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Monetary Policy Review

Ball set rolling but may lack momentum

Economy Update

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- As expected, the RBI cuts CRR by 50bps. Non-committal on cutting policy rates but sets definitive context for the same. More OMOs and a 50bps CRR cut before the rate cut begins
- Repo rate cut contingent on consistent moderation in non-food inflation and fiscal consolidation (less inflationary and more investments inducing)
- GDP growth rate revised down to 7%. Slow down more broad based. RBI hints that the inflation is no longer function of demand pressure or pricing power
- RBI hints at fears of growth falling below potential. Unless pro-investment measures taken, economy can slip back into supply shortage driven inflationary pressure

RBI cuts CRR by 50bps; keeps other rates unchanged...

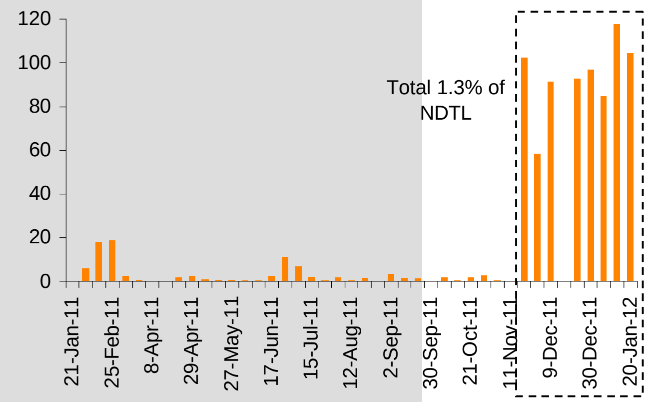
In its third quarter review (TQR) of monetary policy 2011-12, the RBI has cut CRR by 50bps to 5.5%. This would add Rs320bn of liquidity into the banking system. Along with Rs700bn of OMO purchases done till date, this amounts to injection of liquidity upto 1.6% of NDTL.

… Recognizing structural liquidity deficit problem

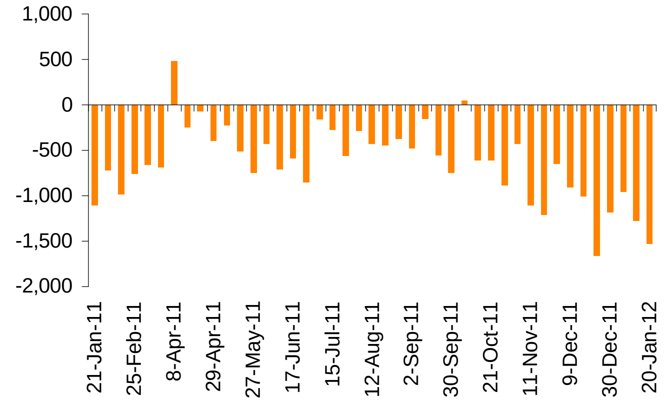
As we have been highlighting in our past few notes on inflation and IIP, the OMO purchases have failed to have meaningful impact on the liquidity deficit in the system. Despite Rs700bn of OMO purchases done over last nine weeks, the LAF balances are still at Rs1.2-1.4tn or 2.2% of NDTL.

As we had highlighted in our note on inflation *"Nearing the RBI's comfort" (dated Jan 16, 2012),* given the backdrop of sharp decline in inflation (Jan-12 may be sub 7%) and the slow down in the IIP growth (3.8% YTD), we believed that there was a strong case for the RBI to initiate a CRR cut so as to address the sustained liquidity deficit scenario.

Open market operations of RBI (Rs bn)



Weekly average LAF balances (Rs bn)



Source: RBI, Emkay Research

Policy rate cuts may have to wait; RBI intended to keep liquidity in deficit

Even as the CRR cut remains consistent with the monetary stance of the RBI (that the interest rates have peaked out), the repo, reverse repo and MSF rate will have to wait at till end of Q4FY12 for reversal as the RBI still remains quite unconvinced about the pace of the decline in inflation.

The RBI's intention to keep the liquidity still under moderate deficit shows that the RBI doesn't want to tinker with short term rates any soon.

Although the context has been built

Clearly as we have been highlighting, the RBI has been spelling out definitive context for reversal in its monetary policy stance since last mid-quarter policy review in December 2011.

Thus, in the mid-quarter policy review on 16th Dec'11, the RBI had laid down pre-conditions for the reversal of the monetary policy stance as downward pressure on growth and moderation of inflation, which are both met now. The GDP growth projection have been lowered to 7% for FY12E from 7.6% earlier and inflation is already likely to be below 7% in Jan-12. And hence, we had expected a CRR cut to come through in the TQR.

In this TQR, the RBI has set up a definitive context for a policy rate cut viz.

a) Consistent moderation in non-food manufacturing inflation which in turn will depend on INR movement (key driver over Q3FY12) and fuel prices pass through

b) Meaningful fiscal consolidation which can induce positive supply responses. RBI attributes significant importance to the Union Budget due in March 2012 and expects to see investment accretive measures

Guarded view on inflation but aggregate demand pressure clearly off

Although, the inflation is clearly moderating and is well within the RBI's projected territory, the RBI still not let it off the hook. Despite a downward revision in GDP growth, the inflation projections have been kept unchanged (we kept 100% probability of revision here too) for few reasons:

a) Exchange rate pass-through of INR depreciation, specially on non-food manufacturing inflation

b) Incomplete pass-through of embedded subsidy-specially in fuel items

c) Recent decline in primary food prices could be temporary in nature, as per RBI

However, the words like "pricing power" and "aggregate demand pressure" are clearly missing now in the TQR unlike in past reviews. This clearly vindicates our earlier assessment that the pricing power of manufacturers had faded way back and it was not the driving factor behind inflation.

Excerpts for our report "Inflation-growth matrix to create room for easing" dated 14-Dec-11

Pass-through coefficient improves but pricing power is still feeble

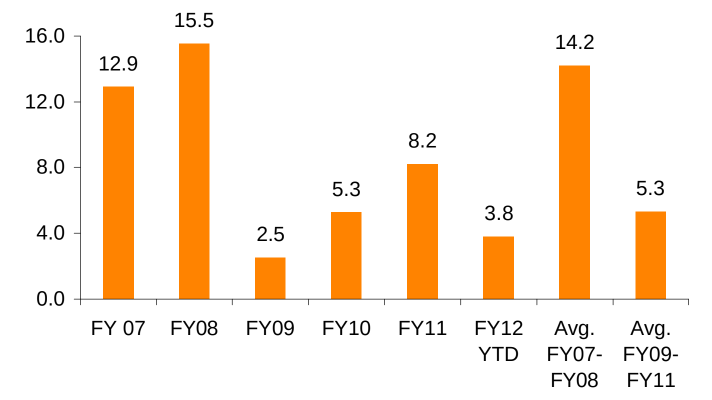
While manufactured product (ex-food) inflation rose 7.9% YoY (vs 7.6% in Oct and 8.0% in Sep 2011), excluding gold and silver it was lower at 7.4%. Evidently, a significant part of the core inflation was caused by rise bullion prices. The pass-through coefficient (12 month elasticity of core inflation ex-food, gold & silver w.r.t. primary non-food inflation) increased marginally to -0.01 in Nov 2011 vs -0.03 in Oct 2011 and -0.08 in Aug-Sep. While the improvement is indicative for receding margin pressures for the manufacturing sector we believe the pricing power is still very weak as the coefficient is far lower than 2008 levels (peaks 0.45 in Aug 2009 and 0.36 in Aug 2010). In addition, during Nov 2011 core manufacturing index (ex-food, gold and silver) increased modestly by 0.3% vs 1.7% rise in primary non-food index preventing us from turning optimistic on operating margin outlook.

GDP growth projections revised downwards to 7%

As expected, the RBI has revised its GDP growth projection for FY12E to 7%. The factors feeding into scaling down of projection include the rise in the global uncertainty, slower growth in investment demand and crowding out impact coming from the higher government borrowings. With industrial growth slowing down, rub off impact on the services sector is also expected to ensue in forthcoming quarters.

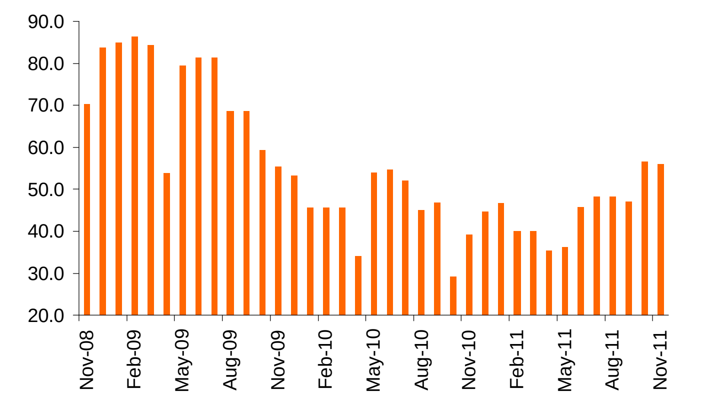
Quite clearly, the risks to the GDP growth have risen significantly, reflecting in the consistently lower trajectory of growth in YTD FY12 (3.8%) vs FY09-11 (5.5%). Also, the slowdown is quite widespread with sectors having nearly 56% weight in manufacturing showing less than 5% growth.

Growth in IIP (% yoy)



Source: CSO, Emkay Research

% weight of sectors (out of 22) in mfg growing less than 5%#



 # Cumulative growth

Is there danger of falling below potential growth rate?

Importantly, in addition to the above cyclical slowdown, RBI also indicates the possibility of growth falling below the potential (or "trend rate of growth" in RBI words) in absence of structural policy actions to stimulate the investment climate. RBI's uncertainty stems from the possible lack of fiscal consolidation in light of the ongoing state elections and 2014 general elections, which can prolong the weak investment climate.

According to us the most critical aspect of TQR is the recognition of a possibility of shifting of cyclical growth towards a lower potential growth. If this structural risk materializes it would indicate scaling down of multiple indicators which are anchored to nominal GDP growth e.g. tax revenue growth, budgetary allocations, topline growth of companies, monetary aggregates etc. Hence, shifting of domestic growth model towards investments from consumption led model is very vital from this stand point.

We expect more CRR cuts and OMOs before rate cut

We view today's CRR cut announcement as part of the transition from being over hawkish to being more accommodative. RBI has already laid down the context for future rate actions. Hence, we believe there will be few more OMO purchases and at least another 50bp cut in CRR before we see repo rate cuts. Requirement for liquidity enhancement measures will continue to prevail at least till Q4FY12 due seasonal demand for funds aggravating the structural liquidity deficit.

Rate cuts will become imminent if we see stability on the external financial front, even with INR stabilizing at Rs50-51 band, sustenance of food inflation at reasonable level around 5%, and moderation in non-food inflation due to the observed moderation in aggregate demand.

Bull inversion of yield curve to continue; rare chances of lending rate cut

The enduring nature of liquidity through CRR cut alongwith likely aggressive OMOs will imply continued bullish inversion of the yield curve i.e. both long and short end of the G-Sec yield curve falling equally. The inverted shape is likely to continue specially, given the RBI's reluctance to tinker with repo rate and its expressed intention to keep the liquidity in moderate deficit. We do not expect the banks to tinker with lending rates soon as 50bps cut in CRR will help improve the yields by just 6bps, very immaterial to be passed on.

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