RBI POLICY PREVIEW

25bps hike in policy rates anticipated

January 21, 2011

In the forthcoming quarterly review of the monetary and credit policy on January 25, 2011, the Reserve Bank of India (RBI) is likely to raise repo and reverse repo rates by 25bps each. In the previous (December) policy review, the central bank had kept both rates unchanged and injected liquidity in the system, keeping excessive liquidity deficit in mind. Now, as liquidity conditions are beginning to improve and inflation has rebounded much above the comfort level, RBI is expected to focus on inflation. Headline inflation has rebounded largely due to high food prices. Sticky non-food primary articles' and non-food manufacturing products' inflation also contributed to the rise. Food prices are on an uptrend due to temporary and structural reasons. As the economy is growing close to trend, the risk of structural food inflation spilling over into prices of other commodities is significant. Additionally, inflation pressure persists both from domestic demand and higher global commodity prices. Therefore, in an effort to anchor inflationary expectation and control the spillover of high food inflation into manufacturing inflation, the central bank is likely to resume tightening by raising repo and reverse repo rates 25bps each, keeping the LAF corridor intact at 100bps.

The forthcoming mid-quarter review will be conducted against a backdrop of rebound in headline inflation, decent domestic growth momentum, and improving growth prospects in western economies led by the US. Though price stabilisation is expected to be RBI's dominant concern, an aggressive tightening (given the tight liquidity conditions) could impact sentiment and derail growth.

■ High inflation poses challenge to monetary policy

Headline inflation rebounded to ~8.4% in December after some moderation in earlier months. This rebound was largely due to high food inflation. Sticky non-food manufacturing inflation and non-food primary articles' inflation have also contributed to the rise. The upward trend in WPI inflation is reflected in M-o-M 3MMA (seasonally adjusted) growth figure, which has consistently grown in the past four-five months. The sequential growth has jumped from 0.06% in August 2010 to 1.34% in December 2010.

Food inflation has catapulted largely due to unseasonal rains and hoarding, leading to rise in prices of vegetables and fruits. Apart from this, structural rise in demand of certain protein-rich food items—milk, meat, and fish—due to changing consumption patterns also contributed to the stickiness in food inflation. Food prices are expected to correct to relatively lower levels in the next couple of months due to a host of measures taken by the government such as selling subsidised vegetables. Non-food manufacturing inflation (core inflation) has stabilised around 5.4%, but due to increasing global commodity prices and higher primary articles' inflation feeding into core inflation there are significant risks to the upside.

Inflation remains significantly above RBI's comfort level and risk to core inflation is on the upside. Based on this, we expect the central bank to increase its inflation projection of 5.5% by March 2011 to 6.0%.

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Decent growth momentum in economy

India is expected to grow at ~ 8.6% in FY11E, indicating strong growth momentum in the economy. Although in recent months industrial production growth has moderated somewhat, the economy's overall growth momentum is intact as seen from export and non-oil import growth, credit growth, and manufacturing and service PMI index. RBI is expected to retain its baseline projection of 8.5% real GDP growth for FY11.

In the external sector, recent data has been pointing to improving growth prospectus in western economies, primarily US and Germany. This, along with high inflation in emerging markets, has increased the likelihood of capital outflows from emerging markets, including India. Additionally, the ongoing sovereign European debt problem also remains an area of concern, as spread of crisis will increase risk aversion in markets, leading to capital outflows from emerging markets.

Liquidity conditions improving

Liquidity conditions, which were excessively tight in December 2010, are beginning to improve. Average injection from RBI's LAF window in January 2011 is around INR 852 bn compared to INR 1,204 bn in December 2010. Liquidity conditions were helped by RBI's purchase of government securities of INR 370 bn via open market operations (OMO) auctions. Pick up in government spending also helped ease the liquidity deficit. After lagging in the first half of the year, in response to higher deposit rates, deposit growth is on an uptick. This growth is expected to provide incremental liquidity to support pick up in credit.

Liquidity conditions are expected to improve further from the current level on account of government spending and redemptions of G-secs of INR 262 bn by February 2011 end. Nonetheless, liquidity is expected to continue to be in deficit, consistent with RBI's policy stance. In order to avoid any increase in call rates, the central bank is expected to extend the date of additional liquidity support of 1.0% of NDTL to banks under LAF, which ends on January 28.

Based on the above, we expect overnight inter-bank rates to move closer to repo rates from the current high levels.

RBI to raise policy rates

The central Bank's dominant concern is inflation as it is much above the comfort range and risk to core inflation is on the upside. Admittedly, there are some concerns regarding moderation in industrial growth and tight liquidity conditions. But on balance, inflation concerns far outweigh growth momentum concerns. Given this scenario, RBI's monetary policy stance would be to contain inflation and anchor inflationary expectation.

In line with the policy stance, we expect RBI to increase repo and reverse repo rates 25bps each. We also expect hawkish statement on inflation along with increase in inflation projection for March 2011 to 6.0% from the current 5.5%.

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Recent Research

Date	Title	
14-Jan-11	**Inflation**	Headline inflation rises in line with expectations
12-Jan-11	**IIP**	IIP comes in below expectations**,** driven down by consumer goods
11-Jan-11	**Edelweiss ET-Now Lead Indicator Index**	Be future ready
03-Jan-11	**External Trade**	Trade deficit shrinks in November