



RBI's Third Quarter Review of the Annual Policy Statement 2009-10: Expectations

Jan 25, 2010

We expect the RBI to continue with the tightening phase in the upcoming Monetary Policy it had commenced in the October 2009 Policy Review. Thus,

- CRR to be hiked by 50 bps to 5.5% from the current 5%
- Repo rate to remain unchanged at 4.75%
- Reverse Repo rate to remain unchanged at 3.25%
- SLR to remain unchanged at 25%
- Bank Rate to remain unchanged at 6%

Current macro-economic environment – Classic growth v/s inflation dilemma

I. Inflation:

Inflationary concerns

- Liquidity rollback to curb the same

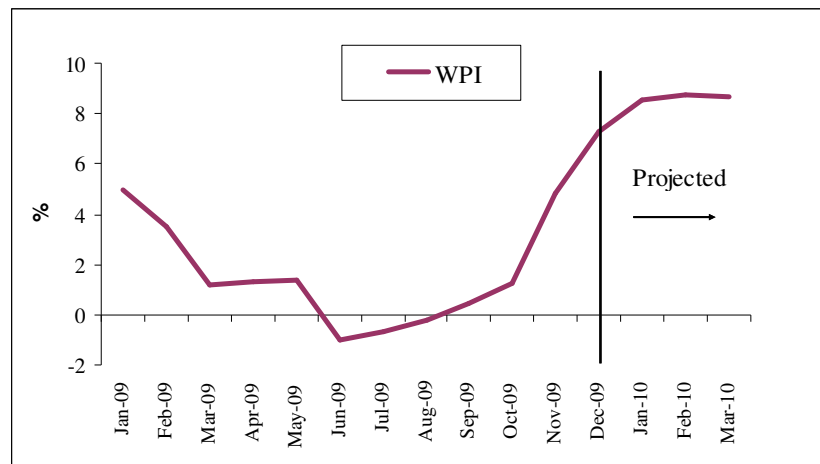
The years 2008-09 and 2009-10 have marked apparent extremes for the inflation as measured by the WPI. The journey of the inflation rate from double digits to the negative zone and then reversing to rise to disconcerting levels has been rapid and treacherous from the point of view of policy makers. Since the last Policy Review the WPI has been released on a monthly basis and has risen steeply. The rise in inflation for the current fiscal year, which stands at 8% till date, is much higher than 1.86% in the corresponding period of the previous year. The major culprit remains the rise in food articles that have surged by 18.29% since March 2009. Despite the current rise in WPI being largely attributable to supply driven factors, the Central Bank remains vigilant about how it can feed into raising overall inflation expectations. Given the visible signs of pick up in the manufacturing activity, the Manufactured Products index would tend to rise in the months to come. Also the continued base effect would keep the WPI at elevated levels in the 4th quarter of the current fiscal. This sets the stage for appropriate roll back of excess liquidity in the system, which if not curbed may sow the seeds of the next inflationary cycle.

“In 2009-10, however, CPI inflation has remained inflexibly high and WPI inflation has also started firming up – led by significant acceleration in food prices – which has raised the risk of endangering generalized inflation through adverse inflation expectations.” – Smt. Shyamala Gopinath, Deputy Governor, RBI

The Government recently announced a slew of measures to contain food inflation. Assuming that these non-monetary efforts to tame inflation are effective and the WPI index does not rise, we would see a



headline rate of around 8% at the year end. Towards the year end the rise in the Manufactured products index would be offset by a decline in the Primary articles. We expect the year end inflation number to be in the range of 8.5% - 9.5% well beyond the tolerance zone of the Central Bank.



(Note: The estimates are based on the current usage of 1993-94 as the Base year)

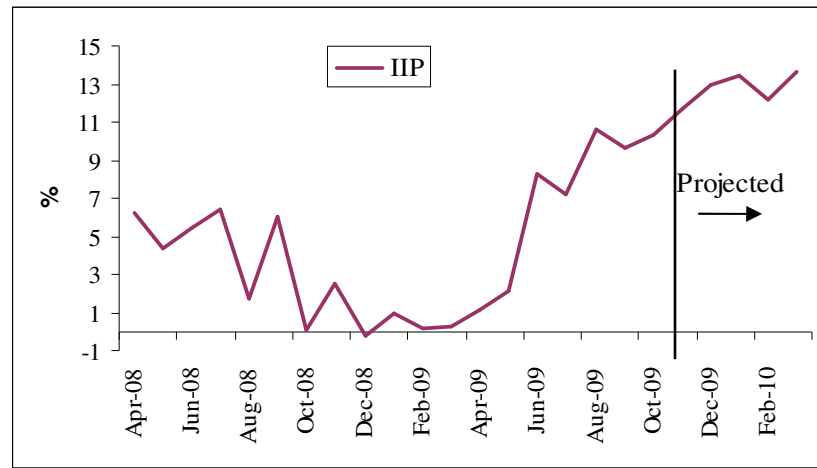
II. Index of Industrial Production:

IIP spiked up tracking pick up in Manufacturing

- Industrial production robust

Fueled by stimulus backed demand, IIP figures have gathered substantial pace since the month of June 2009. Apart from rising preliminary headline numbers, the trend observed in the revised data, too, invariably marks an uptick. Undeniably, the sluggish industrial growth observed in the same period last year provided a base that has pushed the IIP figures northwards, but the case rests that the manufacturing sector has picked up speedily. In terms of the use-based classification, the capital goods sector has witnessed a welcome growth. IIP growth is expected to remain buoyant given the pick up in the manufacturing activity and the visible pick up in the core industries. A gradual translation of improvement in Consumer goods demand to Intermediate & Basic goods was marked in the last few IIP releases.

The graph shows the trend for the estimated figures up to the month of March 2010. We expect IIP growth figures to remain in double digits till the fiscal year end. The industrial growth trajectory would probably face strong headwinds later next year (considering the lag effect) tracking the expected monetary tightening in the next calendar year.



“IIP numbers show growth pattern is skewed.. So there is still an imbalance in the pattern of growth. I am not saying recovery is not happening but it does suggest that recovery is ‘uneven’ and that is really a consideration that will dominate our thinking” – Mr. Gokarn, Deputy Governor, RBI

The continuous rise of industrial production gives hope that the recovery is on a firm footing but also fuels the debate whether stimulus provided by the government to spur the economy should be withdrawn at the current juncture. The fears remain that incipient signs of recovery may not be so robust after all and the global economies remain vulnerable to being dependent on stimulus led consumption. This may prompt the Central Bank to hold its hand and explicitly reverse the monetary stance only when the growth momentum gets firmly rooted.

III. Liquidity Scenario:

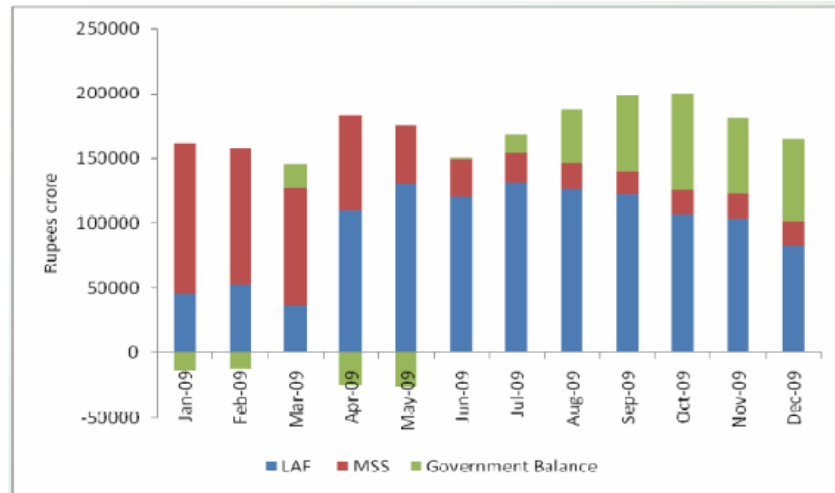
Systemic liquidity has been comfortable ever since the Central Bank pumped in potential liquidity of approximately Rs.5,61,700 Cr into the system since the beginning of the global slowdown. In its October Policy, liquidity was referred to as a threat for future inflation as against a support to ensure non-disruptive Government borrowing as done in all earlier policies. The Central Bank clearly signaled a caution against the deluge of liquidity. The huge foreign capital inflows into the resurgent Indian economy observed since July 2009 have led to a significant appreciation of the domestic currency apart from adding to the liquidity. Indian exports marked a positive growth for the last two months reversing the declining trend observed since the crisis. Amidst rising inflows, an appreciating currency could mar the incipient

Ample systemic liquidity

- 50 bps CRR hike likely towards the wrap up



recovery in exports. Any hike in the key interest rates would further push the Rupee northwards and stymie the nascent turnaround witnessed in the export sector.



Source: RBI

“We need to see that liquidity does not put inflationary pressures and for that some action on the monetary front would also be required.” – Mr. Rangarajan, Chairman, PMEAC

We expect the RBI to only siphon the excess money from the system to check incipient demand pressures from building up, leaving the scenario conducive for GDP growth and aid a pick up in exports. A 50 bps CRR hike would drain approximately Rs.20,000 Cr from the system and seems tenable in the current scenario. Although such a measure could see tight liquidity conditions once the system is strained by the advance tax outflows in March 2010, the Central Bank’s priority at the moment would be to tackle inflation expectations arising out of this liquidity surplus feeding into demand pressures.

IV. Monetary Aggregates:

SLR comfortable

- SLR need not be changed

Attribute	Oct '09	Jan '10
Central Govt WMA (Rs)	(+) 19,491 Cr	(+) 10,221 Cr
Money Supply M3	18.3%	17.1%
M3/M0	5.3	5.4
NDTL (Rs)	41,81,693 Cr	42,64,540 Cr
Investment Deposit Ratio	32.25%	33.13%
Credit growth (YoY)	9.5%	13.7%



Since the last Policy Review the Government cash balances with the RBI have remained in a comfortable zone. The money supply growth has eased from 18.3% to 17.1%, closer to the target of 17% set by the RBI in its October policy. The money multiplier (M3/M0) has inched up marginally from 5.3 to 5.4. The investment deposit ratio has risen from 32.25% to 33.13% tracking the SLR hike announced in the earlier policy. Credit growth has picked significantly from 9.5% to 13.7%. The improving credit off-take marks signs of the earlier measures trickling down into the system. The same however, could be disguised tracking the base effect. However, the growth in the money multiplier mandates the containment of excess liquidity. The rising credit off-take and higher velocity of money growth puts the Central Bank in the classical dilemma of spurring growth v/s controlling inflation. Systemic SLR is around 30%, much higher than the mandated 25%. The last Policy marked a hike in the SLR and hence no change is expected on that front.

V. Fiscal Situation:

Fiscal Deficit not expected to overshoot

- Unwinding of Fiscal Package a concern

The Union Budget 2009-10 retained a conservative stance with respect to the Receipts and an accommodative outlook towards expenditure. The data as released by the Controller General of Accounts does not hint any cause for concern.

2009-2010	Budgeted Annual (Rs. Cr)	Actual till Nov 09 (Rs. Cr)	Actual Completed (%)
Fiscal Deficit	400996	306221	76.4
Revenue Receipts	614497	307125	50.0
Out of which taxes	474218	232873	49.1
Total receipts	619842	315451	50.9
Expenditure	1020838	621672	60.9
Non plan head	695689	447995	64.4
Plan head	325149	173677	53.4

With the month of November 2009 representing around 66.67% completion of the fiscal year, we analyze the fiscal scenario based on a comparison of the actual percentages given in the table above. Although total expenditure at 60.9% appears to be under control, total receipts at 50.9% paint a gloomy picture, though not a complete one, as the robust advance tax collections observed in the month of December would support a better ratio for the rest of the year. However, as we approach the financial year end the non-plan expenditure would tend to



rise. The fiscal deficit at 76.4% seems a tad above the comfort level. Any deficit in the revenues would be compensated by the proceeds from disinvestment that have not been fully budgeted for. Bulk of the ambiguity remains hinged on the completion of 3G auctions in the current fiscal. Any cash deficit is expected to be met with via issuance of Cash Management Bills. With major portion of the borrowing completed, the concern now would be to keep the expenditure in check and unwind the expansionary stance.

VI. Global Scenario:

Improving Global scenario

- India on the path of recovery

Unlike on the domestic front, that has seen a growth story pick up pace, the global economies seem to be moving gradually towards the path of sustained positive growth. The contraction of economies may have ceased, but nonetheless growth seems to be demanding some more time to take firm root. Most Central Banks continue to support the economies by means of unconventional tools. Major economies have come out of recessionary shackles, but remain at too fragile a stage to withdraw support. Recovery in the commodity prices and a discernible recovery in equity markets support a steady stabilization. Issues with regards to the unemployment scenario would continue for a while. Post rate hikes by Australia and China, India seems to be poised to follow its steps.

“The timing and sequencing of exit from the accommodative fiscal and monetary policy is a challenge for the RBI...These issues are being debated all over the world and occupy the central place in our policy matrix too.” – Dr. D. Subbarao, Governor, RBI

The case for pre-emptive rate hikes ?

The RBI recognizes the need to be pre-emptive in reversing the policy stance in order to curb price pressures, bearing in mind the needs of a developing economy. The October Policy hinted a stance reversal from managing crisis to managing growth. The January Policy would be apt to begin the tightening in terms of liquidity mop up and a wait and watch period for one quarter to begin with interest rates hikes.

VII. Expected Measures in the Policy:

The Policy would mark a crucial beginning to the tightening process. With Q2 growth figure falling into place the Central Bank would be keen to move towards consolidation.



“I had a detailed discussion with RBI and found that there is no reason to believe that excess liquidity is contributing to inflation in the economy.” – Mr. Pranab Mukherjee, Finance Minister

CRR hike, Repo &
Reverse Repo unchanged

- WPI, GDP targets to be revised with an upward bias

However, the Government would want to retain the interest rate scenario till the GDP numbers mark an impressive and consistent elevation. The recent measures taken by Government to curb food price inflation, hint an inclination to retain the accommodative stance.

Tracking the abundance of systemic liquidity and further expectations of capital flows, we expect the Central Bank to contain the same via a hike in the CRR. We do not expect the RBI to raise the key interest rates in the January Policy itself. A hike in the Reverse Repo rate as mulled by several market participants would only lead to narrowing of the LAF corridor, a trend contradictory to that seen during the tightening phase between 2004 and 2007 (where the corridor widened). In terms of the targets set by RBI, the WPI for the year end could be revised with an upward bias from the 6.5% stated in the October Policy review. The GDP growth estimate could also be revised upwards from the 6% stated in the previous Policy.

Conclusion:

We expect RBI to begin with the tightening phase explicitly by raising the CRR by 50 bps. Amidst fragile signs of a recovery, the Central Bank may not rush into hiking the key interest rates. We expect a vivid shift of stance from neutral to hawkish in the Third Quarter Review of the Annual Policy Statement 2009-10.

The economy seems to be gaining pace on the growth trajectory with robust industrial growth, rising FII inflows, an appreciating currency, resurging credit off-take, recovery in the equity & commodities market and positive exports growth. The economy, poised to grow rapidly, however faces the hurdle of rising inflation expectations in the months ahead. The Central Bank's top priority would now be to unwind the expansionary and accommodative measures provided earlier. The dilemma remains tightening now and risking a relapse of low growth and holding off long enough to set off a wage price spiral. The Central Bank would be focusing on taming inflation (keener to tighten the Policy) whereas the Government on higher GDP numbers (support an accommodative stance). Amidst a rerun of these contradictory goals we expect the Policy rates to remain the same for the quarter to come.

We expect RBI to begin hiking the Repo and Reverse Repo rates post the January Policy. We expect the Central Bank to have completed the borrowing programme of the Centre by early February as well as a better performance from the exports sector till the next Policy, and hence expect the RBI to be gaining additional liberty to move towards rate hikes then.



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