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भारतीय स्टेट बैंक
STATE BANK OF INDIA

'Be the Bank of Choice for a Transforming India'

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FEARS OF RATE HIKE ARE UNWARRANTED

So goes the saying in existence till mid 1500: "*Birds of a feather flock together*". This aptly summarises the current market sentiments of a probable rate hike by RBI in response to inflation trends. Such fears are unwarranted and defies convention, even though it is now being factored in by market participants. Let us explain why.

First, inflation numbers were expected to jump, though the core inflation print at close to 6% though disconcerting is possibly is closer to peak (it may touch 6.3% by June and then rebound, but aided by an unfavourable base, though: 3.85% in July 2017, the lowest since January 2012) However, at 4.5%, and our average for first half for FY19 is still lower than the RBI 4.7%-5.1% band. So where is the data to support such rate hike fears?

Second, in the second half, our internal inflation trajectory supports a benign inflation path, aided partly by a lower base. Our numbers are again lower than the revised RBI projection at 4.4%.

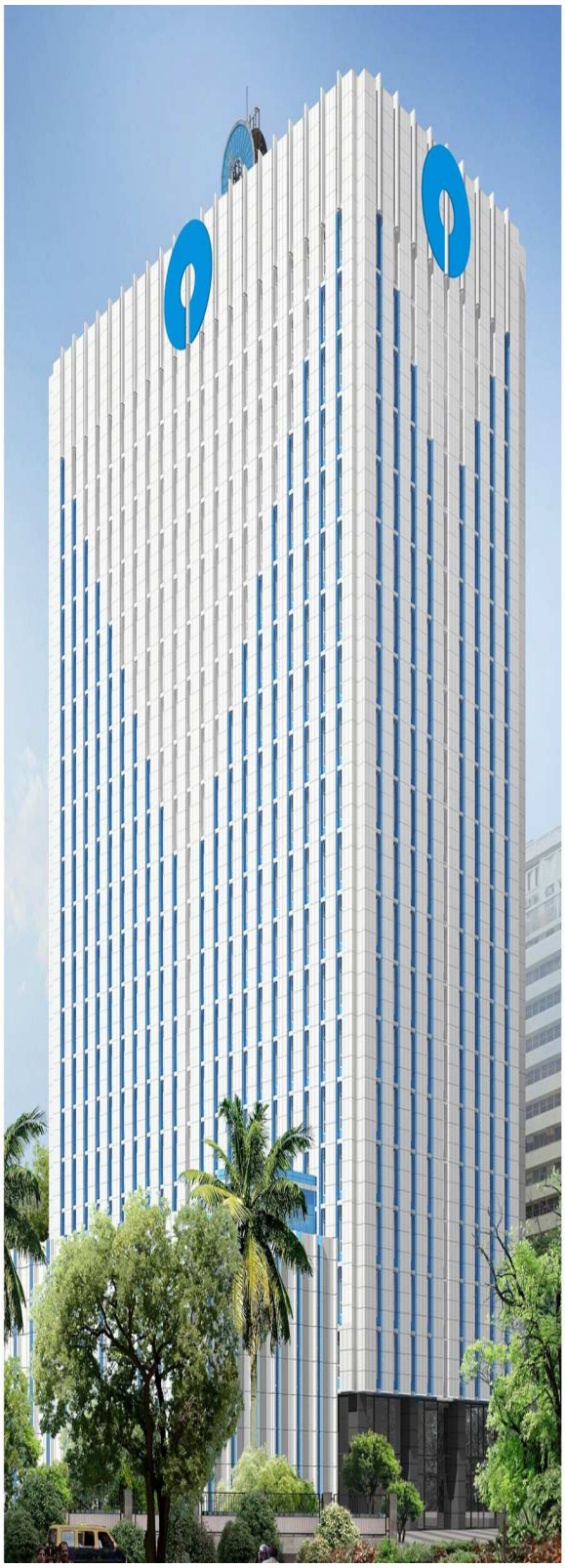
So numbers don't support market conjecture, as off now.

Additionally, inflation numbers for June is supposed to peak at 5% or higher, and this number will be available to RBI for August policy. However, from July onwards, inflation will begin its downward trajectory and that number will only be available in September policy. So, it is entirely upto RBI understanding to either see through the base effect or be guided by June inflation number.

Interestingly, the RBI also needs to carefully interpret any jump in IIP numbers in Q1 of FY19, as it will be mostly guided by destocking of Q1FY18 / low base, and thus could be a pure statistical artefact, rather than portending a recovery!

If we analyse the weighted contribution on headline CPI and changes in crude oil prices, we find that during Jun'17 to Apr'18 period (crude prices started to jump from Jun'17) while average crude oil prices (Indian basket) increased by $23 per barrel, the direct and indirect impact is around 21 basis points. This translates, roughly, into CPI increase by 10 bps for every $10 a barrel increase in oil price.

Interestingly, the distribution plot of MCLR changes by majority of banks shows an average 15 bps hike in MCLR. This indicates rate hikes have been divorced from repo rate auctions with inadequate liquidity playing a spoilsport. The RBI may thus be well advised that liquidity does not get into deficit mode quickly, lest the bank rate actions may continue.



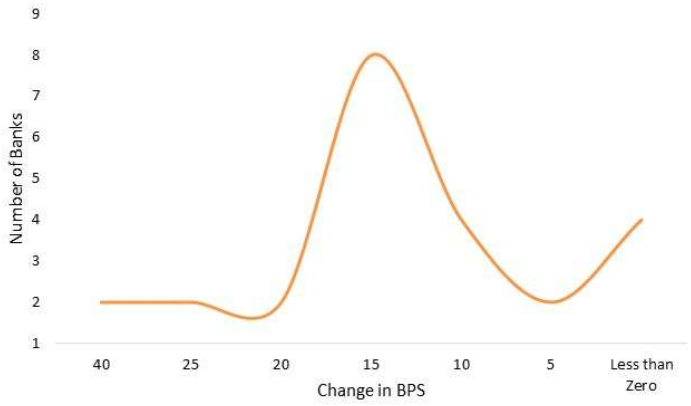
CPI INFLATION INCREASED

- As expected CPI inflation increased moderately to 4.58% in Apr'18 from 4.24% in Mar'18, with increase in prices in clothing, housing and miscellaneous group within which transport and communication witnessed a significant jump. Prices of food and beverages moderated to 3.00% this month compared to 3.08% in Mar'18.
- Meanwhile, the Core CPI has increased further to 5.92% compared to 5.37% in Mar'18, getting a push from education and clothing and footwear. Rural inflation (4.67%) has grown faster than urban inflation(4.42%).
- Assuming a normal monsoon and no major exogenous/policy shocks, we believe that CPI will remain in the range of 4.0-4.5% for FY19 and even go below 3.5% for some months in Q3 FY19.
- WPI inflation, on the other hand also increased to 3.2% in Apr'18 compared to 2.5% in Mar'18. Though compared to Apr'17 (3.8%), WPI was a bit low. During FY18, till Oct'17, both CPI and WPI moved closely to each other but diverge thereafter largely. Currently the difference between CPI and WPI is around 140 bps.
- Crude oil prices are increasing continuously and there is a fear that increasing level of crude oil prices will get diffused across all petroleum products and will subsequently increase the fuel and light inflation. However, empirical findings tell us a different story. Interestingly, RBI research studies (Bhattacharyya, et.al., 2012) show that *a strategy of calibrated and phased adjustment of domestic prices may be useful in stabilising inflation expectations* rather than full instantaneous adjustment which may spiral inflation out of control and destabilise growth. International experience also suggests that sudden deregulation of oil prices can result in a sharp upsurge in inflation (e.g. Indonesia).
- If we analyse the weighted contribution on headline CPI and changes in crude oil prices, we find that during Jun'17 to Apr'18 period (crude prices started to jump from Jun'17) while average crude oil prices (Indian basket) increased by $23 per barrel, the direct and indirect impact is around 21 basis points. This translates, roughly, into CPI increase by 10 bps for every $10 a barrel increase in oil price.

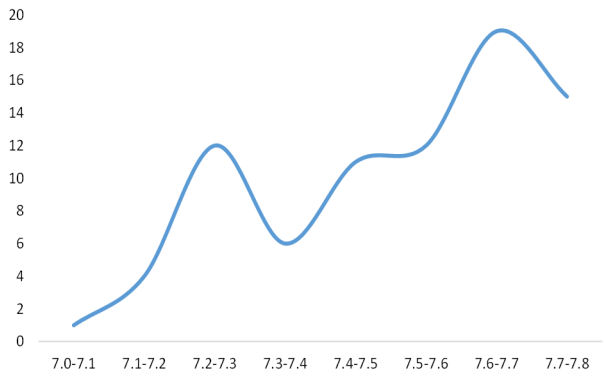
INTEREST RATE & MONETARY POLICY MOVEMENT

- The recent rise in 10-Yr bond yields and pressure on liquidity has pushed the cost of funds of the banks in India. Following to this, a number of banks has raised their both lending and deposits rates in Q4 FY18. Out of the sample of 45 Public and private banks, 17-banks have raised their 1-Yr MCLR rate in the range of 05-40 bps, while there are 4-banks have reduced the rates, 24-banks have not made any changes in their lending rates.
- We believe low inflation and inflationary expectations, probability of normal monsoon, buoyant GST collections, etc., we believe that RBI will take all such factors into account while formulating monetary policy in future.

Graph 1: Frequency Distribution of Bank-wise change (bps) in 1-Yr MCLR



Graph 2: Frequency Distribution of 10-year Yield: Jan-May,18 (%)



Source: RBI, SBI Research

IIP GREW BY 4.4% IN MAR'18

- The Index of Industrial Production (IIP) grew by 4.4% in Mar'18, compared to 7.1% in Feb'18 and 4.4% in Mar'17. Low growth in Mining (2.8%) and Manufacturing (4.4%) were the major reasons behind this performance. Electricity though grew by 5.9% in Mar'18. Cumulatively, IIP growth for FY18 was 4.3% compared to 4.6% in FY17.
- As per use based classification, capital goods declined by 1.8%, which is 9-month low. Primary goods increased by 2.9%, intermediate goods by 2.1% and Infrastructure/ Construction goods by 8.8%. The Consumer durables and Consumer non-durables have recorded growth of 2.9% and 10.9%, respectively. Out of 23 industry groups in the manufacturing sector, only 11 have shown positive growth during Mar'18 as compared to the corresponding month of the previous year. For the last two fiscal the IIP growth remain subdued. Of 23 groups, 9 displayed negative growth in FY17 and 11 in FY18.
- Going forward IIP is likely to be on the higher side in the months of April and May. However, this is mainly a statistical artefact as Q1FY18 witnessed destocking by companies. This is evident from the production of commercial vehicles for the month of Apr'18 which has shown a robust growth. This in turn might propel Q1 GDP growth numbers to more than 7%. However, it should take some time for the growth to show substantial pick-up.

Manufacturing Growth by Sub-Sector (%)							
	Wt in IIP	FY13	FY14	FY15	FY16	FY17	FY18
Manufacture of food products	5.3	3.3	1.3	6.0	-5.6	-5.5	8.4
Manufacture of beverages	1.0	6.7	-1.8	3.2	1.4	-3.1	-0.8
Manufacture of tobacco products	0.8	7.5	8.3	12.6	4.0	-15.0	-17.9
Manufacture of textiles	3.3	8.0	4.3	3.8	2.1	-1.7	-0.5
Manufacture of wearing apparel	1.3	-1.0	16.0	-0.3	14.5	15.8	-11.0
Manufacture of leather and related products	0.5	10.6	2.2	8.8	0.5	-1.1	1.3
Manufacture of wood and products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials	0.2	-3.0	-2.5	0.7	2.3	-4.5	-1.2
Manufacture of paper and paper products	0.9	3.3	10.6	0.8	1.2	-2.1	-4.6
Printing and reproduction of recorded media	0.7	-3.2	9.3	-5.5	3.8	2.1	-6.5
Manufacture of coke and refined petroleum products	11.8	5.9	2.0	0.6	4.7	4.7	3.7
Manufacture of chemicals and chemical products	7.9	3.9	4.7	0.4	4.1	2.5	-0.3
Manufacture of pharmaceuticals, medicinal chemical and botanical products	5.0	8.1	5.7	2.3	13.0	30.4	23.1
Manufacture of rubber and plastics products	2.4	1.0	11.3	4.7	0.5	1.9	-8.2
Manufacture of other non-metallic mineral products	4.1	2.9	0.2	4.9	2.0	-0.5	3.4
Manufacture of basic metals	12.8	7.8	4.4	9.8	0.6	5.1	5.6
Manufacture of fabricated metal products, except machinery and equipment	2.7	-3.0	4.6	4.3	-2.4	2.0	1.9
Manufacture of computer, electronic and optical products	1.6	0.6	14.5	2.1	5.1	2.5	16.9
Manufacture of electrical equipment	3.0	13.0	3.9	3.9	5.2	-4.5	-12.6
Manufacture of machinery and equipment n.e.c.	4.8	2.9	0.4	-0.7	3.2	7.7	6.3
Manufacture of motor vehicles, trailers and semi-trailers	4.9	0.1	-1.0	3.5	-1.5	0.6	12.6
Manufacture of other transport equipment	1.8	-0.8	4.3	6.3	2.3	4.4	14.0
Manufacture of furniture	0.1	12.9	11.1	-7.8	41.8	7.5	11.9
Other manufacturing	0.9	13.1	-7.0	0.5	13.4	4.8	-14.9
Total Manufacturing	75.5	4.8	3.6	3.8	2.8	4.4	4.5
Source: CSO'< 0% Red; 0-5% Purple; 5-10% Yellow; >10% Green							

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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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