

In case you missed it: One hike, one tweak, one hold

It was a busy week for the world's major central banks and while we weren't really surprised at the outcome of the meetings, there was just enough in there to keep us interested

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Federal Reserve reaction: No deviation

The Federal Reserve has left policy unchanged. The accompanying statement continues to provide an upbeat assessment, necessitating ongoing “gradual” interest rate hikes



Source: Shutterstock

1.75-2% Fed funds target range

The Federal Reserve has left monetary policy unchanged and the accompanying statement is little changed versus June. The main tweak is that they now state economic activity is expanding at a “strong” rate, rather than “solid” as they described the situation in June. It also sounds as though they acknowledge a pick-up in inflation, stating that inflation will “remain near” 2% rather than “have moved close to” 2% as stated in June. These are marginal changes with the main point being that they are sticking to the assessment that “further gradual increases” in interest rates are anticipated by the FOMC.

Last Friday's GDP report really underlined the positives within the US economy. Businesses and households are reaping the benefits of massive tax cuts while the jobs market goes from strength to strength. While we are likely to see a bit of a slowdown in 2H18 reflecting tighter monetary

conditions and some nervousness over trade protectionism we still expect to see 3% GDP growth for 2018 as a whole.

At the same time inflation is approaching 3% and there is growing evidence that wage growth is showing signs of life. Consequently, we see some risk to the market's benign reading of inflation prospects in the months ahead. Trade policy remains a threat, but for now the positives significantly outweigh the negatives, hence the Fed's decision to stick to the "gradual" rate hike path. As such we look for rate hikes in September and 4Q18 – probably December – with two more coming in 2019. The risks, in our view, remain skewed to the upside.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

US jobs: Headline disappoints, but it will turn round

US payrolls growth of 157,000 is disappointing but there were upward revisions, and forward-looking indicators suggest more big jobs gains to come



Source: Shutterstock

157,000 Number of job gains in July

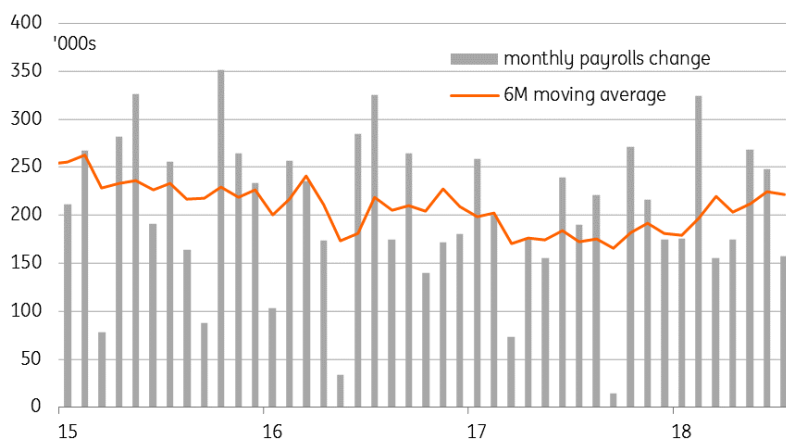
Mixed report

The July US jobs report shows payrolls rising 157,000 versus the 193,000 Bloomberg consensus, but there were 59,000 upward revisions to recent history so overall it's close to market predictions. Wages rose 0.3% month-on-month, in line with expectations, which leaves the annual rate of wage growth at 2.7%. The unemployment rate moved back down to 3.9% from 4% while U6 underemployment is at 7.5% versus 7.8% previously.

The headline payrolls number is softer than hoped given the rise in the ISM employment component, the strong ADP private payrolls report (219,000) and another really firm NFIB

employment data release. Nonetheless, the marked step up in employment gains versus 2017 remains in evidence. Last year averaged 182,000 jobs per month whereas the first seven months of 2018 have averaged 215,000 job gains. This will help underpin consumer sentiment and spending through the rest of the year.

Monthly change in US nonfarm payrolls



Source: Bloomberg

Outlook still looks good

In terms of the outlook for employment, the fact that the economy is growing so strongly bodes well for ongoing job creation. There are certainly worries about protectionism and its potential economic impact, but we also have to remember that the stimulus from tax cuts dwarfs the tax hit from higher tariffs. As such we are still expecting the US economy to expand 3% this year.

This view is seemingly supported by the employment numbers released by the National Federation of Independent Businesses yesterday. According to them, the proportion of small businesses with unfilled vacancies has never been higher in the survey's 45-year history and nor has the "job creation plans" for the coming three months.

NFIB: Unfilled job openings (% with at least one unfilled opening)



Source: Macrobond

So the US has an economy that is growing incredibly strongly with a robust jobs market. At the same time, consumer price inflation is set to hit 3% next week with the core rate (ex-food and energy) coming in at 2.3%. This will ensure the Federal Reserve keeps hiking rates, with September and December moves looking probable.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

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Trump: The destroyer of economic relationships?

President Trump's penchant for shaking things up has evidently, although presumably not intentionally, spread to data relationships. What is causing this and will things ever return to 'normal'?



Donald Trump, campaigning in South Carolina 2016

Great is good, fantastic is better...

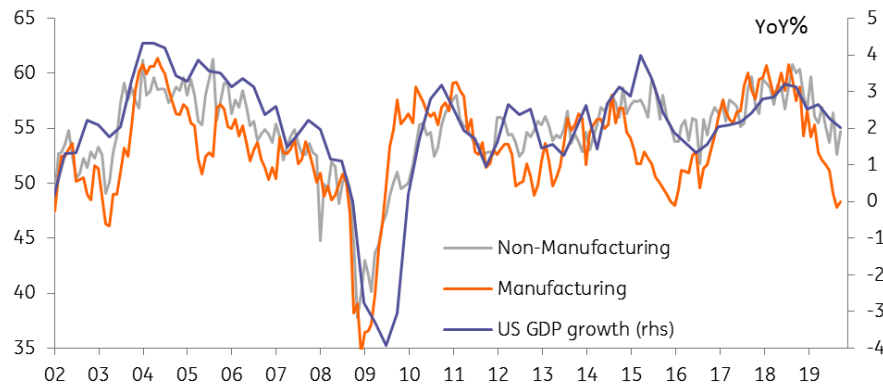
Last Friday's 2Q GDP report was obviously great. The 4.1% annualised growth figure was the strongest recorded since 2014 and suggests that the economy is reaping the benefits from the tax cuts enacted last December. However, surveys suggest that growth should have been even stronger. 'Great' growth is good, but 'fantastic' growth would have been much, much better.

A notable breakdown in historically strong relationships

Since President Trump's election, there's been a notable break down in historically strong relationships between official activity data and third-party surveys. For instance, the ISM manufacturing index has been asking businesses what they are experiencing in terms of orders, output and employment for the past 70 years and it's arguably been the best lead indicator for

GDP growth in the coming quarter. However, rather than agreeing the economy is growing around 4%, it is at levels historically consistent with GDP growth of nearly 8%.

ISM manufacturing index suggests GDP growth could have been even stronger

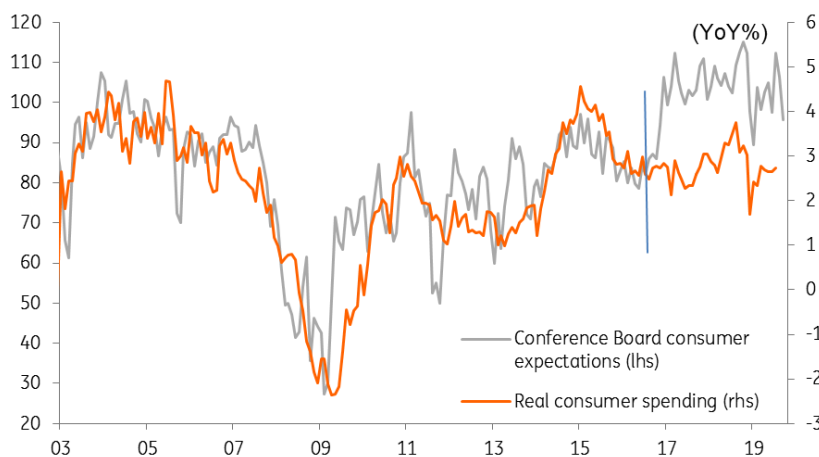


ISM surveys ask major US companies what they are seeing in terms of output, order, employment, inventories, supplier delivery times and comes up with an aggregate index of performance. #>50 = expansion #<50 = contraction

Source: Macrobond, ING

We can see a similar relationship break down between the Conference Board measure of consumer confidence and real consumer spending growth. As the chart below shows, consumer spending has grown at half the rate that the historical relationship with consumer spending suggests is achievable.

Consumer confidence suggests spending could have been stronger too



Source: Macrobond, ING

There have been divergences between sentiment and spending in the past, but they tend to last just a few months rather than the best part of two years. Instances include Hurricanes Rita and Katrina, which depressed sentiment briefly in 2005, but Federal relief spending helped support consumption and we saw confidence quickly recover. Sentiment also plunged in 2011 after rating

agency S&P downgraded the US from AAA status amid worries about a government shutdown. However, the shutdown was averted and sentiment recovered with little impact on consumer spending overall.

Is it different this time?

The divergences since late 2016 appear to be far more structural than those previous instances, so what is going on? Well, we know the ISM generally follows the economic cycle, so we look at news on things such as orders and employment when trying to forecast this series. We also look at what is happening to the global economy and the lagged effects of currency movements to see if the US is becoming more or less competitive on the international stage.

As for consumer confidence, we know that employment levels, pay rates, and the pace of inflation all act as key drivers. However, we also note that changes in prices of highly visible goods, such as gasoline and food, have disproportionately large effects while asset prices – primarily equity and house prices – are also important swing factors.

External factors, such as natural disasters, can also lead to shifts in both business and consumer surveys while tax changes can also make households and businesses more positive on their personal situation.

Are the surveys offering 'fake news' or is it down to President Trump's policies?

Looking at the current juncture, employment is strong, the economy is robust, asset prices are high and tax cuts are feeding through the system. These are all clear positives for consumer confidence and the ISM survey. However, there are worries about trade wars and their economic implications. At the same time wage growth is modest and is flat when adjusted for headline inflation, while highly visible gasoline prices are holding at relatively high levels versus recent history. These factors should be weighing on sentiment.

On balance, there are positives that could at least partially explain a rise in both the ISM and consumer confidence, but they don't seem strong enough to justify the divergence with the official data. As such, are the surveys offering "fake news" or is it down to President Trump and his policies?

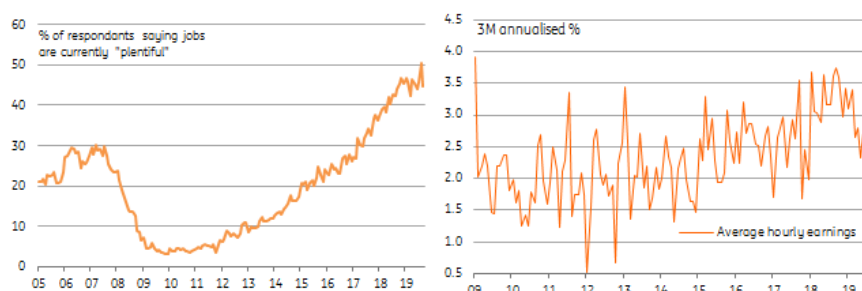
Trump the driver?

In terms of the key Trump factors going on right now, we have substantial tax cuts and fiscal spending increases, but we also have trade protectionism. However, not everyone reacts to these events in the same way. For example, we can see within consumer confidence that sentiment among the under-35s has actually decreased since Trump was elected. For people aged 35-55 it has increased a decent amount while confidence among the over-55s has soared.

It could be that the under-35s tend to earn less so will benefit less from the tax cuts while they may feel more exposed to trade protectionism and potential trade wars that they feel could harm their long-term career prospects. An analogy could be Brexit in the UK with young people much

more hostile and fearful of perceived economic nationalism.

Consumer confidence by age

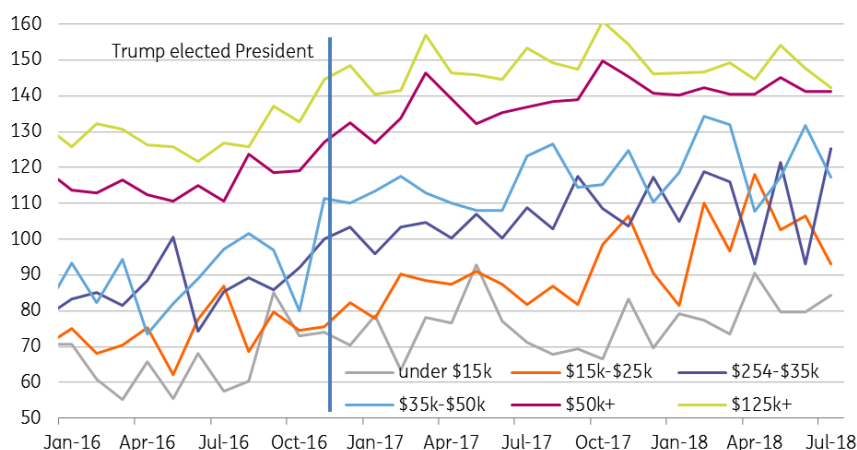


Source: Macrobond, ING

Conversely, the 35-55s tend to earn more so will benefit disproportionately from tax cuts, which is likely to support sentiment. The over 55s, which may not benefit quite so much from tax cuts due to a significant proportion being retired (therefore earning less money), may have more nostalgia for the way things once were in America. Again, we use the analogy of Brexit where older voters disproportionately back leaving the EU.

Consumer confidence divergences by income category are less easy to rationalise. Confidence amongst the highest earning groups has changed little since Trump was elected, but at least remained very strong. For the lowest earners, it has changed little from already low levels. In the middle-income categories, we see confidence has risen sharply for those earning \$15k-25k and \$35-50k, yet for those earning \$25k-35k it has actually fallen.

Confidence by income group



Source: Macrobond, ING

Businesses are obviously very happy about the tax cuts, but are nervous about protectionism. However, conversations we have had with US corporate clients suggest the tax story is more impactful for them right now given the tariffs are measured in the tens of billions of dollars rather than trillions. This would likely explain the generally positive reaction in business surveys. Here we would point out that the ISM survey isn't directly measurable on different categories and there is

scope for human sentiment to influence the survey responses.

Why the breakdown?

It is important to point out that massive tax cuts while supporting business and consumer sentiment don't necessarily translate directly into a massive increase in economic activity. For example, on the corporate side they may make firms more encouraged about the prospect for investment and hiring, but in actual fact, the money may instead be used on special dividends or share buybacks.

Likewise, for the household sector, the tax cuts are boosting real household disposable income and that is good news for household finances. But it is clear that households are not spending all of those gains, or certainly not as much as history would have suggested. Personal savings rates are rising so there does seem to have been a behavioural change in how consumers respond to income increases.

Ricardian equivalence... anyone?

Now, in terms of consumer spending, it could be that the US is suddenly behaving like a boring old rational academic economist. i.e. offering proof of Ricardian equivalence. For those that may have forgotten, the theory goes that forward-looking consumers and businesses feel that the huge tax cuts President Trump got through Congress mean government borrowing will rise sharply and unsustainably (we think the Federal deficit will hit 5% of GDP next year for reference). As a result, these households and businesses recognise that they'll be faced with substantially higher taxes in the future so are choosing to save the money to cover the cost of the future tax

Given the empirical evidence of Ricardian equivalence is somewhat tentative this would be a remarkable outcome. I don't think this economist would behave that way, let alone the US population as a whole, but theories are there to be tested...

A behavioural context

The divergence between expectations and real consumer spending appears to align closely with Trump's presidential election, an event that we expect will be influencing household sentiment. Behavioural science suggests that when faced with what feels like a sure loss, as some have described the most recent US voting environment, we have a higher tendency to gamble. In this case, the gamble has been Trump and relative uncertainty.

Steering away from predictability comes with risk and it can be challenging to maintain a consistent, or long-term trend in the face of ambiguity as we see comfort in altering our activities to play it safe in the short-run. Many of us are risk averse and the unknown impact and probability of change, such as a looming global trade war, is uncomfortable. This may be steering some towards reduced outlay as a 'just-in-case' measure.

And while market measures are currently relatively positive, we see strong employment, economic robustness and high asset prices, Trump's low approval ratings suggest mixed feelings towards the confident and resilient president. Couple global scale impact and relative uncertainty and we may be starting to understand why consumer spending is lower than anticipated.

Will things revert?

There appears to have been a structural shift in the relationship between surveys and official data since President Trump was elected, but these “new paradigms” have a habit of fizzling out in the world of economics. It doesn't necessarily mean that surveys are less useful in this new world, but it will perhaps make predicting the next downturn more challenging. If we get a drop in the ISM and consumer sentiment, is this really a downturn or is it merely a regrouping of surveys and data?

For now, we have to accept “great” official data and “fantastic” survey data. This isn't a bad place to be and suggests the Federal Reserve will have to continue tightening monetary policy – at least twice more this year and two additional moves next year.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Three takeaways as the Bank of England hikes rates

The Bank of England has hiked rates and the hawkish tone of the statement has taken markets slightly aback. But despite the Bank's optimistic outlook, we think policymakers will find it tricky to hike rates again before Brexit. We don't expect another rate rise before May 2019



Source: Bank of England

The Bank of England has opted to increase interest rates for only the second time since the financial crisis, but for investors what really matters is what it has – or hasn't – said about its next steps. Here are our three key takeaways

1 The Bank's unanimous decision came as a slight surprise for markets

Back when the Bank of England hiked in November, two voters (John Cunliffe and Dave Ramsden) dissented, preferring to keep rates on hold. This time, however, the committee was much more united. Ramsden – who said recently that he is “more comfortable” with the balance of risks –

voted in favour of a hike. And despite recently making the case for “stodginess” in the approach to setting policy, Cunliffe decided not to dissent either. That meant that today’s decision to raise rates was unanimous, which may have caught some investors slightly off-guard.

2 The Bank remains upbeat on growth - we are more cautious

Back in May, markets weren’t totally convinced by the Bank’s bold assertion that the first quarter economic weakness was temporary. But generally speaking, the data since then has backed up the BoE’s story and it’s clear they remain comfortable with the outlook. Whilst it did give a nod to trade tensions and Brexit uncertainty in the minutes, it continues to expect business investment and trade to support activity and it now expects a slightly higher path of growth in the medium term.

We are more cautious. Once the effect of the sunny weather starts to fade, the cracks in the high street are likely to resurface. Consumers remain cautious, and real incomes remain under pressure (even if they are no longer falling). And given that Brexit uncertainty is only likely to ramp up, we think investment is likely to stay subdued too.

3 Few hints about the Bank's next steps as 'no deal' chatter increases

Going into Thursday’s meeting, markets were anticipating the next rate hike in roughly a year’s time. But given the Bank’s outlook for growth and inflation, we think policymakers would ideally prefer to raise rates before then. The big question going into this meeting was whether they’d come out and say so explicitly.

In the end – unsurprisingly – they didn’t. Aside from reiterating that “ongoing tightening” was needed, the Bank offered no stronger signals of intent. We suspect this is because policymakers are acutely aware that Brexit could make it increasingly complicated to increase rates again before the UK leaves the EU in 2019. Talk of ‘no deal’ is ramping up, and crucially it might not be until early next year before a deal to avert a cliff edge scenario is struck. Until then, there’s a risk consumer and business sentiment starts to deteriorate.

Having said all that, the Bank has announced explicitly for the first time that it estimates the longer-term neutral rate to be 2-3%. Depending on how you look at it, this could be interpreted as a subtle prod for markets to lift their rate expectations for two-three years’ time. That’s possibly a stretch, but either way, with Brexit risks mounting, markets are unlikely to take too much notice.

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Belgian jobs deal: We want more!

It has been THE hot topic of the Belgian government's summer deal: 28 measures were decided to further improve the functioning of the labour market and, finally, employment. Some could have a real impact, but in our view, in order to durably solve the labour market problem in Belgium, more reforms are necessary



Moves in the right direction

Among the recently decided measures, we highlight the decreasing path of unemployment benefits across time, special training budgets for people losing their job and special effort to reduce the lack of qualified job seekers in certain sectors (IT, nurses,...). The Belgian government expects these measures to create 12,500 additional jobs in 2019, implying a half billion euro reduction in the public deficit.

While we don't consider this an unreachable target, we have some doubts about the ability of such measures to solve the labour market problem in Belgium. They certainly go in the right direction, but erasing high structural unemployment requires much stronger reforms.

In fact, the Belgian labour market suffers from two main problems:

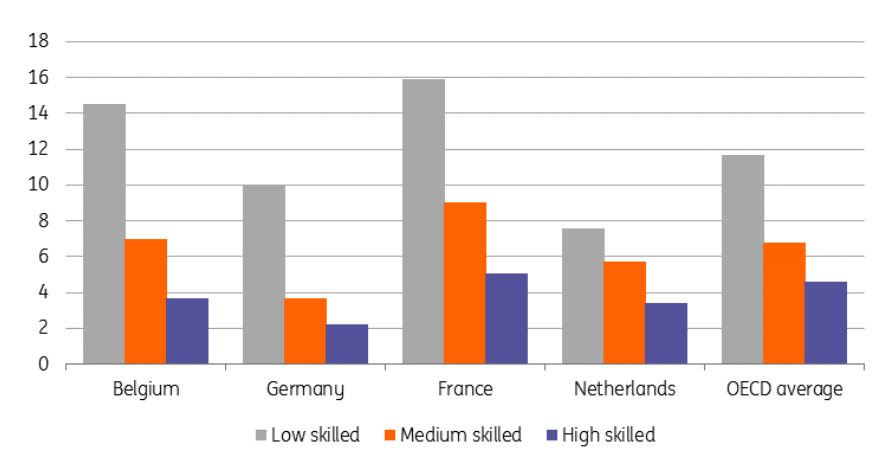
1 There are too many unqualified job seekers

On average, there were 500,000 job seekers in Belgium between July 2017 and June 2018. Half of

them (!) were low skilled (having only a partial secondary school education at best). Moreover, the unemployment rate of low-skilled people in Belgium (14.5% in 2016) is far higher than the OECD average (11.7%), while it is similar for intermediate-skilled people and below the OECD average for high-skilled people (3.7% in Belgium, 4.6% in OECD). In other words, the Belgian labour market is not able to absorb low-skilled job seekers. This is no surprise considering the rigidity of the Belgian labour market and high labour costs. It also explains while many vacancies are not fulfilled, even with half a million job seekers.

In this context, developing training programmes focused on sectors where there are labour shortages is far from easy, as these programmes need basic knowledge and would probably only be accessible for medium-skilled jobseekers. Given the reality of unemployment, reducing labour shortages requires a deeper effort, starting by improving the basic skills of half the job seekers. Alternatively, new jobs for low-skilled people could be created, but this would mean a drastic reduction in the labour cost for this type of job (e.g by lowering the minimum wage), which would be hard to push through.

Unemployment rate by level of qualification (2016)



Source: OECD

2 Only six out of 10 people aged between 50 and 64 years are employed

This is due to a (past) very generous early retirement system and to an age-related automatic wage increase system. The government is trying to correct this by reducing the accessibility to the early retirement system and by trying to break the link between age and wage. Once again, these are moves in the right direction, but we doubt that this will be sufficient. A cultural revolution (among workers and businesses) would be needed to have a different approach towards careers after 50: let's remember here that surveys show more than two-thirds of workers don't want to work after age 60 and that the effective average retirement age is still around 60 in Belgium. The process to change this situation will be, once again, very long and will require more than financial penalties or incentives.

Author

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Japan: Some policy tweaks but not a lot

Has the Bank of Japan strengthened its commitment to reaching the 2% inflation target or conceded defeat in getting there anytime soon? Absent a departure from an ultra-easier monetary policy stance, the 10-year JGB yield should retrace its recent spike



Source: Shutterstock

-0.1% BoJ policy rate
No change

BoJ maintains ultra-easier monetary policy stance

As widely expected, there was no change to the Bank of Japan's ultra-easier monetary policy stance, though today's policy meeting wasn't a complete non-event. There were some policy alterations aimed at enhancing the sustainability of its monetary policy, with more flexible market operations towards the price stability target of 2%. But the changes were subtle.

As we expected, the BoJ didn't abandon its inflation target nor was there any reduction in the asset purchases pace, both having grossly underperformed the 2% and JPY80 trillion targets, respectively.

So what's changed today?

1. **Inflation:** the downgrade of its inflation forecast for FY2018 to 1.1% from 1.3%, and that for FY2019 and FY2020 to 1.5% and 1.6% respectively, from an earlier 1.8% forecast for both years. The statement noted that “it is likely to take more time than expected to achieve the price stability target of 2%”.
2. **Forward guidance (introduced for the first time):** the persistently low level of short- and long-term interest rates for an extended period of time, depending on uncertainty regarding economic activity and prices.
3. **JGB purchases:** some flexibility in the 10-year JGB yields around the 0% target, depending on economic activity and prices. A gradual reduction in the current account balances of financial institutions at the BoJ with the negative rate of 0.1%, from the current JPY 10 trillion.
4. **Asset purchases:** adjustment in the asset purchase amount depending on market conditions, and a shift in ETFs allocation towards Topix from Nikkei.

All boils down to inflation

However, everything boils down to achieving the price stability target. And after downgrading its inflation forecast for this and the next two years, the key question is: has the central bank conceded defeat on the objective of raising inflation to the 2% target level? Or just as today's statement notes at the outset, is the Bank actually strengthening its commitment to achieving this target? Only time will tell.

Even with the planned consumption tax in 2019, meeting the inflation target by next year remains a far cry, not only from the BoJ forecast but also from the consensus view. So is the unwinding of stimulus. While inflation so far this year is on track to meet our 0.9% annual forecast, we are reviewing our 1.8% inflation forecast for 2019 as well as the forecast timing of the start of tapering by the end of next year. But for now, absent a significant departure from an ultra-easy monetary policy stance, the 10-year JGB yield giving back its recent spike seems to be a reasonable expectation.

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com**Alissa Lefebvre**

Economist

alissa.lefebvre@ing.com**Deepali Bhargava**

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com**Ruben Dewitte**

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon

Asia Chief Economist
+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist
benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

India: Reserve Bank hikes rates for second time

Although the Reserve Bank of India's (RBI) tightening cycle has yet to fully play out, evolving growth-inflation dynamics will likely cut it short. We have pencilled in one more 25 basis point rate hike in October



Source: Shutterstock

6.5%

RBI Repurchase Rate

A 25bp hike today

As expected

No RBI policy surprise

In its second policy tightening this year, the RBI lifted the benchmark policy interest rates by 25 basis points today, taking the repo rate to 6.50% and reverse repo rate to 6.25%. There was no change to the 4% reserve requirement rate for the banking sector.

However, unlike the June rate hike, today's decision wasn't a unanimous vote by all six policy committee members. There was one dissenter. Still, the outcome was in line with the broad

consensus, including ING's forecast. Hence, we expect little to no market impact.

RBI statement in detail

- **Inflation:** The RBI raised its inflation forecast for the second half of FY2018-19 (financial year runs from April to March) to 4.8% from 4.7%. Although a slight rise, the statement notes that a larger than average increase in minimum support prices (MSP) for farmers will have a direct impact on food inflation and then to headline inflation. Further, inflation in items excluding food and fuel has been broad-based and has risen significantly in recent months, reflecting greater pass-through of rising input costs and improving demand conditions.
- Some relief is likely from good monsoon support to the farm sector and a reduction in Goods and Services Tax for several goods and services. But the upside inflation risks outweigh the downside risks due to supply disruptions to oil prices and elevated household inflation expectations.
- **Growth:** There was no change to the RBI's GDP growth forecast for FY2019 from its 7.4% projection in the June policy statement. The statement points to evenly balanced growth risks, with good monsoon support to farm output and MSP prices contributing to improved rural demand. It also said good corporate earnings and FDI inflows would support investment. On the downside, rising trade tensions could adversely impact exports.

ING policy view

The minutes of today's meeting to be released later this month will provide more insight into policymakers' thinking. While we believe the current tightening cycle has further room to run, the extent of tightening will depend on how India's growth-inflation dynamics evolve going forward.

We have already seen some signs of tapering in GDP growth starting from the April-June quarter. Although exports gained some traction in May and June, this hasn't stimulated manufacturing enough to push GDP growth higher while a wider trade deficit has meant a larger negative contribution of net exports to GDP growth. Higher global trade tariffs will be the potential dampener on exports and GDP growth going forward. This is why we recently cut our growth forecast for FY2018-19 from 7.2% to 6.7%.

Consumer prices will remain sticky as a weak currency and administrative price hikes will likely keep inflation above the RBI's 4% policy goal within a band of +/-2%. We maintain our 4.7% inflation forecast for the current financial year.

With growth and inflation potentially moving in undesirable directions, the current tightening phase looks to be shorter. We have already pencilled in one more 25 basis point rate hike at the next meeting in October. This will still leave ample accommodation from the 200 basis points of rate cuts implemented over the last three years. Nonetheless, we don't see any near-term respite from the ongoing upward pressure on government bond yields and the USD/INR exchange rate. Our end-2018 forecast USD/INR rate is 71.5 (spot 68.5).

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com**Gustavo Rangel**

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com**Carlo Cocuzzo**

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com**Disclaimer**

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