010 following the 2008 global financial crisis. This time around, the global backdrop is far from similar, and rates are normalising.

August 2017 rate cut is a close call: We see 50% chance of a rate cut in August 2017, if the RBI goes by the inflation data of the past couple of months. However, we are not taking a rate cut for granted, as an inflation-targeting central bank should ideally be forward-looking. Going forward, we see inflationary pressure from the increase in house rent allowance under the Seventh Central Pay Commission, upturn in food prices - particularly vegetables, formalisation effect of GST, increase in rural wages and minimum support price (MSP) for crops and farm loan waivers. Therefore, we believe it will be a close call, given the differences in views within the MPC. If the RBI waits till October 2017, the probability of a rate cut falls to 20%, as global factors including gradual reduction in the balance sheet by the US Federal Reserve may also come in the way of the RBI. Moreover, if the RBI refrains from cutting rates in response to the soft patch of inflation, we believe it will also be able to push back a rate hike as inflation rises.

Inflationary pressure on the rise: In our view, the June 2017 inflation reading is likely to be the bottom, and we expect an uptick from July 2017 onwards (Exhibit 1). We also believe that inflation is likely to be slightly above the RBI's 4.5% upper bound forecast in 2HFY18. We expect the increase in house rent allowance (HRA) under the Seventh Central Pay Commission to push up inflation by 50bps-75bps in the next couple of months. Please read our report: [Impact of 7th CPC HRA on CPI inflation](#). While tax rates under GST are inflation neutral from Consumer Price Index or CPI standpoint, we expect the formalisation impact of GST on account of higher tax compliance, and costs associated with the regime shift could be slightly inflationary. Please read our report: [Impact of GST on CPI](#). We also expect the return of corporate pricing power as demand recovers, increased government spending in rural areas and waning of base effect to contribute to the pick-up in inflation in 2HFY18.

Vegetables prices have spiked: Vegetables have been the largest contributor to disinflation witnessed over the past couple of months (Exhibit 2). Pulses come second in their contribution to disinflation, but the disinflation in vegetables began as early as September 2016 whereas for pulses the trend began only in early 2017. However prices of vegetables, particularly tomatoes, have witnessed a spike in July 2017. Prices of tomatoes which were hovering at Rs15-Rs20/kg at the beginning of June 2017, are now ruling at Rs70-Rs100/kg. Moreover, while rainfall across India is 5% above normal, the southern and north-eastern states are facing a significant shortfall (Exhibit 3). What is worrying is that Karnataka, one among the states with deficient rainfall, is also the second-largest producer of tomatoes (12.4% of total output), a close second after Madhya Pradesh (Exhibit 4). Similarly, while Maharashtra controls the market for onions (28% of output), Karnataka is again second accounting for 17.1% of output (Exhibit 5). In addition, while kharif (autumn crop) sowing is progressing well, certain crops like oilseeds lag behind (Exhibit 6).

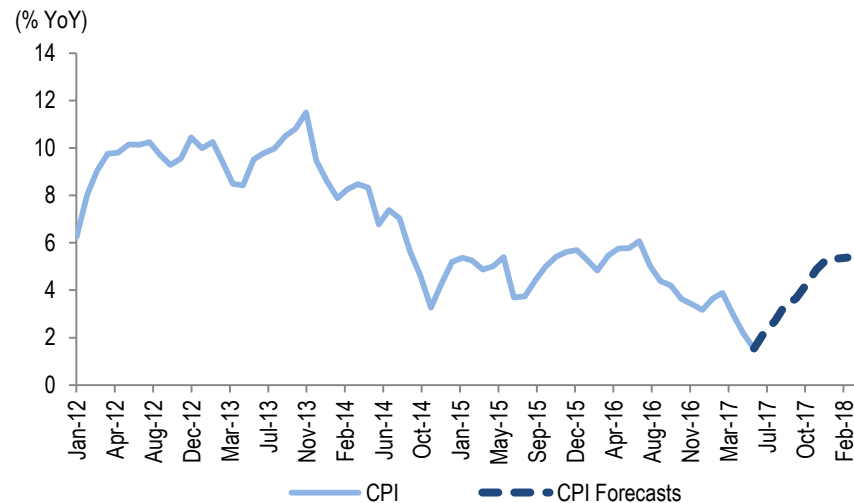
Increase in MSP and farm loan waiver also potentially inflationary: The government has hiked MSP for kharif crops by nearly 7%, the highest increase since the Modi-led government took office at the Centre. MSP for pulses has been increased by over 13%; while for rice, coarse cereals and oilseeds the increase was over 5%; and 4% for cotton. MSP hikes are typically inflationary, but manifest itself with a lag of about six months (Exhibit 7). Farm loan waivers of about Rs.850bn have also been announced so far by four states, which could also be inflationary.

Limited room for easing: In any case, we see very limited room for policy easing, and do not believe that rates can be cut by more than 25bps. The only time since 1970 that benchmark interest rates in India have been lower than 6% was between January 2009 and August 2010 following the 2008 global financial crisis (Exhibit 8). This time around, the global backdrop is far from similar. Interest rates across the developed world are being normalised. Therefore, with benchmark interest rates already at 6.25%, we do not believe rates can fall by more than 25bps in this cycle.

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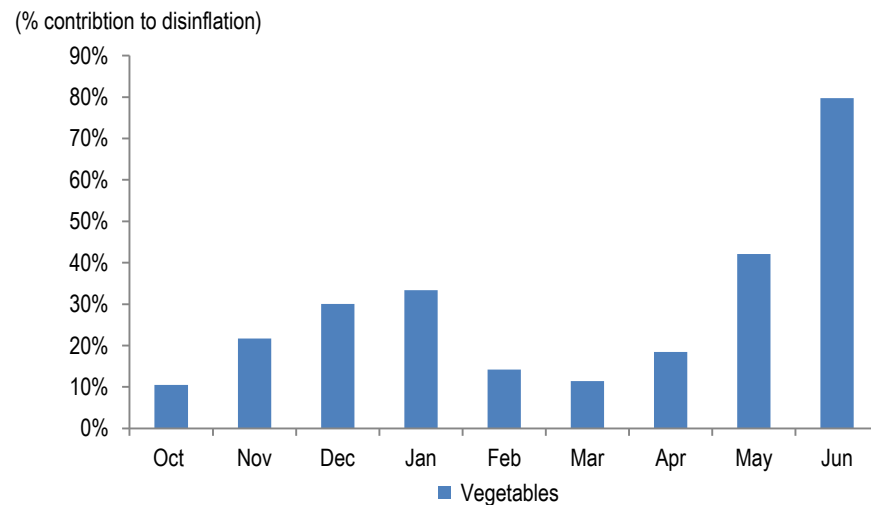
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Exhibit 1: CPI inflation likely at bottom, but may prompt a 25bps rate cut in August 2017



Source: Central Statistical Organisation or CSO, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 2: Vegetables have been the largest contributor to disinflation, but this is now reversing

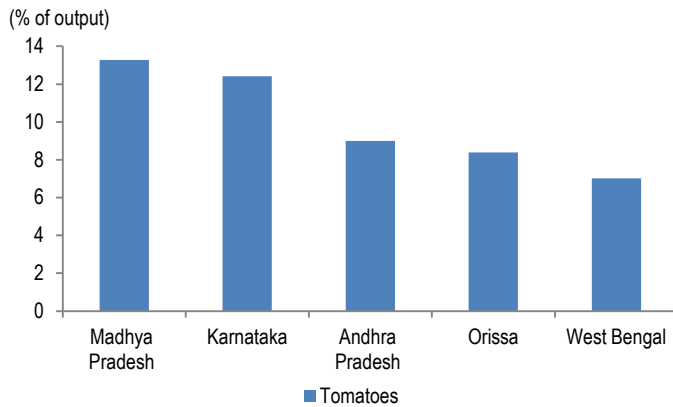


Source: CSO, CEIC, Nirmal Bang Institutional Equities Research

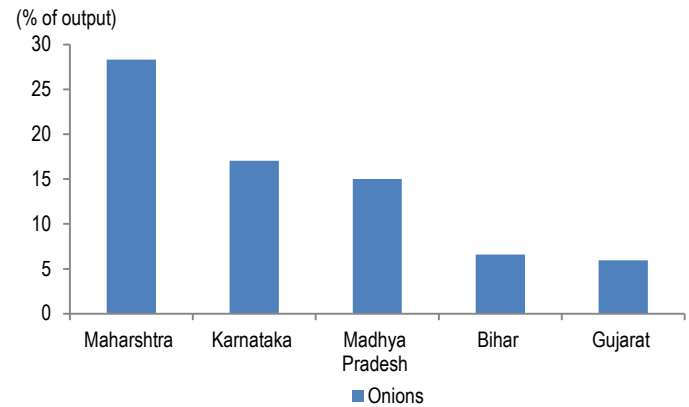
Exhibit 3: Rainfall is deficient in southern states including Karnataka

State	Rainfall deviation from normal (%)
East and north-east (5%)	
Arunachal Pradesh	(19%)
Assam	(10%)
Meghalaya	(17%)
Nagaland	(31%)
Manipur	(65%)
Bihar	(5%)
Southern (14%)	
Tamil Nadu	(30%)
Karnataka	(19%)
Kerala	(27%)
All India	5%

Source: India Meteorological Department or IMD, Nirmal Bang Institutional Equities Research

Exhibit 4: Karnataka is the second-largest producer of tomatoes...
Exhibit 5: ...and also onions


Source: National Horticulture Board (NHB), Nirmal Bang Institutional Equities Research.

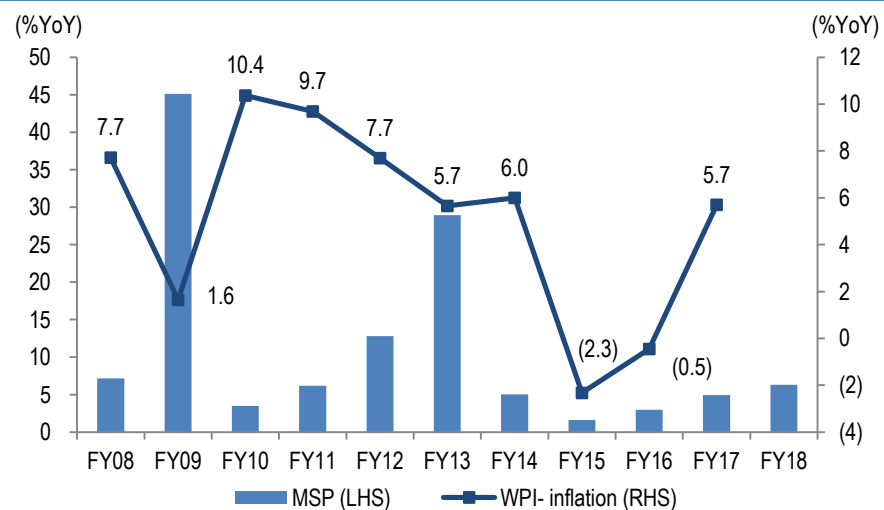


Source: NHB, Nirmal Bang Institutional Equities Research

Exhibit 6: Kharif crop sowing progressing well, but oilseeds a concern

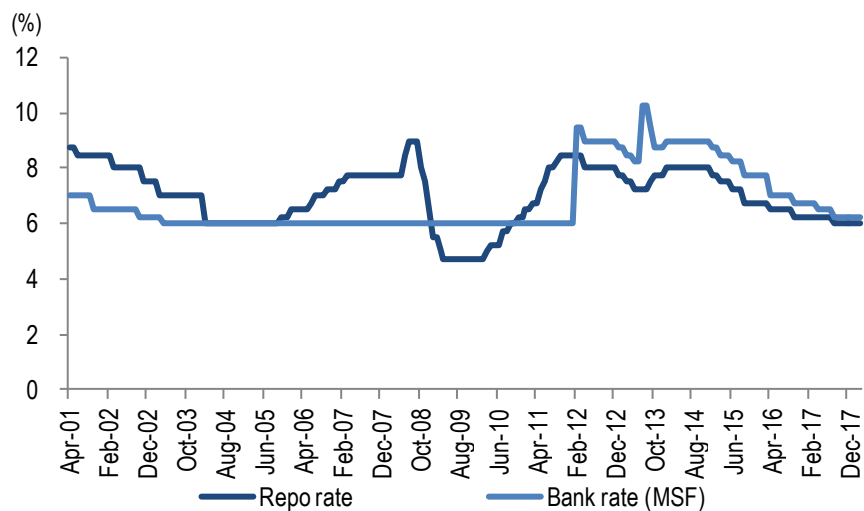
	FY17 (mn. ha)	FY18 (mn. ha)	% YoY
Rice	16.92	17.70	4.62
Pulses	9.03	9.34	3.35
Coarse cereals	12.94	13.09	1.15
Oilseeds	14.48	12.36	(14.69)
Sugarcane	4.52	4.92	8.69
Jute & Mesta	0.75	0.70	(6.63)
Cotton	8.69	10.43	20.07
Total	67.34	68.53	1.77

Source: Ministry of Agriculture, Nirmal Bang Institutional Equities Research

Exhibit 7: MSP hikes are potentially inflationary


Source: Ministry of Agriculture, CEIC, Nirmal Bang Institutional Equities Research

Exhibit 8: Policy rates have not gone below 6%, except in 2008



Source: RBI, CEIC, Nirmal Bang Institutional Equities Research

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