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Monetary Policy: Expectations

RBI's Second Quarter Review of Monetary Policy 2011-12

Economy

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- **Inflation has remained above 9% for 10 consecutive months – Persistently high**
- **IIP numbers peaked out; Growth – Marginal slowdown expected going ahead**
- **Liquidity expected to remain tight; CRR, SLR to be unchanged**
- **Considering the growth inflation dynamics we expect the RBI to hike the Repo rate by 25 bps to 8.5%**

Despite a dozen rate hikes in a year and a half the economy continues to face the persistent challenge of high inflation. Also, this time around, the required action to curb these price pressures remains in question due to the evolving scenario on the domestic and global growth front. The tightening phase has marked 12 rate hikes, a cumulative of 350 bps in the Repo and 400 bps in the Reverse Repo rate. However, the translation in terms of a decline in inflation remains minimal. March 2010 WPI stood at 10.36% and the latest September 2011 WPI at 9.72% (revised value could touch double digit). The RBI has placed primary focus on curbing price pressures as inflation has remained above 8% consistently since the last 21 months. Thus, though the sound bytes from the industry and banks against any further rate hikes gain strength, we expect that the upcoming policy would ensure continued efforts towards inflation control.

The upcoming Second Quarter Review of Monetary Policy would aim at taming price pressures amidst acknowledgment of a slowdown in the growth momentum. Though the convolution of a trade-off between tightening rates for price control and the need to support growth continues, we expect the RBI to incline towards curbing inflation. Thus we expect,

- Repo rate to be hiked by 25 bps to 8.5% from the current 8.25%
- Reverse Repo rate to be adjusted automatically to 7.5% from current 7.25%
- CRR to remain unchanged at 6%; SLR to remain unchanged at 24%

Inflation

WPI inflation which has remained above 9% for the last 10 consecutive months has remained a constant cause of concern for the RBI. Despite aggressive measures taken earlier, the average inflation in H1 FY 12 stands at 9.6% (Aug – 9.78% and June – 9.72% are yet to undergo their final revisions). The earlier translation of food and fuel price rise into manufactured products has led to sticky core inflation above 7%. The headline WPI numbers remain high and consistently above RBI's target of 7% for March end 2012 set in the July policy.

Inflationary pressures persistent

- Warrants measures to tame inflation

Month	Core Index	Core WPI
May-11	74.48	7.34
Jun-11	74.75	7.73
Jul-11	74.67	7.65
Aug-11	74.85	7.74
Sep-11	74.92	7.62

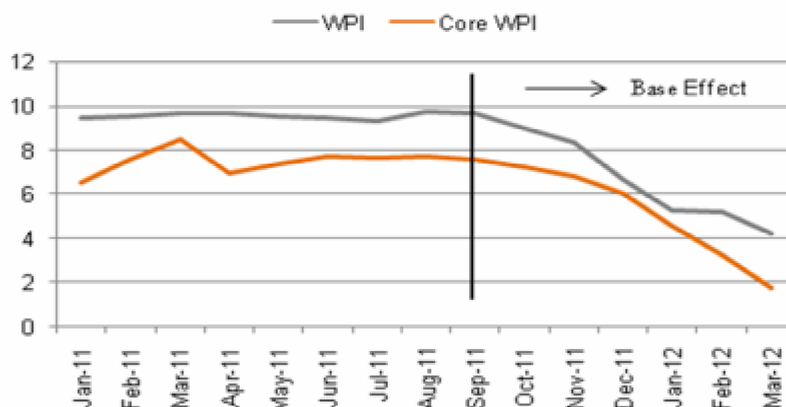
Source: Office of Economic Advisor, Emkay Research

The core index marked a sharp rise since Nov 2010 keeping the core inflation above 6% for the whole of this calendar year. A marginal comfort can probably be found in the base effect that will aid getting the core inflation down by the end of the fiscal year. The Sep 2011 WPI index stood at 155.8 and the core index stood at 74.92. The graph below highlights the base effect, showing the trajectory of headline and core WPI inflation in case the two indices remain flat till the Mar 2012.

Headline WPI to soften marginally

- Favorable base effect

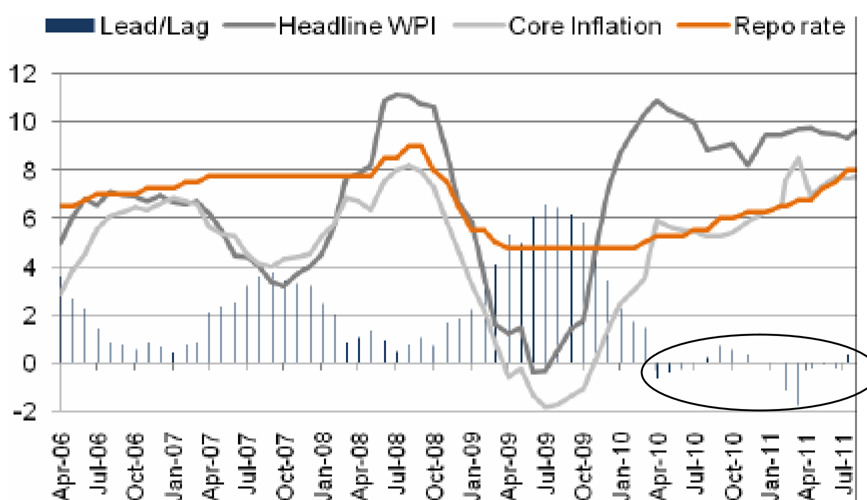
Headline & Core WPI: Base effect trajectory



Source: Office of Economic Advisor, Emkay Research

The inflation rate released for the month of Sep 2011 stood at 9.72%, only marginally lower than 9.78% (Aug) despite a favorable base effect. The core inflation stood at 7.62%, again very high for RBI's comfort level. Several upside risks to inflation remain going ahead, viz. a probable rise in electricity prices. The 10% depreciation seen in the Indian Rupee since Aug 2011 would put upward pressure on the cost of imports. Consumer demand in the festive season would keep prices intact. Since the July policy, crude prices have almost reverted to earlier elevated levels post showing some softening. Food prices too have risen and remained high since August despite a good monsoon. This will all lead to the inflation rate remaining at elevated levels and outside the comfort zone of the Central Bank for at least another couple of months.

The following chart gives the lead/lag of the Repo rate with respect to the core inflation. A lead implies the repo rate was higher than the core inflation which also means positive real interest rates. The circled area marks the tightening process wherein the Repo rate has been hiked to catch up with the inflation. The RBI resorted to steep hikes (50 bps) in July 2010 and in the May and July 2011 policies wherein the Repo rate lagged behind the core inflation (Lag as shown in the graph). The last quarter (Jul-Sep 2011) has marked a reversal with the Repo rate higher than core inflation. This probably hints at no steep rate hikes by the RBI. The current levels of price pressures warrant a continued effort to control inflation which however is not too strict to dent the growth momentum. Going ahead, the headline inflation number will find some deceleration tracking the base effect. However, it is expected to remain above 8.5% at least till December. The number still remains uncomfortable and warrants action.



Headline WPI, Core Inflation, Repo Rate - %, Lead/Lag – Absolute

Source: Office of Economic Advisor, Emkay Research

Index of Industrial Production

The IIP numbers continue to remain volatile with a peculiar strength seen in the quarter ending release which marks the completion of a production cycle. The average IIP growth since Jan 2011 stands at 6.5% and that since the start of the fiscal stands at 5.6%. The industrial growth trajectory has faced strong headwinds (considering the lag effect) tracking the monetary tightening. The rate hikes announced since March 2010 have impacted industrial growth leading to muted headline numbers as compared to the double digit growth seen earlier.

Industrial production slowing

- Case for calculated rate hike

Mining sector (weightage of 14%+ in the IIP index) has witnessed a slowdown in wake of prohibition of mining in several regions (No-Go areas) as well as a declining seasonal trend seen in monsoon. The manufacturing sector reflects a reasonable performance (average 6% since April), albeit a slower one from the robust performance seen a year earlier. Within manufacturing, the basic goods segment has held up steady growth rates, the capital goods segment marks huge volatility, the Intermediate goods data marked a recovery in the latest release whereas the slowdown is markedly evident in the consumer goods segment. The transmission of recent aggressive hikes could further dent the consumer goods demand going ahead. However, the festive season demand would support the same.

The survey conducted by RBI in Apr-Jun 2011 shows that the business condition in India's manufacturing sector has shown continuing moderation in the sentiments for assessment quarter (Apr-Jun) as well as expectation quarter (Jul-Sep). The Business Expectation Index – a measure that gives a single snapshot of the industrial outlook in each study quarter – declined from 122 to 116.3 for assessment quarter and marginally from 121.9 to 121.5 for the expectation quarter; however, it still remains much higher than 100 which is the threshold that separates contraction from expansion.

The average IIP growth for Q3 FY 2012 is pegged in the range of around 4 – 5%. The data release for October faces a huge unfavorable base that would pull down the number. The strikes with regards to the coal sector would dampen sentiment. The IIP numbers are expected to settle down in the lower single digit zone going ahead.

The latest GDP data release reflected a marginal slowdown in the investment cycle. However, the trade data has reported a robust performance. The exports have grown by 52% (YoY) in the period Apr-Aug. The domestic growth remains strong with regards to the external sector. Overall growth currently seems to be treading at a reasonable pace and may witness a softening going ahead.

Considering the structural rigidities of our economy, earlier measures taken by the Central Bank are yet to fully trickle down in to the system. However, the current price pressures do not leave room for a pause in rate tightening yet. Though the current inflation demands a continued aggressive stance, the decline in the growth sentiment and IIP growth rates demands a calibrated pace of rate increase. Balancing the two variables, the RBI may opt to continue with the hawkish stance at a gradual pace. We expect the RBI to take a step further to tame inflation in the economy by hiking the Repo rate by 25 bps.

Liquidity Scenario

No change in stance

- CRR to remain steady

Apart from a marginal surplus seen for a couple of days, the systemic liquidity has remained in a deficit mode for the last whole quarter. In line with RBI's stance of retaining a liquidity deficit for better monetary transmission, the current fiscal year has witnessed an average deficit broadly remaining in the range of 1% of NDTL (as guided by the Central Bank). Barring around the advance tax payment the liquidity deficit has remained within the intended limit. The RBI would continue to retain a similar stance on the liquidity front.

We expect liquidity to remain tight with a continuing deficit in the quarter ahead. The huge G-Sec supply lined up for the quarter would be only marginally comforted by the redemption of 12% GS 2011 and 11.50% GS 2011 (total of around Rs.14,250 Cr). On the contrary, the continuous bond supply and rollover of CMB (in case) would add to the strain. Apart from RBI's stance on liquidity, the pan out of systemic liquidity would also depend on the extent of Government expenditure. Any change in the CRR remains remotely possible at the current juncture as liquidity remains in line with the desired stance. We expect the RBI to retain the CRR at the current 6%.

Monetary Aggregates & SLR for banks

With regards to the monetary aggregates, the last three months have marked limited substantial changes. The loans and advances to the Government by the RBI broadly remain in line. The Government has managed its cash position with the aid of CMB issuance.

Attribute	Jul' 11	Oct' 11
Central Govt Deposits	(-) 33,672 Cr	(-) 38,311 Cr
Money Supply M3	17.1%	16.2%
M3/M0	4.9	5.19
NDTL	60,09,867 Cr	61,56,637 Cr
Adjusted SLR	28.46%	28.32%
Credit Growth (YoY)	19.9%	19.45%

Source: RBI, Emkay Research

Systemic SLR high

- No change in SLR

Money supply growth has come down to 16.2% (YoY) from 17.1%, though above RBI's target of 15.5%. M3/M0 as on Oct 7th (5.19) has witnessed a steep rise as seen in the table. This is primarily tracking a rise in M3 due to the advance tax money and the month end Government spending coming into the system in the first week of October.

The average M3/M0 otherwise has remained around 5 in the quarter Jul-Sep. M3/M0 has moved from 4.9 in July to 5 on an average in the quarter Jul-Sep due to a decline in M0. The absolute increase in M0 in the quarter Jul-Sep has been lower than that seen in Apr-Jun. This is primarily tracking lower CRR requirements, again because of a lesser rise in deposits in the quarter Jul-Sep as compared to Apr-Jun. Deposit growth stands at 17.4% (YoY). Credit growth has moved from 19.9% to 19.45%, exceeding RBI's target of 18%.

Systemic SLR is around 28.3%, much higher than the 24% mandated by RBI. As on Sep 30th, the FY so far has witnessed investments in SLR by banks to the tune of Rs.1,79,192 Cr as against a mere Rs.92,341 Cr seen for the same period last year. This is despite the fact that the SLR stood at 25% last year and is currently lower at 24%. FY 2011 marked total investments at Rs.1,15,287 Cr. The investments in H1 FY 12 have been substantially higher. The total gross borrowing for the year stands revised to around Rs.4,70,000 Cr. Thus, around 38% of the borrowing has been aided by banks in the first half of the year. With systemic SLR way above RBI's mandated 24%, the SLR is not expected to be tweaked. We expect no change in the SLR rate.

Global Scenario

The critical slowdown in the global economy continues to pose challenges for the Indian economic outlook. In the last quarter the key economies such as USA as well as Spain both marked a downgrade in their sovereign debt ratings. Resolving the debt crisis in Europe and USA remains the prime concern on the global front. The high domestic inflation and another soft patch in global growth are adding to RBI's policy setting complexities. Measures such as Operation Twist by the USA and hike in the bond purchase limit by UK signal the need for low interest rates in the advanced economies for a long time here on. Several Central Banks across the globe have hit the pause button on the rate front. Economies are more worried over sluggish growth despite elevated headline inflation levels.

Inflation up globally

- Domestic pressures demand rate tightening

In emerging economies, inflation clearly remains the major concern. India has adopted a more aggressive approach with respect to the conduct of its monetary policy in comparison to its global peers. India as a developing economy faces several structural challenges and the monetary requirements are different from that seen in other economies. Fiscal slippage and supply side constraints are likely to keep inflation higher than RBI's comfort levels. Though the RBI has believed in coordinated and calibrated measures earlier, the current inflationary pressures demand appropriate rate tightening.

Conclusion

The RBI firmly believes that high inflation would hamper medium to long term domestic growth and hence it is imperative to tame inflation even at the cost of some near term growth. The RBI has reiterated that inflation remains high and well above its comfort zone. Despite the slowdown in the global as well as domestic growth, the Indian economy continues to grow at a reasonable pace.

In a bid to contain inflation and inflationary expectations we expect the RBI to hike the Repo rate by 25 bps. With hardly any signs of inflation cooling off so far, the headline number is further expected to be high for at least a couple of months. The RBI in its July policy had revised March 2012 WPI at 7%. The RBI may hold its projection at the same level. The GDP growth for FY 2011-12 estimated at around 8% by the RBI may be tweaked with a downward bias. The GDP growth may be pegged at 7.5-8%.

A slowdown in the IIP numbers and the stabilization of the core WPI index going ahead may trigger a pause by the RBI in terms of assessing 2-3 months data points before taking further action. The RBI may assess the impact of earlier rate hikes before taking action in the subsequent policy reviews. We place little probability to further rates hikes beyond the 25 bps hike in the October policy. Production data released post October would be critical in determining the action in the December mid-quarter review.

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