Economy

Monetary policy

Anti-inflationary stance and rising commodity prices could impact growth

We see the RBI getting into an uneasy balancing between managing inflation and growth. From Thursday's action and statement, the RBI seems to be toning down growth expectations. And the elevated concerns on inflation imply that the RBI would continue with its anti-inflationary stance. Rising rates, cost of production and inflation are seen as factors that would feed into growth slowing in FY12, lower than the projected 8.6% for FY11.

Contrary to our expectations of unchanged policy rates (but inline with the consensus view), the RBI hiked the policy rates by 25bp in its mid-quarter policy review announced on Thursday.

Key takeaways: Rising inflation a bigger concern than declining growth

Elevated risk from rising commodity prices; fiscal contraction need to be meaningful

- Rising global crude prices, their impact on domestic inflation on top of the recent surprises from vegetable prices continued to concern the monetary policy. While the RBI acknowledges that fiscal contraction announced in Budget FY12 indicate easing of demand and inflationary pressures, it is not convinced that it will fructify unless subsidy spending is contained convincingly. Given the risk to global crude prices, the RBI seems to be having doubts.

Contradictions - Rising pricing power and falling investments

- The recent spike in non-food manufactured product inflation has prompted the RBI to believe there is considerable pricing power, which in the backdrop of high commodity prices, could reinforce inflationary pressures.
- This seems contradictory to the concerns the RBI has raised on slowing investment cycle. The RBI highlights that contraction in capital goods sector growth in the recent months (19% YoY in Feb 2011) indicates slowing investment cycle. This along with sharp rise in cost of production can pose risk to growth outlook. Quite clearly, views of rising pricing power and falling investments are not in sync.
- In our view, the rise in non-food manufactured product prices has been a lagged influence of rising raw material prices and it has been considerably modest. Our estimates show that the pass-through coefficient (% change in non-food inflation/ % change in raw material inflation, 12-months rolling) has declined to -0.01 in Feb 2011, the lowest since June 2008.

Anti-inflation stance, but moderating growth expectation

- Overall, we see the RBI getting into an uneasy balancing between managing inflation and growth. From Thursday’s action and statement, the RBI seems to be toning down growth expectations. And the elevated concerns on inflation imply that RBI will continue with its anti-inflationary policy stance. Rising rates, cost of production and inflation are seen as factors that will feed into growth slowing in FY12 lower than the projected 8.6% for FY11.

Policy measures

- Bank rate has been retained at 6%
- Repo rate hiked by 25bp from 6.50% to 6.75% with immediate effect
- Reverse repo rate up by 25bp from 5.50% to 5.75% with immediate effect
- Cash reserve ratio (CRR) of scheduled banks retained at 6% , SLR 24%

Expected outcome

- Continue to rein in demand side inflationary pressures while minimizing risk to growth
- Manage inflationary expectations and contain the spillover of food and commodity prices into more generalized inflation

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Summary of what RBI said

Fiscal policy - While fiscal contraction is encouraging there are doubts on subsidy budget: While the budgeted level of fiscal deficit for FY12 gives some comfort on the demand front, a potential increase in the subsidies on petroleum products and fertilizers as a result of high crude prices could put pressure on expenditure. Given the uncertainty around the fiscal management RBI seem to be somewhat doubtful on whether the announced fiscal contraction can contribute to demand-side inflation management in the visible future.

Global economy - A mixed picture; commodity price rise a big concern:

- Strong growth in emerging economies, gaining momentum in the US and the Euro area
- Sharp increase in oil prices as a result of the turmoil in the Middle East and North Africa adding uncertainty to the pace of global recovery
- **Natural disaster in Japan:** As normalcy is restored, expenditure on reconstruction may provide a boost to the economy. However, substitution of thermal for nuclear energy in Japan may exert further pressure on petroleum prices.
- **Domestic economy - Risks to current growth trajectory-High commodity prices and slowing investments:** GDP growth target for FY11 maintained at 8.6%, in line with CSO's advance estimate. However, continuing uncertainty about energy and commodity prices may vitiate the investment climate, posing a threat to the current growth trajectory. The weak performance of capital goods suggests that investment momentum may be slowing down.

Inflation: March-end inflation seen around 8%

- While there has been a decline in food prices since Dec 2010 manufacturing non-food prices have picked up resulting in increase in inflation in Feb 2011 to 8,3% after a decline the in Jan 2011
- Fuel prices remain high, reflecting the global trend, with potential for further rise
- Non-food manufactured products inflation rose from 4.8% in January 2011 to 6.1% in February 2011 and continues to stay above its medium-term trend (around 5%). As per RBI the acceleration was spread across manufacturing activities, indicating that producers are able to pass on higher input prices to consumers
- The RBI increased the March-end projection for WPI inflation from 7% to 8% on account of various factors viz. upside risks from high international crude prices, increase in administered coal prices and pick-up in non-food manufactured product prices.

Some comfort on the CAD front; but concern on funding profile remains

- The RBI's concern on CAD has eased somewhat on the back of stronger than expected export growth in the recent months. CAD/GDP ratio for FY11 has scaled down to 2.5% compared to 3.5% earlier
- Concern of funding profiles and quality of capital flows continues to be a concern as RBI emphasis the need for attracting long-term components, including foreign direct investment (FDI), so as to enhance the sustainability of the balance of payments (BoP)

Domestic liquidity pressure seen easing:

Liquidity expected to move closer to RBI comfort level i.e. +/-1% of net demand and time liability of banks. The liquidity pressure has eased of the past two months with daily balance under RBI's liquidity adjustment facility declining from Rs 930bn in January 2011 to Rs790bn in February 2011, and further to Rs 680bn in March (up to March 16) due mainly to decline in government cash balances with the Reserve Bank.

Appendix A

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