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April 17, 2007

India Economics

Monetary Policy – Is it Too Aggressive, Too Soon?

Steep rise in interest rates over the last four months: While Reserve Bank of India (RBI) had been gradually tightening since the second half of 2004, the pace picked up sharply over the past four months. This sparked a debate amongst the policymakers, the corporate sector, and market constituents, with some questioning the need for such aggressive tightening.

Corporate sector is most vocal on the issue: In a recent survey, 86% of the 250 CEOs, CFOs and Managing Directors believed that "the RBI has started over-reacting to the inflationary expectations without realizing that increasing the cost of money beyond a certain point would slow down economic growth."

Many questions on RBI's policy moves: The debate centers around: (a) the pace of tightening; (b) lack of adequate forward-looking guidance on policy actions; (c) apparent lack of concern regarding the adverse on impact on demand growth; and (d) aggressive tightening hurting supply response (growth in investments and productive capacity).

The real issue is the demand-supply imbalance: We believe RBI had pursued a balanced approach until the third quarter 2006. As stronger evidence of overheating emerged, RBI had little choice but to slow demand growth in order to reduce demand-supply imbalances. Clearly, the ideal outcome would be to get a strong supply response. However, the effective supply creation could take some time and in the meantime macro stability risks could be exacerbated.

More tightening ahead: We believe that RBI is unlikely to pause until there are clear signs of growth slowing. Apart from cyclical sector data points like automobile sales, we believe the most important indicator would be bank credit growth. We expect RBI to maintain tight monetary policy for least in the next 3-4 months.

Monetary Policy – Is it Too Aggressive, Too Soon?

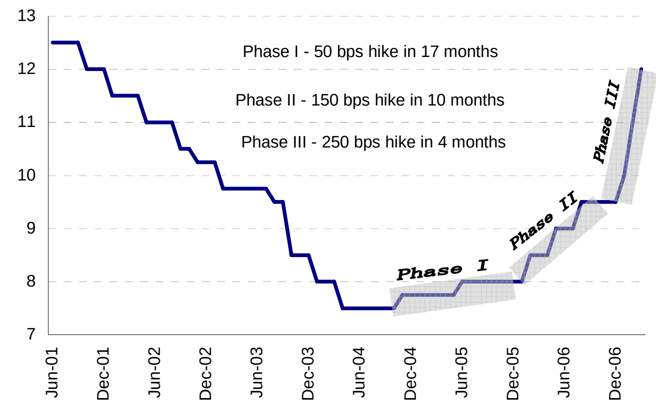
Steep Rise in Interest Rates in the Last Four Months
While Reserve Bank of India (RBI) had been gradually tightening since second half of 2004, the pace has picked sharply over the past four months. A representative measure for broad trend in tightening would be the trend in mortgage lending rates. While they had moved up only 50 basis points from the bottom of 7.5% during the 17 month period between Sept 2004 to Jan 2006 (we call it phase I) and 150 bps in the ten month period between Feb 2006 to Nov 2006 (phase II), it has moved up sharply by 250 bps in the four month period between Dec 2006 and Mar 2007 (phase III). A similar trend is reflected in consumer loan rates and borrowing costs for small and medium sized companies.

Debating Measures Taken by RBI
The RBI tightening move in the past four months has raised a debate amongst policymakers, corporate sector, and market constituents. The corporate sector is the most vocal group. Indeed, in a recent business barometer survey by Delhi-based The Associated Chamber of Commerce and Industry of India (Assocham), 86% of the 250 CEOs, CFOs and Managing Directors believed that "the RBI has started over-reacting to the inflationary expectations without realizing that increasing the cost of money beyond a certain point would slow down economic growth" and 90% of the respondents were "upset over RBI catching them by surprise every now and then, without giving them time to even hedge their borrowing cost in the short term."

There have been many such arguments criticizing RBI's measures. In following paragraphs, we discuss some the criticisms against the RBI's policy moves and possible explanations for these moves:

First, a large part of the inflation pressure is due to food prices rising and that monetary policy tightening will not help it. Analysis of price trends for various WPI components indicates that a major part of the recent acceleration in overall inflation is due to manufacturing products. Over the past 12 months, while the headline overall inflation rate has accelerated to an average of 6.5% in March 2007 from 3.9%, inflation in manufacturing products basket has accelerated to 6.6% from 1.7% (manufacturing products have a weighting of 63.75% in WPI). During the same period inflation in food articles, which have a weighting of 15.4% in WPI, has accelerated to 10.6% from 5.3%. Most importantly, inflation excluding food and global commodity linked products (a proxy for core inflation) has accelerated to 6% as compared with 3.9% in the corresponding week last year.

Exhibit 1
Impact of RBI's Tightening Effort on Mortgage Rates



	Phase I (Sep-04 to Jan-06)	Phase II (Feb-Nov 06)	Phase III (Dec-Mar 07)
Relevant Policy Rate*	1.00	0.50	0.50
Cash Reserve Ratio	0.50	0.00	1.50
Mortgage Rates	0.50	1.50	2.50

* Relevant policy rate refers to movement in repo or reverse repo rate based on liquidity conditions prevalent during that period; Source: Morgan Stanley Research

Exhibit 2
WPI Breakdown

(% YoY)	Weight (%)	Mar-07	Mar-06	%pnt Cont. to Acceleration
Manufactured Products	**63.8**	**6.6%**	**1.7%**	**3.1%**
Textiles	9.8	1.9%	-0.4%	0.2%
Basic Metals	8.3	16.4%	-2.8%	1.6%
Capital Goods	6.5	9.7%	5.3%	0.3%
Transport Eqpt	4.3	1.7%	1.3%	0.0%
Food Products	11.5	5.3%	1.0%	0.5%
Fertilisers	3.7	1.7%	0.3%	0.1%
Non Metallic Minerals	2.5	12.0%	7.3%	0.1%
Primary Articles	**22.0**	**11.9%**	**4.4%**	**1.7%**
-- Minerals	0.5	20.6%	39.9%	-0.1%
-- Food products	15.4	10.6%	5.3%	0.8%
-- Others	6.1	14.7%	-0.9%	1.0%
Fuel	14.2	1.3%	8.9%	-1.1%
All	**100.0**	**6.5%**	**3.9%**	**2.6%**
Global Commodity Linked Products	37.1	5.3%	3.2%	0.8%
Core Inflation#	47.5	6.0%	3.9%	1.0%

Source: CEIC, Morgan Stanley Research # Inflation excluding food and global commodity linked production

The weekly inflation rate has become the most widely watched number in the financial market as it is perceived that the

Central Bank is concerned by rising inflationary pressures. We believe that inflation is only one of the symptoms of the root problem of domestic imbalance of actual growth running above potential growth. Moreover, as the Central Bank has already highlighted in the recent policy statements, it is concerned not only about inflation (one of the symptoms) but also about the widening trade deficit, property prices, stretched banking sector balance sheet, and credit quality.

The real issue is the demand-supply imbalance. Strong growth in demand at a time when effective supply creation (growth in productive capacity) response is weak explains this overheating. Over the last three years, while global risk appetite-driven liquidity supported strong demand growth, government policy response to accelerate the country's production capacity has been slow. Hence, the problem of overheating is unlikely to be resolved with three months of aggressive tightening and/or two months of denominator effect led deceleration in inflation.

Second, why was RBI so slow in the first place? The key argument supporting this question is that RBI is supposed to be forward looking and take tightening measures in time and not shock the market. However, in this context we highlight the monetary policy statements dated July 25, 2006, and October 31, 2006, wherein RBI clearly presented the complexities it is facing in estimating potential growth and therefore arriving at the conclusion on overheating. While there were traditional signs of overheating like sustained high consumer credit growth, widening trade deficit and rising asset prices, we believe the RBI had consciously been taking some risk pursuing tightening in a measured manner. By the second quarter of 2006, in our view, it was clear that demand was running higher than supply (productive capacity) and was showing up in traditional overheating indicators.

However, RBI did not start tightening aggressively until December 2006 as it argued its ability to conclude on the need to tighten at a faster pace was made difficult by the fact that the economy was going through structural transformation and its gradual integration with the global economy added to the uncertainties *(see excerpts from July and October 2006 monetary policies at the end of this note)*. In other words, RBI did not want to go aggressive before being sure that supply side response would not match the accelerating demand growth. The aim was not to over-react to a potential transient overheating.

***Third, the recent aggressive tightening will slow (demand) growth*:** RBI statement released on March 30, 2007, has left no doubt that the Central Bank is opting for price stability at the cost of growth. It appears that since the last quarter of 2006, RBI has started becoming concerned on overheating. We believe that the first clear signal towards a coming shift in monetary policy was indicated in October 2006 statement, which raised concerns on the issue of overheating. As further strong evidence of overheating emerged, RBI had little choice but to slow demand growth in order to reduce demand-supply imbalances. The key objective is to ensure that inflationary trend does not become self-reinforcing and elevate inflationary expectations.

***Fourth, aggressive tightening will choke off the very supply side response that the RBI was hoping would come through*.** As we have been highlighting, clearly the ideal outcome would be to get a strong supply response. The key challenge for RBI in determining monetary policy response to the concerns on potential overheating is the extent of lag in supply side changes. Although later than warranted, clearly the investment cycle is picking up and therefore in the strictest sense a large part of the supply constraints will be transient in nature. However, the effective supply creation could take some time and in the intermittent period macro stability risks could exacerbate. This lag will be particularly high in areas where government participation is required.

In this context, in December 2006, when RBI hiked the cash reserve ratio, it indicated “there are also reports that expansion of capacity is underway, but the realisation could be constrained over the next two years.” Considering this lag, RBI is forced to tighten right at the time when capex is picking up. Moreover, as RBI’s statement in January highlighted, “Investment demand is strong and is augmenting productive capacity. But it is also important to recognize that the addition to productive capacity occurs with a lag and the first sign of a step up in investment is reflected in an expansion of aggregate demand”. In other words, the RBI is indicating that in the near term even investments would only push aggregate demand higher, exacerbating the overheating problem.

Fifth, inflation is a transient problem and the country should absorb the cost of high inflation in the intermittent period instead of tightening aggressively. One of the options for RBI would be to wait for the supply response to emerge over the next two years, appreciating the point that supply response is always inelastic, particularly during the takeoff stage of economic growth. Some inflation pressure is inevitable though transient in nature. However, there are two issues before RBI in the Indian context. The democratic political structure does not permit politicians to accept higher inflation for 1-2 years. More important, to be sure that overheating is transient there needs to be a firm policy response from the government to ensure it clears all the hurdles in investment cycle, particularly in the infrastructure sector. Indeed, as we highlighted in our recent note on this subject (see *Supply Response: New Hurdles Are Emerging*, 2 April 2007) that India's supply side response tends to be particularly slow in areas where government influence is high. The Central Bank has little control on this issue.

Bottom line

We believe RBI had pursued a balanced approach until third quarter of 2006. However, with persistent signs of overheating on account of aggregate demand running higher than supply (growth in productive capacity), RBI has clearly chosen to focus on macro stability even if it comes at cost of slowing growth. We believe that RBI is unlikely to pause until there are clear signs of growth slowing. Apart from cyclical sector data points like automobiles sales, we believe the most important indicator would be bank credit growth.

We expect RBI to maintain tight monetary policy at least in the next 3-4 months. In the coming monetary policy statement to be announced on April 24, we believe that there is 50% chance of RBI leaving policy rate unchanged. However, in such a scenario, RBI would indicate that it is still in the tightening mode. We believe that RBI is likely to hike its policy at least once or twice more. The wildcard for policy moves, particularly the cash reserve ratio, will be the trend in capital inflows and global risk appetite for emerging markets assets.

Appendix: Excerpts from RBI's Monetary Policy Statements

July 25, 2006

"………..Central bankers all over the world revel over the dream run of low inflation coupled with high growth in recent years. They are confronted with the confusing realities presented by financial markets, oil markets and inflation uncertainties. They face the uncertainties of the future more acutely than ever before, since an increasingly globalised world is making assessments as well as policy options in the domestic arena very constrained. **India is no exception to this**, **but a greater complexity is imparted since structural transformation of the economy and its gradual integration with the global economy add to the uncertainties.** Yet, the trade-offs and judgments have to be made, keeping in view the criticality of timeliness in actions and flexibility to respond appropriately.

For our economy, the domestic considerations continue to dominate and maintaining growth momentum is of the highest importance, but if, contextually, priority has to be accorded to demand management, price stability, inflation expectations and financial stability, there should be no hesitation to do so. The current situation calls for some stabilising influences while keeping all the options open for the future to maintain a successful and dynamic balance between growth and stability that has been the hallmark of our macroeconomic policies during the reform period……"

October 31, 2006

"……Against this background, it is critical to be watchful for early signs of overheating. An overheating economy is one which is growing rapidly and its productive capacity cannot keep up with resulting demand pressures. Emergence of inflationary pressures is usually seen as the first indication of overheating. In this context, policy makers keenly analyse the behaviour of the output gap, i.e., the excess of current output over potential or full capacity output. In the context of setting monetary policy, judging how close an economy is to operating at full capacity is crucial. If the monetary authority senses that there is unutilized capacity, the increase in demand generated by growth can be accommodated without inflationary pressures and, therefore, the need to act against overheating may not arise. On the other hand, if demand is running ahead of full capacity, there is a case for tightening of monetary policy with a view to slowing down the economy and heading off overheating.

Globally, there seems to be increasing difficulty in identifying the symptoms of overheating. There is some evidence of a blurring of the relationship between output gaps and inflation. Moreover, the size and direction of an economy's potential output is becoming increasingly difficult to diagnose. In particular, globalisation has expanded the supply potential of various economies, especially emerging economies. In the recent period, it appears that the current positive supply shock has made the concept of potential output fuzzier than in the past.

For a developing economy like India, the concept of overheating is less of a guide for monetary policy than in advanced economies on account of the existence of large unemployment/ underemployment of resources and the absence of a clear assessment of potential output. Furthermore, **it is difficult to obtain a clear judgment of potential output in an economy that is undergoing structural transformation**. Nevertheless, recent developments, in particular, the combination of high growth and consumer inflation coupled with escalating asset prices and tightening infrastructural bottlenecks underscore the need to reckon with dangers of overheating and the implications for the timing and direction of monetary policy setting. **While there is no conclusive evidence of overheating in the Indian economy at the current juncture, the criticality of monitoring all available indications that point to excess aggregate demand is perhaps more relevant now than ever before**……."

"……….In the **external sector**, there are signs of abiding strength and the current account deficit has been well-managed so far. On the other hand, there are indications of growing demand pressures and potential risks from **rapid credit growth and strains on credit quality**. High levels of monetary expansion and the evolution of the liquidity situation will need to be continuously monitored for any signs of risks to inflation. The **elevated levels of asset prices** also represent a risk to the outlook for macroeconomic and financial stability. In brief, at the current juncture, for policy purposes, the two major issues that exert conflicting pulls are exploration of signs of overheating firming up to warrant a policy response, and, the impact of lagged effects of earlier policy action on the evolution of macroeconomic developments….."

"….**recent developments, in particular, the combination of high growth and consumer inflation coupled with escalating asset prices and tightening infrastructural**

bottlenecks underscore the need to reckon with dangers of overheating and the implications for the timing and direction of monetary policy setting. While there is no conclusive evidence of overheating in the Indian economy at the current juncture, the criticality of monitoring all available indications that point to excess aggregate demand is perhaps more relevant now than ever before."

December 8, 2006

"……….As per the RBI's Industrial Outlook survey, a majority of respondents from the private corporate sector expect higher increase in prices of both inputs and outputs. There are reports of growing strains on domestic capacity utilisation. **There are also reports that expansion of capacity is underway but the realisation could be constrained over the next two years**…"

January 31, 2007

"........the demand for bank credit remains high, extending the high growth phase that began in 2004. Accordingly, concerns remain relating to credit quality and that some banks may be overextended in terms of the balance between sources and uses of funds, as reflected in high credit deposit ratios. The growth in banks' investments in Government and other approved securities appears to be low relative to credit growth. Excluding LAF holdings, banks' SLR investments are close to the statutory minimum which has implications for liquidity management. Credit growth is also being reflected in the sizeable and higher than anticipated expansion in money supply. <…….>on the external front, the trade deficit, which is a relevant indicator of domestic demand conditions had expanded to 6.5 per cent of GDP in 2005-06 and is set to rise even higher in the current financial year. Export growth has regained vigour, but there are shifts in the pattern of imports. There are reports that expansion of capacity may be constrained in terms of pending import orders. <…….> there is increasing evidence that the infrastructural bottlenecks are becoming tighter and more binding. <…….> some indications of wage cost pressures seem to be in evidence. Surveys of corporate activity show that the staff costs of the sampled firms increased sizeably in the first half of 2006-07, particularly for information technology (IT) and services companies. While staff costs in manufacturing firms have increased at a more moderate pace, they are likely to face incipient pressures on margins from rising input costs. <…….> elevated asset prices are generating wealth effects which are fuelling aggregate demand."

March 30, 2007

"……….The stance of monetary policy has progressively shifted from an equal emphasis on price stability along with growth **to one of reinforcing price stability with immediate monetary measures and to take recourse to all possible measures promptly in response to evolving circumstances**….."

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