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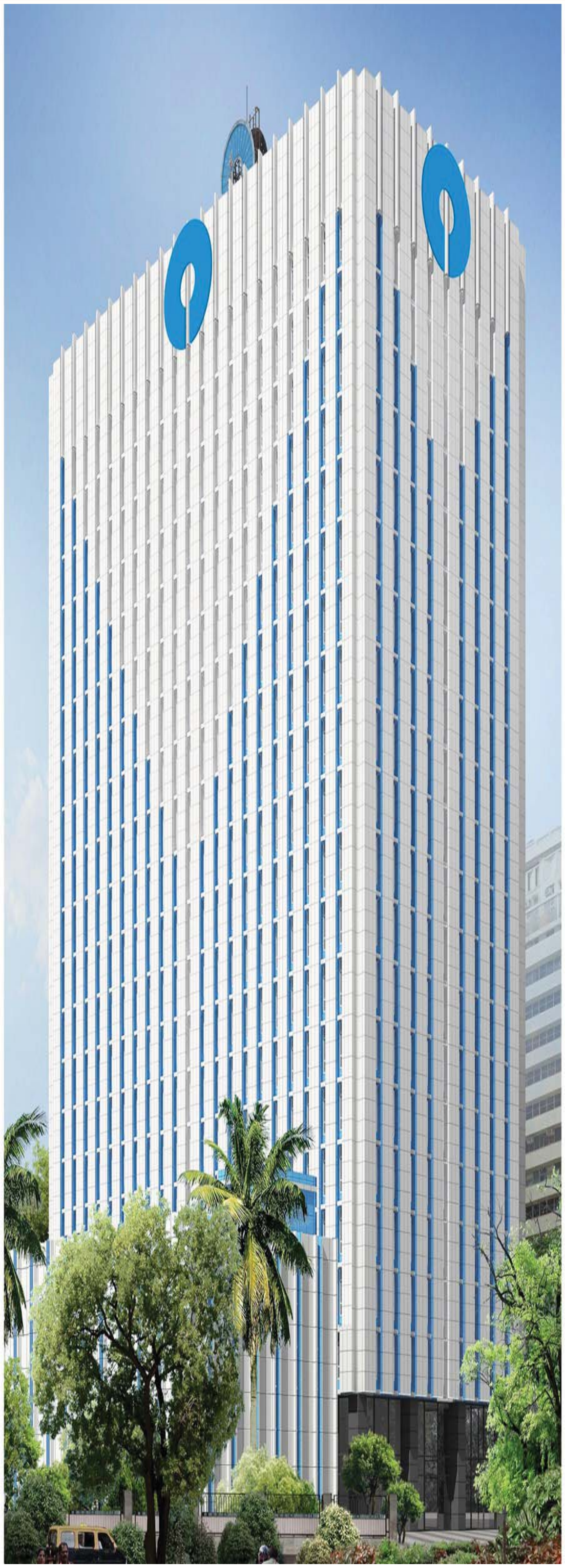


RBI TO WAIT AND WATCH IN AUGUST : JULY INFLATION AT SUB 4.5%

We believe August rate decision is a close call, though we believe status quo rather than a hike looks the best option. The only reason for a rate hike by RBI at this juncture might be to satiate the self fulfilling prophecy of market expectations of a rate hike to stem the rupee depreciation (though rupee depreciated by 3% post June).

In our view, inflation risks are still evenly balanced. While the MSP hike could statistically push up CPI by 73 basis points, such inflation is unlikely to materialize as it is purely subject to procurement by the Central Government/State Government. In fact, without effective procurement, historical trends suggest that market prices have often fallen below MSP due to demand supply dynamics.

The impact of MSP could also be negated by declining oil prices. HRA impact till date is 37 basis points. However, due to uneven spatial distribution of monsoon food prices might just move up, particularly cereals. But core inflation is expected to gradually come down to 4.5% by end March and the recent data shows that the increase in core inflation is not broad based. The outlook thus will remain stable on inflation.

US has already started normalizing its monetary policy with 3rd rate hike expected in Sep'18. Even in Eurozone after Sep'18, monthly pace of net asset purchases will be reduced to €15 billion until the end of Dec'18 and then net purchases will end, subject to the incoming data. However, in Japan inflation remains stubbornly low. None of the indicators followed by the Japanse central bank to assess inflation expectations have risen in line with the official inflation target.

Additionally, within the span of a month Chinese Yuan has depreciated by around 4% against the US Dollar. This can spell fresh trouble for emerging markets' exports as a consequence of weaker Renminbi which reduces the purchasing power for Chinese importers, adding to the argument that regional export growth could weaken over the rest of 2018. Materially, this means that until or unless trade tensions are resolved, there may be little chance of Asian central banks moving on rates until the first half of 2019.

NO AUGUST RATE HIKE ON TABLE

- After a period of more than 4 years, the Monetary Policy Committee (MPC) increased Repo rate by 25 bps to 6.25% unanimously and keep the stance neutral in Jun'18. The projection for CPI inflation for FY19 is revised to 4.8-4.9% in H1 and 4.7% in H2, including the HRA impact, with risks tilted to the upside.
- However, in the upcoming policy RBI should adopt the wait and watch stance as outlook on inflation is still stable and there are global uncertainties regarding the policy stance adopted by other central banks.

FACTORS INFLUENCING INFLATION

- Various estimates have placed inflation impact of the recent MSP hike of 14 Kharif crops between 50-100 bps on CPI. However we believe, such estimated inflation impact could just be a statistical artefact and will only transpire if there is procurement by Government. It is well known that when the public agency starts procuring the crops at MSP, it ensures a convergence between market prices and MSP and thereby impacting inflation. Our estimate suggests that post announcement of MSP with 150% hike in cost of production, the CPI inflation could increase by 73 bps and this could materialize in one or two quarter but purely subject to procurement by the Government/State Government.
- For India as a whole, cumulative rainfall during south-west monsoon 2018 upto 20 July, 2018 is 334.1 mm, which is below Long Period Average by 4%. However, the spatial distribution has not been uniform and many states in East and North India, important in terms of food grain production of cereals, have received deficit rainfall. This may have adverse impact on food inflation, if rainfall does not pick up pace in recent times.
- Core CPI for Q1 FY19 came at 6.20%. However it is expected to move downwards to reach 4.5% by year-end. Additionally, if we dissect the recent core inflation data we find that out of 118 bps increase, only two items, viz. Housing (37 bps) and Transport and Communication(33 bps) accounted for 60% of total core increase. So it is unfair to say that jump in core inflation is more broad based, as Housing inflation could be just a statistical artefact and Transport is because of oil, the outlook of which is shrouded in uncertainties. However, crude oil price has softened recently. Thus the outlook for inflation is evenly balanced till now.

Progess of Monsoon (till 20th Jul 2018)

States	% Deviation from Normal	Major Crops
UP	-46%	Wheat, Rice, Barley, Sugarcane
Haryana	-15%	Wheat, Linseed, Mustard, Gram
MP	9%	Wheat, Gram, Linseed, Mustard
Kerala	23%	Coconut, Coffee, Rubber, Tea, Spices
Punjab	13%	Wheat, Bajra, Maize, Cotton
Odisha	-7%	Rice, Jute, Linseed, Mustard
Karnataka	12%	Coffee, Rubber, Cardamom
Maharashtra	35%	Barley, Bajra, Sugarcane, Cotton
Bihar	-48%	Jute, Rice, Maize, Wheat
WB	-27%	Rice, Jute
Rajasthan	25%	Barley, Bajra, Oilseeds
AP	11%	Oilseeds, Spices
Gujarat	9%	Bajra, Groundnut, Cotton
TN	18%	Gram, Groundnut, Cotton, Spices
All India	-4%	-

Source: SBI Research

Arithmetic of Weighted Contribution in CPI

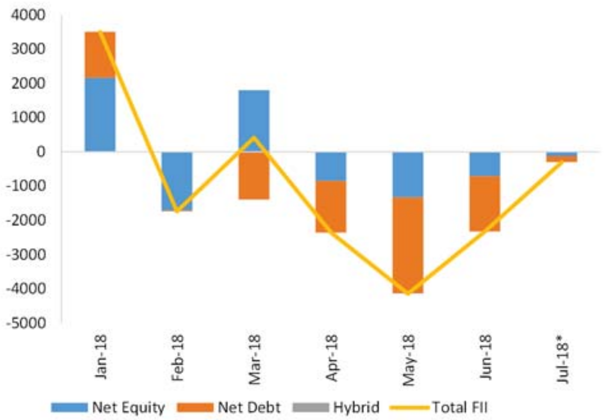
	Jun-18	Jul-17	Increase (bps)
Headline CPI	5.00	2.37	263
Non-Core CPI	2.01	0.56	123
Food *of which*	1.49	0.21	119
Vegetables	0.48	-0.27	75
Fruits	0.31	0.09	22
Protein (Meat, Egg & Milk)	0.33	0.37	-4
Fuel and light	0.48	0.31	16
Core CPI	2.99	1.81	118
Pan, Tobacco and Intoxicants	0.21	0.16	5
Clothing and Footwear	0.39	0.28	11
Housing	0.85	0.48	37
Miscellaneous	1.54	0.86	68
Household Goods and Services	0.20	0.14	5
Health	0.35	0.22	13
Transport and Communication	0.47	0.14	33
Recreation and Amusement	0.08	0.05	3
Education	0.27	0.20	6
Personal Care and effects	0.20	0.09	11
Memo:			
Core CPI Ex Housing	2.14	1.33	81
Core CPI Ex Transport	2.52	1.67	85
Core CPI Ex Housing & Transport	1.67	1.20	48

Source: SBI Research

WITHDRAWAL OF GLOBAL MONETARY EASING

- The US has already started normalizing its monetary policy and another rate hike is expected in Sep'18.
- Even the Eurozone anticipates that, after Sep'18, subject to incoming data the monthly pace of the net asset purchases will be reduced to €15 billion until the end of Dec'18 and that net purchases will then end.
- However things in Japan are looking a little different. For example, it is now a consensus that inflation in late 2019 will still be around a full percentage point below the central bank's latest forecasts, a considerable miss. A key reason why inflation remains stubbornly low is that inflation expectations in Japan seem to be driven largely by reported inflation data on a backward-looking basis. This has held wages down and flattened the Phillips Curve. None of the indicators followed by the Japanese central bank to assess inflation expectations have risen in line with the official inflation target.
- India has witnessed portfolio outflows, amounting to $6.94 billion during Jan'18-Jul'18 (till 20 Jul'18). The only reason for a rate hike by RBI at this juncture is to satiate the self fulfilling prophecy of market expectations of a rate hike to stem the rupee depreciation.
- However, within the span of one month the Chinese Yuan has depreciated by around 4% against the US Dollar. This can spell fresh trouble for emerging markets' exports, as already their currencies have not depreciated against the dollar as much as Chinese Yuan in the past month. Against the US dollar, the Renminbi has fallen more than 5% since the start of Jun'18. The consequences of a weaker Renminbi reduces the purchasing power for Chinese importers, adding to the argument that regional export growth could weaken over the rest of 2018. Remnibi is also weakening against other Asian currencies. Among the options for Asian central banks are hence to copy the PBoC, which has been reverting to monetary easing to stem the impact of trade tensions or intervene in the forex market. Materially, this means that until or unless trade tensions are resolved, there may be little chance of Asian central banks moving on rates until the first half of 2019.

Net FII inflows ($ mn)



Source: CDSL India

Asian Currencies' Exchange Rate Dynamics between 21 Jun'18-20 Jul'18	
Currency	**% change***
Chinese Yuan	-4.3
Indonesian Rupiah	-2.8
Thailand Baht	-1.4
Japanese Yen	-1.3
Indian Rupee	-1.3
Malaysian Ringgit	-1.2
Source: SBI Research, * (+ appreciation, - depreciation)	

ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of "tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis".

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management, corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

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