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## RBI's Annual Monetary Policy 2012-13: Expectations

RBI's Annual Monetary Policy 2012-13 is scheduled to be announced on 17-Apr-12. The policy is a highly anticipated event as there are wide expectations that RBI will start to ease its policy rates after nearly two years of continuous tightening.

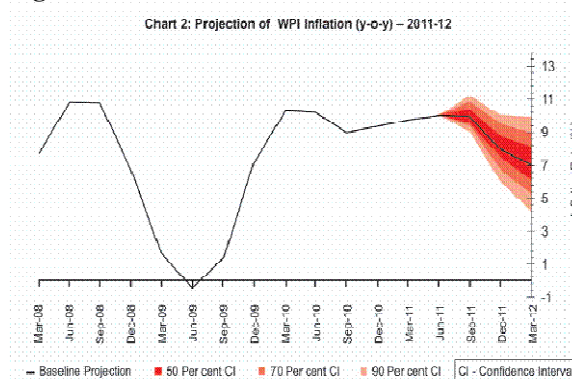
We expect that RBI may cut policy rates by 25 basis points mainly to provide some boost to the growth sentiment. We also expect RBI to ease CRR by 50 bps as liquidity is expected to tighten going ahead. RBI has indicated in the previous three policies (Dec-11, Jan-12 and Mar-12) that rate cycle has peaked and future actions will be towards lowering the rates. The softening of inflation in recent months is mainly because of sharp decline in food prices which have begun to reverse recently. The growth indicators like IIP and PMI are giving conflicting signals. The quality of IIP data continues to be a major source of concern with sharp revisions in Jan-12 data swinging the sentiment from optimism to pessimism.

Persistent liquidity deficit, much beyond RBI's comfort level along with record high Current Account Deficit (CAD) are additional factors that will be taken into account while deciding the policy outcome. In the above backdrop, we look into the recent macro economic developments and their influence on RBI's policy decisions.

### I. Inflation

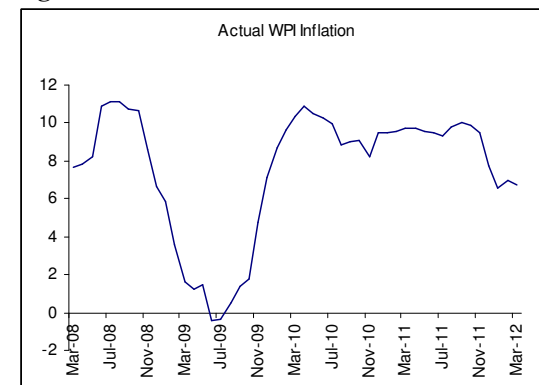
The inflation trajectory in 2011-12 has broadly been in line with RBI's trajectory given in Q1 2011 Monetary Policy Review in June-11. The inflation was expected to remain around 9.5% till Nov-11 and then decline from Dec-11 onwards to touch 7% by Mar-end. We expect Mar-12 inflation to be at around 6.75% slightly lower than RBI's year-end projection.

Figure 1



Source: RBI

Figure 2



Source: Commerce Ministry

However, the decline in inflation from Dec-11 onwards is mainly on account of sharp reversal in food prices. The primary article inflation declined from 15% in Apr-11 to just 2.25% in Jan-12. Within primary, Food articles inflation declined from 10.7% in Apr-11 to -0.52% in Jan-12. Core inflation on the other hand declined but at a much lower pace from 7% in Apr-11 to 6.7% in Jan-12.



RBI would have liked to see the impact of rate hikes on the demand side of inflation which is measured by core inflation which has not declined as much.

Moreover, the decline in food prices seems to have reversed in Feb-12 and primary articles inflation was noted at 6.28% and food articles inflation at 6.07%. Table 1 shows the swing in contribution of primary articles inflation in total inflation. Based on preliminary evidence, we expect the same trend to continue in Mar-12 and next year as well. Food inflation is unlikely to decline till we see some significant improvement in agriculture yields and production levels.

	<b>Primary Articles</b>	<b>Fuel</b>	<b>Core</b>
Apr-11	43.3	22.9	36.3
Jan-12	9.1	33.0	49.3
Feb-12	22.6	27.7	39.4

*Source: Commerce Ministry, STCI-PD Research*

Apart from food, there are upside risks to inflation on account of suppressed fuel inflation, a fact that RBI has been repeatedly expressing its concern over. RBI in its Mar-12 Mid Quarter Review mentioned that "... *there continues to be significant suppressed inflation in fuel, fertilizer and power as administered prices do not fully reflect the costs of production.*" Petrol prices despite being deregulated in Jun-10 have not seen any increase in prices since Nov-11. Administered fuels like diesel, LPG and kerosene too have not undergone revision since Jun-11. On the other hand Crude oil prices in the international market have risen from average \$110 per barrel in Nov-11 to average \$122 per barrel in April-12.

In Mar-12, core inflation reading is likely to be below 5%. RBI is likely to draw some comfort from this possible sharp fall in core inflation as it seeks to bring down core inflation around 4% levels in the medium term. However the internals of the inflation data clearly shows that on M-o-M basis most sub sectors of core inflation have risen consistently. Healthy consumption despite increase in interest rates along with weaker rupee are responsible for firmness in core index.

Apart from WPI figures, CPI indices also show inflation rising in Feb-12 onwards. CPI inflation rates jumped in Feb-12 compared to Jan-12. CPI-IW was noted at 7.57% in Feb-12 compared to 5.32% in Jan-12. CPI-AL was at 6.34% in Feb-12 vs. 4.92% in Jan-12. CPI-RL was noted at 6.68%, higher than 5.27% in Jan-12. The new CPI series shows CPI-Total inflation at 8.83% sharply higher than 7.65% in Jan-12.

Going forward, we see headline inflation in the range of 5.50- 6.00% in H1 2012-13 and then rising to around 6.5% levels in H2. However, this is based on our assumptions that monsoons will be normal and geo-political risks do not increase sharply. In case any of these events happen, inflation could easily increase to around 7-7.5% levels. We have seen in the recent years how the higher inflation scenario becomes the benchmark scenario because of supply shocks.

## **II. Growth**

**1) GDP:** GDP growth has slipped each quarter in 2011-12. GDP growth was 7.7% in Q1, 6.9% in Q2, and further slipped to 6.1% in Q3. GDP growth in Q3 11-12 is the lowest since 5.6% seen in Q3 2008-09 during Lehman crisis. CSO has pegged the 2011-12 growth at 6.9% and this would imply a Q4 growth of 6.9%. Given the domestic and external environment, achieving 6.9% growth rate looks difficult.



The major concern in GDP is decline in growth rate of investments. RBI has reiterated its concern over declining growth of investments in all its policy statements. The growth rate in investments has declined for two consecutive quarters (Q2 and Q3 2011-12) which is a first in the time-series. Investment growth declined previously during Q3 2008-09 but it was limited to just one quarter with growth rebounding in Q4 2011-12. The investment growth has declined because of multiple factors like high rates, domestic policy issues and global uncertainty.

In agriculture sector, India is likely to produce 250.42 million tonnes (MT) of foodgrains during 2011-12 compared to 232.07 MT last year. Both wheat and rice production is expected to touch a new record. However the country will have to rely on imported Pulses and Oilseeds to meet the consumption needs as both these crops are expected to yield lower output than last year.

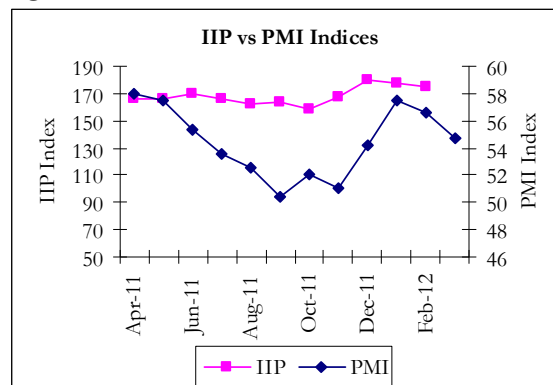
Industry growth continues to be drag on GDP as mining sector recorded negative growth for the second consecutive quarter in Q3 FY 2011-12. Manufacturing also continued to record lacklustre performance. Growth in Services which contribute around 57% to the total GDP held up aided by promising growth in Trade, Hotels, Transportation etc.

We expect GDP in 2011-12 to be around 6.75% lower than CSO's estimate. The Finance Ministry has pegged the 2012-13 growth at 7.6% (+/-0.25%). Given the global and domestic economic outlook, we expect GDP growth for 2012-13 to be lower at around 7%-7.25%.

**2) Index of Industrial Production (IIP):** IIP continues to be a very volatile measure making it difficult to draw any meaningful analysis from the data series. Despite revision in IIP base year, the new series continues to spring surprises. RBI Governor himself remarked that IIP data continues to be "analytically bewildering". The recent IIP release revised data for Jan-12 much lower from 6.8% to 1.1%! Within IIP, non-consumer durables growth was revised from 42% to just 11% on account of over reporting of sugar production in the provisional data release. Till the revised numbers, it was being felt that economic outlook had improved in Q4 2011-12. However, with the revision this sentiment has waned.

IIP data also shows diverging trend when compared with other growth indicators like Purchasing Managers Index (PMI). The IIP and PMI are though not strictly comparable as both follow different approaches for compilation. IIP measures annual output growth on Y-o-Y basis while PMI is a survey based monthly index. But still it should show some synergy in overall trends.

**Figure 3**



Source: CSO, Newswires



## IV. Fiscal Position

The Government's fiscal profligacy resulted in the current year fiscal deficit being revised to 5.9% from the budget estimate of 4.6%. According to the revised estimates of 2011-12, total expenditure is estimated to record an annual growth of 10.1% against the originally budgeted growth of 3.4%. This is largely on account of higher outgo towards subsidy payment. There was an additional subsidy of Rs 72,727 Cr on over Rs 143,570 Cr estimated in Budget 2011-12.

For 2012-13 once again the government has estimated a lower outgo towards subsidy compared to the revised estimates of 2011-12. However in its bid to provide a road map for fiscal consolidation the government in the Budget 2012 has suggested some caps on subsidies. The budget says that *"From 2012-13 subsidies related to food and for administrating the Food Security Bill will be fully provided for. All other subsidies would be funded to the extent that they can be borne by the economy without any adverse implications."* Accordingly the government has proposed:

- To restrict the expenditure on Central subsidies to under 2% of GDP in 2012-13
- To be brought down to 1.75% of GDP over the next three years

This appears to be a good move however its adherence remains to be tested. The markets are already questioning the fiscal numbers and suggesting that fiscal deficit will again be revised upwards to 5.5% of GDP.

RBI in its various reports has mentioned that monetary tightening alone would not be able to achieve its objective of inflation management. Without adequate support from the fiscal side the goal of monetary policy renders itself inefficient. Therefore, though the 2012-13 budget estimates are relatively more credible, questions remain on the intent of the fiscal policy. It will be interesting to see the construct of RBI's monetary policy in this backdrop of expansionary fiscal policy stance.

## V. Current Account Deficit

India has been a twin deficit country for a long time with both current account and fiscal account in deficit mode. In terms of current account deficits, the position has been comfortable so far as capital flows have been robust. Despite a high CAD, substantial capital inflows have ensured that Balance of Payments not just remains in balance but also generates surplus over the CAD.

However, this scenario reversed in 2011-12. In Apr-Dec 12 period, CAD has widened to \$53.6 bn from \$39.6 bn. Capital account balance on the other hand stood at \$46.5 bn vs \$50.6 bn last year. Foreign investments in the same period stood at \$19.5 bn \$38.3 bn last year. Higher CAD and a lower capital inflow has led to balance of payments deficit of \$8.1 bn compared to surplus \$18.3 bn seen last year. In Q3 2011-12, CAD crossed 4% of GDP levels which is alarming.

This has led to rupee depreciating sharply by nearly 20% in the period Aug-Nov. The Rupee appreciated tracking some measures by government and RBI but situation has hardly improved. The intervention by RBI to stem Rupee depreciation has led to tightening of the liquidity and complicating monetary policy. RBI is expected to heighten its concerns over widening of CAD.

## VI. Monetary Indicators and Liquidity

In monetary indicators, reserve money growth has been lower on account of lower forex assets. Despite aggressive OMO purchases and cut in CRR, reserve money creation has been inadequate.



The inflow via OMOs was more or less nullified by the outflow via forex intervention. The growth rate in money supply has also been lower on account of lower reserve money. The credit growth rate however has remained robust and higher than RBI's projection of 16%.

<b>Table 2: Monetary Indicators (in %)</b>			
	Mar-11	RBI Projection for Mar-12	Mar-12
Aggregate Deposits	15.9		13.4
Non-Food Credit	21.5	16	16.9
Investments	8.4		15.7
M3	16.1	15.5	13.0
Reserve Money	19.0		4.3
<i>Source: RBI</i>			

Liquidity still remains tight. Average infusion via Repo rose from Rs 1,17,700 Cr in Dec-11 to Rs 152800 Cr in Mar-12. Usually liquidity is in surplus in the month of April but in Apr-12 it remains in deficit mode. The average deficit liquidity in Apr-12 month is 99,000 Cr. The liquidity has eased slightly in last few days at around a deficit of Rs. 80,000 Cr but still remains higher than RBI's comfort zone of 1% of NDTL (Net Demand and Time Liabilities) which is around Rs. 60,000 Cr.

It is expected that liquidity will tighten further going ahead as forex inflows are unlikely to rise. Though, there are redemptions worth Rs. 60,574 Cr (out of total redemption of Rs 90,616 Cr for the whole year) during the first quarter which will help ease liquidity situation. We also feel that this guidance of 1% of NDTL is too restrictive as RBI has not really intervened despite the actual LAF borrowings much higher than 1% of NDTL. It is hoped that RBI clarifies its position on liquidity management more clearly.

## **V. Policy Expectations and Conclusion**

The background for this policy is again ridden with complexities and trade-offs. The major factor for lowering policy rates is slowdown in growth and particularly investments. However, since the Mar-review inflation outlook has only worsened. The Union Budget has also raised questions on the government intent for credible fiscal consolidation. RBI has indicated that magnitude and timing of rate cuts depend on both lower inflation and credible fiscal consolidation. On both these fronts, RBI's case for cutting rates is not as strong as one would expect. Markets are divided over whether it is the right time to ease policy rates with some questioning whether RBI should be easing rates at all in 2012-13. The expected magnitude of rate cuts has also declined from 100-150 bps to just about 50-75 bps and most expect the rate cuts to be in the first quarter.

Looking at the various for and against arguments, we feel RBI is likely to ease Repo rate by 25 bps to 8.25%. Though, the willingness to cut rates might be low and RBI is likely to continue its hawkish tone. The monetary policy statement is likely to diminish the expectations of aggressive rate cuts by RBI. On CRR front, we are divided over whether CRR cut is warranted at this hour. RBI has chosen not to intervene even when liquidity deficit has been much higher than its 1% NDTL guidance. The recent LAF operations show liquidity is close to RBI's 1% NDTL and may not concern RBI immediately. However as liquidity is expected to tighten going ahead, we expect RBI to cut CRR by 50 bps.

On macroeconomic parameters, we expect RBI to peg GDP growth at 7.5% (in line with Finance Ministry projections) and Mar-13 inflation at around 6.5% with upside risks.



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