

India Macro View

Urjit Patel Committee Report – It's Positive and Bold... but Risky

- **What's New - Urjit Patel Committee Report** – Key recommendations of the Urjit Patel Committee on monetary policy framework are (1) Choice of Nominal Anchor: Inflation, i.e. ,CPI proposed as nominal anchor (2) Inflation target: set at 4% within a band of +/-2% over a 2-year time frame (8% in 12m, 6% in 24m) (3) Setting up a MPC: a 5-member Monetary Policy Committee (MPC) will be held accountable if targets are not met. (see page 2 for details)
- **It's Bold; But Risky** – The choice of a single inflation metric is welcome and if implemented, bodes well for financial savings. Other positives include (1) clarity on the operating framework (2) greater transparency (3) developing a term money market. However, it's risky in the current macro environment with concerns of possible overkill to meet the 6% target at a time of potential political transition.
- **CPI "Numerical Target" - Is it achievable?** Yes, CPI could come down but would be dependent on supportive government policies. E.g. food prices are influenced by procurement policy and minimum support prices. Factors beyond monetary policy control include indexation of wages, suppressed fuel inflation, and fiscal policy.
- **Operating framework – What's been proposed?** The report recommends a two-phase transition of operating framework. Phase 1: continue with LAF repo rate as the single policy rate and weighted avg call rate as the operating target. Phase 2: the "policy rate" as voted by the MPC becomes the target rate with 14-day term repo as the operating target. The report also proposes a re-jig of monetary policy toolkit by introducing uncollateralized standing deposit facility and longer-term repo while phasing out cash management bills/ MSS and the refinance window. (see page 2)
- **If recommendations are accepted fully...** –The report recommends that the real policy rate is expected to be positive when inflation is above the nominal anchor target, but the extent of real rates should depend on the state of output gap and financial stability. As we expect CPI to trend towards 8.3% in FY15 and repo rate at 8%, the forward real rates would still be negative -0.3% (repo-CPI).
- **....then there is potential for further 50bps hike** – As mentioned in our Macroscope, we maintain our call of a 25bps hike in the rest of FY14 and expect rates to remain higher for longer. Going forward, if the recommendations are accepted entirely, there is ~50bps upside risk to our interest rate trajectory. Bond yields could move up further due to (1) higher nominal anchor, (2) limited use of OMO, and (3) proposals to reduce SLR. On a medium term, if inflation and inflationary expectations are brought down to targeted levels, long-term yields will benefit in due course of time.

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With thanks to
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Report Recommendations

Monetary Policy Regime – Flexible Inflation Targeting

New CPI as the Nominal Anchor: The committee proposes that the RBI use the New CPI (combined) as the nominal anchor for monetary policy communication. It further proposes that this nominal anchor be “*defined in terms of headline inflation*”. It reasons that headline CPI inflation “*closely reflects the cost of living and influences inflation expectations relative to other available metrics*”.

Targets CPI at 4% with a band of +/- 2% around it: This inflation target takes into account (1) “*the vulnerability of the Indian economy to supply/ external shocks and the relatively large weight of food in the CPI*” as well as (2) “*the need to avoid a deflation bias in the conduct of monetary policy*”. Based on historical CPI-IW data, the report suggests that a CPI level above 6.2% would be inimical to growth.

Sets Time Horizon for reaching Inflation Target; Transition will be gradual: Acknowledging that initial conditions remain difficult (elevated CPI, hardened inflation expectations, supply constraints, weak output), the committee has recommended a “*graduated*” path to reach the inflation target whereby inflation would be brought down from the current level of 10% to 8% over a period not exceeding the next 12 months and to 6% over a period not exceeding the next 24 months. Then, a formal target of 4% with a band of +/-2% would be formally adopted.

Monetary Policy Committee: Policy decision-making is proposed to be vested in a 5-member committee vs. current practice of governor being the sole decision maker.

- **Composition:** Of the 5 members, two would be external members as decided by the chairman (gov) and vice chair (deputy gov). Members of the MPC are expected to meet once in two months, and each member has one vote.
- **Accountability:** In case of failure to meet the nominal anchor target, the MPC will be held accountable. ‘Failure’ is defined as “*inability to achieve the inflation target of 4% (+ / - 2%) for three consecutive quarters.*”

Operating Framework- Rising Importance of Term Repo

Phase 1: Policy Rate – Overnight Repo; Operating Target – Overnight call – In the first phase, the current framework of overnight repo as single policy rate and weighted average call rate as operating target will be continued. The reverse repo and MSF rates will be tied to repo +/-100bps and ceiling on overnight repo will continue to be imposed (currently 0.5% of NDTL). Introduction of 28-day, 56-day and 84-day may further be undertaken to calibrate the daily dependence.

Phase 2: Policy Rate – Short tenor rate; Operating target – 14 day term repo: As term repo gains acceptance, the MPC proposes to vote for a policy rate which will be a target for the short end of the money market. The RBI will aim to keep 14-day term repo auction cut-off rates close to the policy rate by actively managing liquidity through (1) buy/sell of government securities in secondary market, (2) overnight repos/reverse repos and (3) changes in CRR. MSF in this phase will be penal and rarely used.

Monetary Policy Toolkit Rejig - The report suggests rejig of monetary policy toolkit by introducing two products: (1) standing deposit facility to provide a floor for the operating rate but, unlike reverse repo, the standing deposit facility would not provide any collateral; (2) longer term repo to enhance the term structure. The report also recommends phasing out of instruments such as cash management bills/ MSS securities (no outstanding currently) and the refinance window (currently ~370bn).

Statistical Snapshot

Figure 1. India Macroeconomic Summary FY02 – 15E

Fiscal Year to 31 March	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14E	FY15E
National Income Indicators														
Nominal GDP (Rs bn)	23,676	25,500	28,617	32,422	36,934	42,947	49,871	56,301	64,778	77,953	89,749	100,206	112,932	128,743
Nominal GDP (US\$ bn)	496	527	623	720	834	950	1,241	1,224	1,367	1,710	1,866	1,856	1,848	2,066
Per Capita GDP (US\$)	477	499	582	662	754	847	1,090	1,061	1,168	1,442	1,552	1,521	1,471	1,644
Real GDP growth (%)	5.5	4.0	8.1	7.0	9.5	9.6	9.3	6.7	8.6	9.3	6.2	5.0	4.8	5.6
Agriculture growth (%)	6.0	-6.6	9.0	0.2	5.1	4.2	5.8	0.1	0.8	7.9	3.6	1.9	4.8	3.0
Industry growth (%)	2.6	7.2	7.3	9.8	9.7	12.2	9.7	4.4	9.2	9.2	3.5	2.1	1.5	4.4
Services growth (%)	6.9	7.0	8.1	8.1	10.9	10.1	10.3	10.0	10.5	9.8	8.2	7.1	6.3	6.7
By Demand (%YoY)														
Consumption	5.3	2.3	5.4	1.9	8.7	7.7	9.4	7.7	8.4	8.1	8.1	3.9	4.9	6.4
Pvt Consumption	6.0	2.9	5.9	1.7	8.6	8.5	9.4	7.2	7.4	8.6	8.0	4.0	4.5	6.5
Public Consumption	2.3	-0.4	2.6	3.4	8.9	3.8	9.6	10.4	13.9	5.9	8.6	3.9	7.0	6.0
Gross Fixed Capital Formation	7.4	6.8	13.6	20.7	16.2	13.8	16.2	3.5	7.7	14.0	4.4	1.7	2.5	5.5
Cons; Invst, Savings * (%GDP)														
Consumption	78.9	77.2	75.0	70.1	69.2	68.0	67.2	68.6	69.1	67.2	68.0	68.7	69.1	68.8
Gross Capital Formation	22.3	24.6	26.9	32.8	34.7	35.7	38.1	34.3	36.3	37.0	35.4	35.6	36.0	36.0
Gross Domestic Savings	22.6	25.4	28.7	32.4	33.4	34.6	36.8	32.0	33.7	34.0	30.8	30.2	30.5	30.8
Real Indicators (%YoY)														
Commercial vehicle sales	-4.5	40.4	36.2	22.4	10.1	33.3	4.2	-21.4	39.2	27.0	19.5	-1.9	-12.0	5.0
Car sales	3.2	5.3	27.2	17.8	7.7	20.7	12.1	0.3	25.7	29.2	3.9	2.4	-5.0	3.6
Two-wheelers	15.3	15.8	11.3	15.7	13.6	11.5	-7.8	2.7	25.9	25.8	13.9	2.7	5.0	10.0
Diesel consumption	-3.7	0.3	1.2	6.9	1.4	6.7	11.1	8.5	8.9	6.5	5.0	6.8	0.0	4.0
Mobile Tele density	0.6	1.3	3.1	4.8	8.2	14.1	22.0	33.0	48.5	66.8	75.1	79.0	87.9	89.7
Monetary Indicators (% YoY)														
Money supply	16.0	16.1	13.0	14.0	15.9	20.0	22.1	20.5	19.2	16.2	15.8	13.4	17.0	18.0
Inflation – WPI (Avg)	3.6	3.4	5.5	6.5	3.7	6.5	4.8	8.0	3.6	9.6	8.8	7.4	6.5	6
CPI (Avg)	4.3	4.1	3.8	3.9	4.2	6.8	6.2	9.1	12.3	10.5	8.4	10.2	10.0	8.3
Bank credit growth	15.3	23.7	15.3	30.9	37.0	28.1	22.3	17.5	16.9	21.5	17.0	14.1	15.0	15.0
Deposit growth	14.6	16.1	17.5	13.0	24.0	23.8	22.4	19.9	17.2	15.9	13.5	14.3	13.5	14.0
Fiscal Indicators (% GDP)														
Centre's fiscal deficit	-6.0	-5.7	-4.3	-3.9	-4.0	-3.3	-2.5	-6.0	-6.5	-4.8	-5.7	-4.9	-5.0	-4.5
State fiscal deficit	-3.6	-3.5	-3.9	-3.4	-2.5	-2.1	-1.4	-2.3	-2.9	-3.2	-2.3	-2.1	-1.9	-2.2
Combined deficit (Centre+State)	-9.6	-9.2	-8.2	-7.2	-6.5	-5.4	-4.0	-8.3	-9.4	-8.0	-8.1	-7.0	-6.9	-6.7
Off Balance Sheet Items					-0.5	-0.9	-0.6	-1.7	-0.2	0.0	0.0	0.0	0.0	0.0
Combined liabilities (dom+ext)	87.2	90.7	90.0	88.8	84.6	79.9	76.1	76.8	75.5	70.1	69.9	70.4	69.3	67.7
External Sector (% YoY)														
Exports (US\$bn)	44.7	53.8	66.3	85.2	105.2	128.9	166.2	189.0	182.4	250.5	309.8	306.6	323.4	355.8
% YoY	-1.6	20.3	23.3	28.5	23.4	22.6	28.9	13.7	-3.5	37.3	23.7	-1.0	5.5	10.0
Imports (US\$bn)	56.3	64.5	80.0	118.9	157.1	190.7	257.6	308.5	300.6	381.1	499.5	502.2	482.1	525.5
%YoY	-2.8	14.5	24.1	48.6	32.1	21.4	35.1	19.8	-2.6	26.7	31.1	0.5	-4.0	9.0
Trade deficit (US\$bn)	-11.6	-10.7	-13.7	-33.7	-51.9	-61.8	-91.5	-119.5	-118.2	-130.6	-189.8	-195.7	-158.7	-169.8
Invisibles (US\$bn)	15.0	17.0	27.8	31.2	42.0	52.2	75.7	91.6	80.0	84.6	111.6	107.5	115.9	122.6
Current Account Deficit (US\$bn)	3.4	6.3	14.1	-2.5	-9.9	-9.6	-15.7	-27.9	-38.2	-45.9	-78.2	-88.2	-42.8	-47.2
% to GDP	0.7	1.2	2.3	-0.3	-1.2	-1.0	-1.3	-2.3	-2.8	-2.7	-4.2	-4.8	-2.3	-2.3
Capital Account (US\$bn)	8.6	10.8	16.7	28.0	25.5	45.2	106.6	7.4	51.6	62.0	67.8	89.3	56.6	63.6
% GDP	1.7	2.1	2.7	3.9	3.1	4.8	8.6	0.6	3.8	3.6	3.6	4.8	3.1	3.1
Forex Assets (excl gold) (US\$bn)	51.0	71.9	106.1	135.1	145.1	191.9	299.1	241.6	252.8	273.7	260.9	264.7	278.4	294.8
Months of imports	10.9	13.4	15.9	13.6	11.1	12.1	13.9	9.4	10.1	8.6	6.3	6.3	6.9	6.7
External Debt (US\$bn)	98.8	104.9	112.7	134.0	139.1	172.4	224.4	224.5	260.9	305.9	345.8	392.1	388.5	403.5
Short Term Debt (US\$bn)	2.7	4.7	4.4	17.7	19.5	28.1	45.7	43.3	52.3	65.0	78.2	96.7	96.8	
Exchange Rate														
US\$/INR - annual avg	47.7	48.4	45.9	45.0	44.3	45.2	40.2	46.0	47.4	45.6	48.1	54.0	61.1	62.3
% depreciation	4.4	1.5	-5.2	-2.0	-1.6	2.0	-11.1	14.4	3.0	-3.8	5.5	12.3	13.1	2.0

* At current prices.

Source: CSO, RBI, Ministry of Finance, Citi Research estimates

Appendix A-1

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