Economics

DBS Flash

India: Soft CPI gives RBI room to pause

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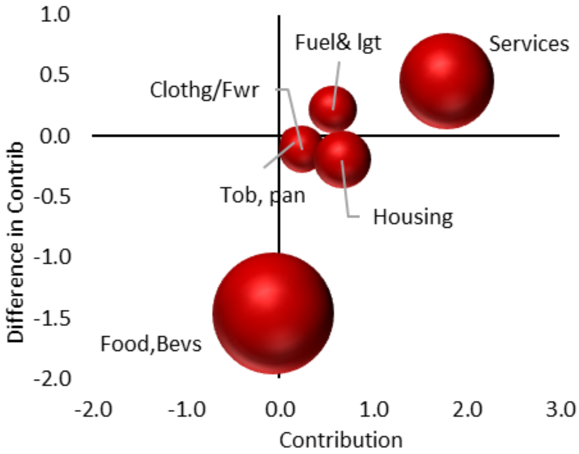
- *October inflation remained below 4% for the third consecutive month, posting a downside surprise. Core inflation ticked up.*
- *Softer inflation profile and lower oil prompts us to revise our call for rates to be now left on hold in December.*
- *Risks of a tighter policy in March 2019 hinge on global developments (impact on rupee) and commodity prices.*
- *Disagreements between the central bank and the government are neither new nor unique to India, but markets' sensitivities are high.*
- *The authorities are expected to reach a middle ground on a few contentious aspects, particularly banks' corrective framework and transfer of RBI's excess reserves.*

Headline and core inflation diverged in October. Headline CPI inflation posted a downside surprise, easing to 3.3% YoY vs 3.7% in September and staying below the 4% target for the third successive month. FY19 is tracking an average of 4.2% YoY yet far, higher than 3.6% last year, but monthly trends, particularly in food, are running below past trends. Stripping out food and fuel, core inflation, however, jumped to 6.2% YoY, reversing higher after four months of pullback. The breakdown reveals that this was largely due to higher gold prices, reflected under the personal care and effects category, in the services segment. **Food (accounts for half the basket) has been biggest drag on the headline,** negating the rise in contribution of non-food segments, including fuel, transport and education - see chart. While positive for inflation, a prolonged phase of weak food/ farm prices has triggered concerns over negative repercussions for agricultural incomes and impacting rural demand.

CPI sub-heads - Oct18 vs Apr18 - food falls, core up

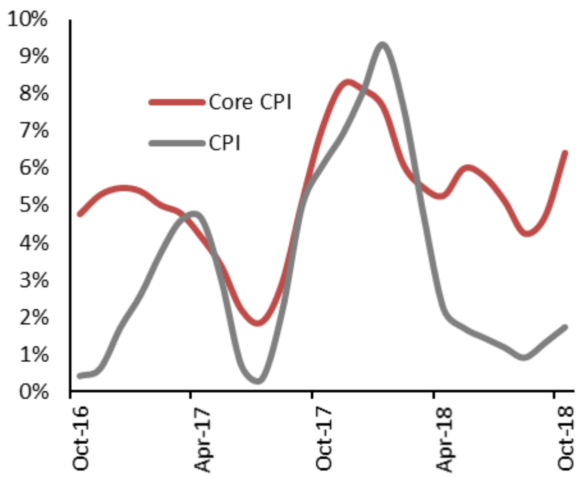
% point; size of the bubble = weightage



Source: CEIC, data transformations by DBS

Providing a gauge of underlying price momentum, our trend gauge (3M/3M% annualised) points to stirrings of a bottoming-out in the trend (see chart). Extending this profile, headline inflation is now likely to average 3.5% by December and inch past 4.0% next quarter, more benign than earlier assumed.

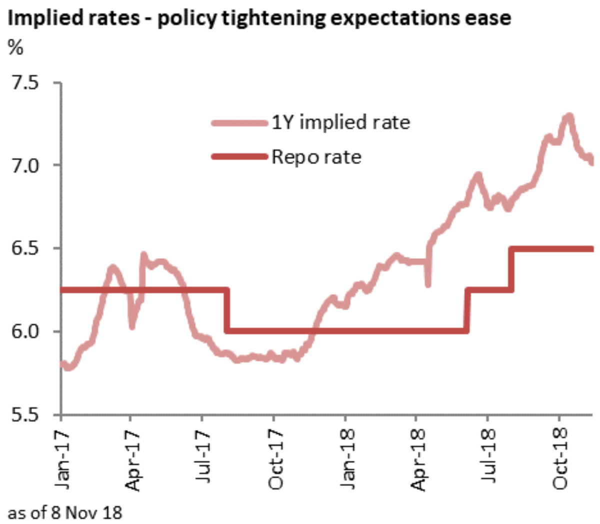
Inflation momentum (3M/3M % annualised)



Source: CEIC, data transformations by DBS

Global pressure points from high oil prices and currency depreciation pressures have ebbed in the near-term, even if not vanished, in our view (see our Weekly note). Indian crude oil prices in November are 10% below October's average and down 16% from this year's highs. The Indian rupee, whilst remaining the regional underperformer, has trimmed year-to-date losses against the USD to 12.5% from over -14-15% earlier.

The RBI surprised by keeping rates on hold in October but revised the stance to 'calibrated tightening'. We had expected this to be followed by a measured rate hike in Q418 factoring in a tough global environment. **Considering the recent correction in oil prices and resultant relief rally in the rupee, the pressure on the RBI to raise rates has eased.** Real rates (1Y T-bill minus inflation) are also well-cushioned at 250-300bp. September quarter GDP numbers (i.e. 2QFY19) due by late-November is likely to slow modestly from a strong 8.2% in June-August. **This makes it likely that benchmark rates will be left unchanged at 6.5% in December.** Markets are also factoring in a lower likelihood of rate hikes, pushing out the December hike to next year.



Source: Bloomberg, DBS Group Research

Risks, nonetheless, remain to tighten policy in March 2019, subject to global developments (impact on rupee) and commodity prices. We continue to expect the US Fed to raise rates later this year and next year, to take the Fed Funds rate to 3.5% by end-2019. This is likely to translate into higher US dollar and increase in US rates, making it necessary for regional central banks to at least partly match these increases.

In the interim, the RBI and the government are in midst of consultations to reach a common ground on few areas of contention. These include, calls by the government to ease part of the restrictions placed on public sector banks under the Prompt Corrective Action (PCA) framework; under the latter 11 public sector banks have been earmarked, subject to restrictions on fresh loans and dividend distribution. Concurrently, the government has called for liquidity windows for non-bank financial companies. There have also been calls for the RBI to transfer surplus reserves (from its balance sheet) to the government.

While disagreements between the central bank and the government are neither new nor unique to India, markets' sensitivities are high. Prudently, consultations are ongoing, with the December 19 meeting of the RBI Board seen as a crucial date to gain clarity on the above-mentioned aspects. We also learnt that the RBI Board assumes an advisory role over the Governor but cannot supersede the latter on substantive issues under the existing RBI Act [1].

Expectations are that tensions will thaw. News outfits are speculating that that four banks might be freed from the PCA framework in the coming weeks, owing to improved financial performance. For NBFCs, the RBI has already provided indirect support through banks, whilst conducting regular bond buybacks. Government officials clarified that they were unlikely to seek transfer of RBI's surplus reserves, instead stressing on the need to construct an 'economic capital framework' for the RBI. This is seen as a tool to calculate the optimal level of reserves in the latter's balance sheet, more than which could be transferred to the government. Of the total (INR9.6trn), RBI's reserves are divided into valuation reserves, asset development and contingency reserves.

Clarity on the working relationship between the RBI and the government is awaited. A challenging global environment and domestic speed-bumps by way of rising funding costs, tighter liquidity, slow improvement in banking sector performance and upcoming elections, makes it crucial to steer the boat steadily in what is likely to be months of choppy waters.

Sources: [1] Former RBI Board member Mr. Y. H. Malegam comments: a) Moneycontrol; 9 Nov; b) Interview with CNBC TV18 on 10 Nov

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).