



## RBI's First Quarter Review of Monetary Policy 2011-12: Expectations

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In a bid to reverse the monetary easing implemented post the Lehman crisis and to tame inflationary pressures the RBI commenced the rate tightening process in March 2010. The tightening phase has marked 10 rate hikes, a cumulative of 275 bps in the Repo and 325 bps in the Reverse Repo rate. However, several macro-economic data releases have led to doubts on the efficacy of measures taken so far, viz. March 2010 WPI stood at 10.36% and the latest June 2011 WPI at 9.44% (with an upward revision expected to touch double digit). An inflation of above 8% consistently since the last 18 months has led to RBI placing its primary focus on curbing price pressures. The upcoming policy would ensure continued efforts in the same direction.

The upcoming First Quarter Review of Monetary Policy would aim at taming price pressures whilst not hurting the growth momentum. Amidst the convolution of a trade-off between tightening rates for price control and the need to support growth, we expect the RBI to incline towards curbing inflation. Thus we expect,

- Repo rate to be hiked by 25 bps to 7.75% from the current 7.5%
- Reverse Repo rate to automatically stand hiked by 25 bps to 6.75% from the current 6.5%
- CRR to remain unchanged at 6%
- SLR to remain unchanged at 24%

*Current macroeconomic environment – Growth reasonable, Inflation not*

### I. Inflation:

India's surging inflation has remained a cause for concern since more than a year and a half now. Despite steep measures taken earlier, the average inflation in Q1 FY 12 stands at 9.4% (May – 9.06% and June – 9.44% are yet to undergo their final revisions). The food and fuel price rise has translated into higher core inflation. The headline WPI numbers remain high and sticky above 9%, well above RBI's target of 6% for March end 2012 set in the Annual policy.

Inflationary pressures  
 persistent

*- Warrants measures to  
 tame inflation*

The inflation rate released for the month of June 2011 stood at 9.44%, with the core inflation coming in at 7.31%. The hikes in the fuel prices announced around June end are yet to have the second round effects. The pass on would imply higher primary articles and manufactured products' prices. Globally crude prices yet remain elevated and continue to pressurize domestic fuel prices. A normal monsoon would be critical to keep food prices in check. Consumer demand remains reasonable and hints at demand side pressures in the economy. With sound bytes of QE-III in the US, the rise in the global commodity prices will also feed into the domestic price pressures. Inflation has caught up not only in emerging economies but in advanced economies too. This will all lead to

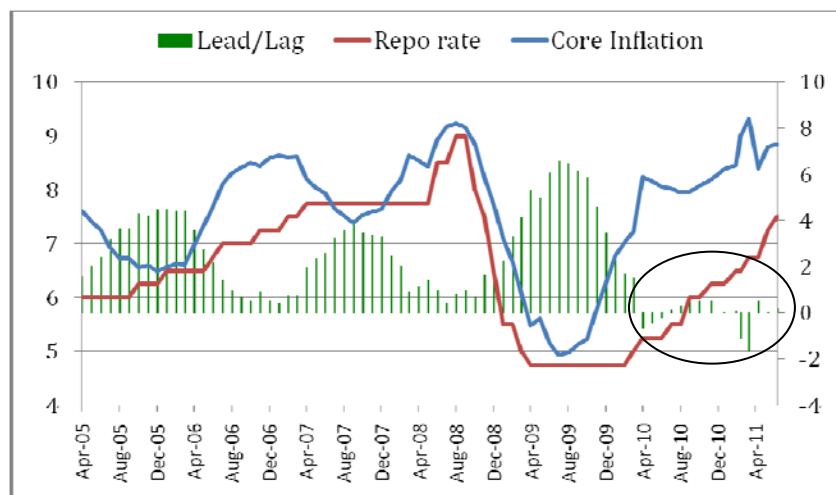


the inflation rate remaining at elevated levels and outside the comfort zone of the Central Bank for a prolonged period.

A marginal comfort can probably be found in the data released for June. The core index marked a sharp rise in the period between Nov-10 and Mar-11. Whereas the Jun-11 core index remained flat at 74.4 marking a steady price level month on month.

Month	Core Index	Core WPI
Jul-10	69.3	5.39
Aug-10	69.4	5.21
Sep-10	69.6	5.24
Oct-10	69.9	5.51
Nov-10	<b>70.1</b>	5.76
Dec-10	<b>70.6</b>	6.21
Jan-11	<b>71.6</b>	6.41
Feb-11	<b>72.6</b>	7.65
Mar-11	<b>73.6</b>	8.42
Apr-11	73.7	6.26
May-11	<b>74.4</b>	7.2
Jun-11	<b>74.4</b>	7.31

RBI released the latest household survey of inflation expectations in June 2011. The survey shows that inflation expectations of households between Jan-Mar 2011 for the next three-month and for next one-year ahead are lower at 11.9% and 12.7% respectively, from 12.4% and 13.1% assessed during the earlier round of survey. It indicates some impact of earlier rate hikes on inflation expectations.



Repo Rate (LHS), Lead/Lag, Core Inflation (RHS)

The 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. April 2010 and Feb-Mar 2011 marked the Repo rate lagging behind the core inflation, post which the RBI resorted to stiff measures in the July 2010 and May 2011 policy reviews (50 bps hike). The last quarter (Apr-Jun 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 derail 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% for another quarter. The number still remains uncomfortable and warrants action.

## II. Index of Industrial Production:

The IIP numbers remain volatile even with the introduction of the new base year 2004-05. The average IIP growth since Jan 2011 stands at 6.9%. The manufacturing sector reflects a reasonable performance, but a gradual slowdown from the robust performance is seen from a year earlier. Though the basic goods and capital goods segment have held up steady growth rates, the slowdown is markedly evident in the consumer durables and the intermediate goods segment. The completion of the transmission of recent rate hikes could further dent the consumer goods demand going ahead.

Industrial production  
reasonable

*- Case for calculated rate  
hike*

The survey conducted by RBI in Jan-Mar 2011 shows that the business condition in India's manufacturing sector has shown moderation in the sentiments after improvement in the previous two quarters (viz., July-Sep 2010 and Oct-Dec 2010). The industrial growth trajectory has faced strong headwinds (considering the lag effect) tracking the monetary tightening. The rate hikes announced since March 2010 have started adversely impacting the double digit growth seen earlier.

The average IIP growth for Q2 FY 2012 is pegged in the range of around 5 – 7%. Even with the stabilization in the IIP index numbers, we would probably be witnessing higher headline numbers going ahead purely on the base.

The latest GDP data release reflected a marginal slowdown in the investment cycle. However, exports have reported a robust performance. The domestic growth remains strong with regards to the external sector. Overall growth currently seems to be robust and may witness a marginal softening going ahead.

Considering the structural rigidities of our economy, as seen in the past, measures taken by the Central Bank take around a year's time to fully trickle down in to the system. The RBI has adopted an aggressive pace of rate hikes recently. Though the current price pressures demand a continued aggressive stance, the beginning of the decline in the 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 curb price pressures in the economy by hiking the Repo rate by 25 bps.

### III. Liquidity Scenario:

Systemic liquidity has remained in deficit mode since a long time now. 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). The RBI would continue to retain a similar stance on the liquidity front.

No stance reversal

*-No case for CRR cut*

Any change in the CRR remains remotely possible at the current juncture as liquidity remains in line with the desired stance. The RBI and Government may take several ad-hoc measures to manage any extreme tightness observed going ahead. We expect liquidity to remain tight with a continuing deficit in the quarter ahead. The redemption of 9.39% GS 2011 in July has aided sentiment. On the contrary, going ahead the continuous bond supply and rollovers of CMBs 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. We expect the RBI to retain the CRR at the current juncture.

### IV. Monetary Aggregates & SLR for banks:

With regards to the monetary aggregates, the last three months have marked several changes. The loans and advances to the Government by the RBI have reduced. The huge supply of CMBs has aided the Government's cash position. Money supply growth has broadly remained flat at around 17.1%, though above RBI's target of 16%. The deposit growth at 18.4% (YoY) includes the quarter end buoyancy seen in deposits. M3/M0 has witnessed a decline. This is primarily tracking a rise in M0 due to higher CRR requirements, again because of a steep rise in deposits in the quarter end. Credit growth has moved from 22% to 19.9%, exceeding RBI's target of 19%. The decline in headline credit growth rate is tracking the huge credit lent to telecom companies (for 3G & BWA payment) that happened in the same period last year.

Systemic SLR high

*- No change in SLR*

Systemic SLR is around 28.5%, much higher than the 24% mandated by RBI. The FY so far has witnessed investments in SLR by banks to the tune of Rs.1,01,806 Cr as against a mere Rs.48,579 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 Q1 FY 12 have been substantially higher. The total gross borrowing for the year stands at Rs.4,17,000 Cr. Thus, around 25% of the borrowing has already been aided by bank



buying in a single quarter. With systemic SLR way above RBI's mandated 24%, the SLR is not expected to be tweaked. We thus expect no change in the SLR rate.

Attribute	Apr' 11	Jul' 11
Central Govt Deposits	(-) 50,607 Cr	(-) 33,672 Cr
Money Supply M3	17%	17.1%
M3/M0	5.25	4.9
NDTL	58,23,898 Cr	60,09,867 Cr
Adjusted SLR	25.95%	28.46%
Credit Growth (YoY)	22%	19.9%

## V. Global Scenario:

Global economy continues to pose challenges for the Indian economic outlook. If rising global inflation was the theme in previous May-11 policy, resolving debt crisis in Europe and US would be the theme in Jul-11 policy. The concerns over global inflation and another soft patch in global growth will add to RBI's policy setting complexities. QE-II was the last major monetary stimulus measure and with it ending in June, central banks in advanced economies are just seeing the emerging trends. ECB is the only central bank which has raised policy rates to tame inflation while other central banks are more worried over sluggish growth despite elevated headline inflation levels. Headline inflation is much higher than core inflation and if one looks at the former, monetary policy should be tighter. Speculation over QE-III has led to a fresh round of steep rise in global commodity prices.

Inflation up globally

*- Fears of imported inflation*

In emerging economies, inflation clearly remains the major concern. Most central banks are tightening monetary policy to mitigate inflation pressures. Worries over capital inflows because of tighter monetary policy have dissipated for a while because of another soft patch in the global economy. Hence, they can focus on tightening policy rates without fearing capital inflows. In some countries like China, housing prices continue to remain elevated leading to some stiff measures from Chinese policymakers. Concerns over China's economy and state of local government finances have risen recently as well. The world economy clearly is not in a position to handle pressures from weakening Chinese economy.

India has adopted a more aggressive approach with respect to the conduct of its monetary policy in comparison to its global peers. Though the RBI has believed in coordinated and calibrated measures earlier, the current inflationary pressures demand appropriate rate tightening.



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### **Conclusion:**

On the back of a reasonable GDP growth currently and in a bid to tame inflation we expect the RBI to hike the Repo rate by 25 bps. Since more than a year now, the monetary policy from the Central Bank has revolved around containing inflation and inflationary expectations. However, there are no signs of cooling and the headline inflation is further expected to be high for at least another quarter. The RBI in its annual policy had pegged March 2012 WPI at 6% with an upward bias. The RBI may hold its projection at the same level. The GDP growth for FY 2011-12 earlier estimated at around 8% by the RBI may not be tweaked in the upcoming policy. A marginal slowdown in the IIP numbers and the stabilization of the core WPI index in the June release 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. A 25 bps hike beyond the July policy may or may not happen depending on the data releases till then. We broadly expect another 25 bps hike till December; the timing of the same however cannot be ascertained.

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