RBI's Monetary Policy Q2 2012-13: Expectations

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RBI's Monetary Policy for Second Quarter 2012-13 is scheduled to be announced on 30-Oct-12. The market expectations are once again divided over rate cut vs. rate pause camps. The dilemma is both camps are right as whichever side one takes, there is enough data to justify one's views.

We continue to remain in the second camp and believe RBI should hold policy rates in the upcoming policy. Both WPI and CPI inflation remain elevated at around 7.5% and 10% respectively. Thus whichever measure one looks at, inflation remains much above RBI's comfort zone of around 5% - 5.5%. The government recently raised price of diesel and capped LPG subsidy at 6 cylinders per household. However, despite these measures there is still significant upside risk to inflation as pass-through of fuel prices is still incomplete.

Some analysts opine that recent inflation has risen on account of revision of diesel prices and capping of LPG subsidy. This will lead to only one time rise in inflation and inflation will ease going ahead. However, we have so far only seen first round impact of diesel price rise and LPG cap with second round impact expected in couple of months ahead. It is important to note suppressed inflation does not mean that once the prices are raised, there will be no inflation. This leads to estimating the actual inflation in the economy and helps shape inflationary expectations.

In the above backdrop, we will first analyse the recent macro economic developments since Sep-12 mid-quarter review. In the second section, we will discuss RBI's policy choices and our expectations.

I. Global Economy

Global economy continues to be highly volatile. Since the crisis, the first half of the year has usually provided signs of optimism which is reversed in the second half with bouts of pessimism. The same is the case in 2012 as well. In H1, there were signs of economy revival. This sentiment was undone in H2 with global economic outlook being revised lower and case for policy activism is rising.

IMF recently revised World economy growth projection for 2012 from 3.5% given in its Jul-12 update to 3.3% in Oct-12 outlook. Growth for 2013 is also revised lower to 3.6%. The growth has been revised lower for both advanced economies and emerging and developing economies. Within developing economies, India's growth for 2012 has been revised significantly lower from 6.2% to 4.9%.

Table 1: IMF's Growth Projections (in %)						
			Jul-12		Sep-12	
	2010	2011	2012	2013	2012	2013
World	5.1	3.8	3.5	3.9	3.3	3.6
Advanced	3.0	1.6	1.4	1.8	1.3	1.5
US	2.4	1.8	2.1	2.2	2.1	2.1
Euroarea	2.0	1.4	-0.5	0.7	-0.4	0.2
Emerging & Developing	7.4	6.2	5.6	5.8	5.3	5.6
India	10.1	6.8	6.2	6.6	4.9	6
China	10.4	9.2	8	8.4	7.8	8.2

Source: IMF

As fiscal policy remains straddled with debate over austerity vs. growth and in US case over fiscal cliff, onus for fighting the slowdown remains with central banks. Globally, we have seen a kind of coordinated central banks action since Aug-12:

- Federal Reserve launched QE3 which will infuse $85b per month or a total of $350 bn by Dec-12.
- ECB lowered policy rate to 0.75% and agreed to buy unlimited bonds via a program named as Outright Monetary Transactions (OMT). OMT has not started yet and ECB is still working on the details of what is a conditional lending program.
- Bank of England increased its Asset Purchase Facility from GBP 325 bn to GBP 375 bn.
- Bank of Japan increased size of its Asset Purchase Program from JGB 70 tn to JGB 80 tn to be completed by 2013.
- Apart from major economies, central banks of Australia, Korea Brazil etc. also eased their monetary policy by cutting interest rates.

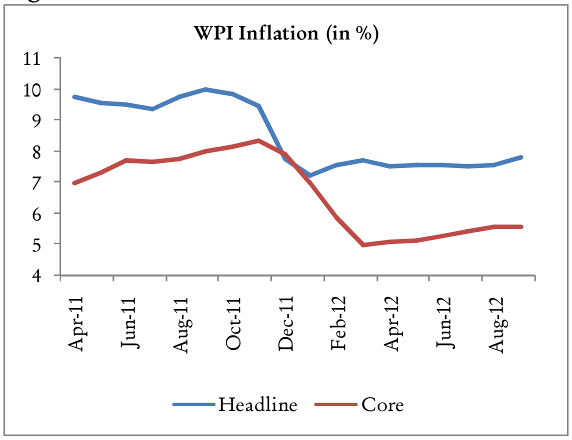
Despite recent Fed measures, US economy has shown some signs of improvement. Housing market seems to have bottomed out, unemployment rate at 7.8% is the lowest since Jan-09 and even confidence indices show optimism. However, we still do not know whether all these trends will show sustained improvement.

Overall despite more than five years after the crisis started, there is only one thing certain over the global crisis – rising uncertainty.

II. Indian Economy

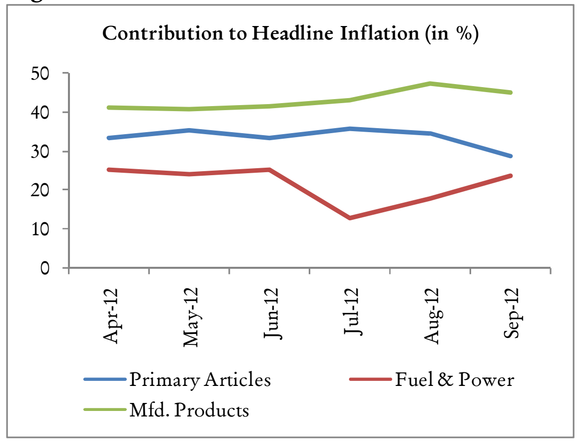
WPI inflation for Sep-12 was noted at 7.81%, higher than market expectations of around 7.6% to 7.7%. Higher inflation was mostly on account of revision in diesel prices. Core inflation has remained sticky at 5.5-5.6% levels for the past few months. The average WPI inflation for H1 FY-13 is 7.6%, lower than average of 9.6% seen in FY12. Average core inflation is 5.3% also lower compared to 7.6% average in FY12. Primary articles contributed around 33% of WPI inflation in Q1 2012-13 which has declined to 28% in Sep-12 tracking decline in vegetable prices. The contribution of fuel products has risen to 23.7% in Sep-12 where as manufactured products share remains steady at around 45%.

Figure 1



Source: Commerce Ministry, STCI PD

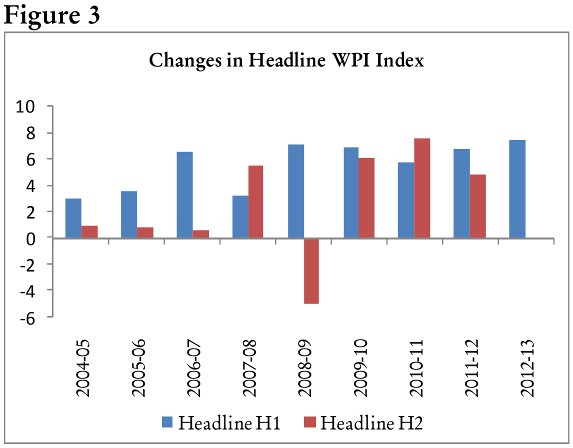
Figure 2



Source: Commerce Ministry, STCI PD

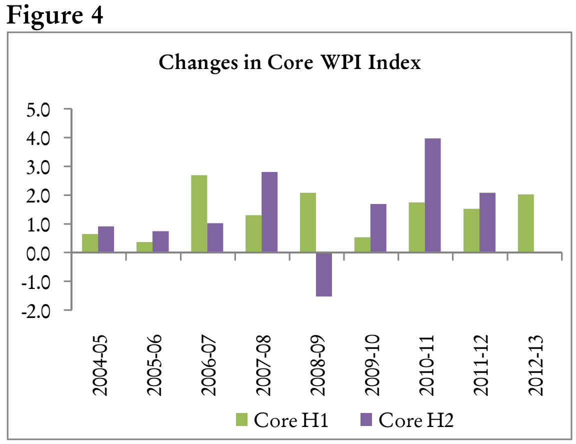
Inflation measured in percentage indicates that there is a decline in inflation in 2011-12, but this is actually just a statistical illusion. In H1, WPI index has gained 7.4 points which is highest gain in the series when compared to first halves of previous fiscal years. Even when compared to second halves, it ranks second to H2 2010-11 when index gained by 7.5 points. Even in core index, gains are seen at 2.1 points which ranks second in the list of first halves with core gaining 2.7 points in 2006-07. Both headline and core indices report higher gains in H1 2012-13 compared to H1 2010-11 and 2011-12, the years of high inflation.

Figure 3



Source: Commerce Ministry, STCI PD

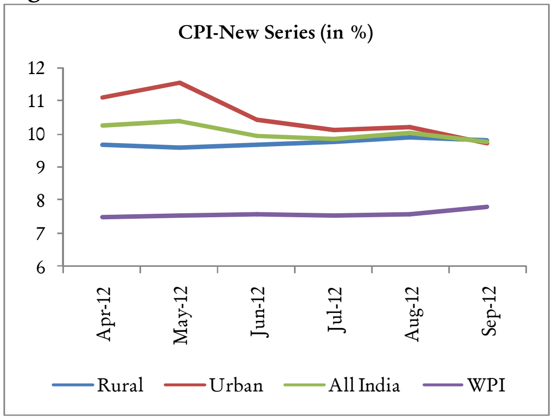
Figure 4



Source: Commerce Ministry, STCI PD

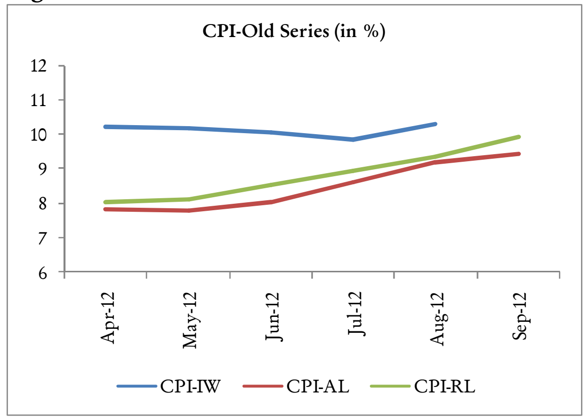
Inflation based on various CPI indices remains elevated and higher than WPI. They are higher than WPI as food prices have a higher weight in CPI indices. In the new series, CPI – Combined was at 9.73% in Sep-12 lower than 10.03% in Aug-12. This was mainly because CPI-Urban inflation reported lower inflation at 9.72% vs. 10.19% in Aug-12. In the old CPI series, CPI-Industrial Workers in Aug-12 was 10.3% and CPI-Agricultural Labour and CPI-Rural Labour were 9.4% and 9.9% respectively.

Figure 5



Source: CSO, Commerce Ministry

Figure 6



Source: Labour Bureau

Going forward, there is tremendous uncertainty on inflation outlook with both upside and downside risks. Upside risks emerge from elevated oil prices, weak currency and suppressed inflation. Downside risks emerge from global uncertainty leading to weakness in commodity and oil prices.

Based on our baseline scenario, we expect inflation to remain around 7-7.5% for remaining part of the year. It is expected to touch 8% plus around December because of base-effect. CPI inflation (new series) is expected to be higher at around 10-5%-11% levels in the remaining half of the year. All the indices continue to point the persistence of inflation at elevated levels.

III. Growth

1) GDP: in Q1 12-13, GDP growth was noted at 5.5%, slightly higher than Q4 11-12 growth of 5.3%. Though in Q1 2011-12 GDP growth was much higher at 8%. In sector-wise composition agriculture posted higher than expected growth at 2.9%. Industry and services were at 0.8% and 7.4% nearly similar to the levels seen in Q4 11-12. In terms of expenditure-wise classification, growth in investment was marginal at 0.7%, lower than 14.7% in Q1 11-12 and 3.6% in Q4 11-12.

RBI revised its growth estimate from 7.3% to 6.5% in Jul-12 policy on account of following factors:

- Deficient monsoon
- Weak industrial activity
- Slow down in global growth

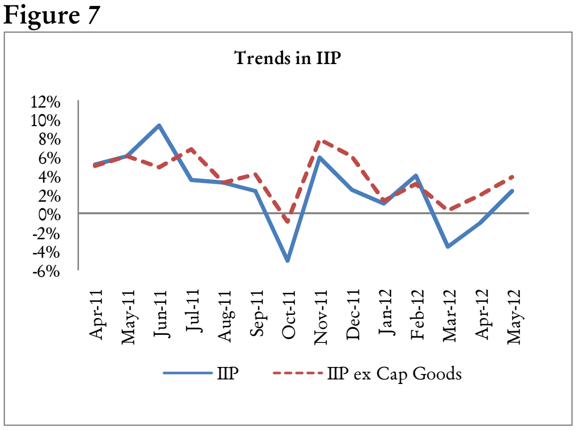
Of the three factors, only monsoon provides some relief. The other two factors viz. weak industrial activity has continued and slow down in global growth has worsened in H2 2012. It is likely that RBI lowers its GDP forecast from 6.5% to 6%. The various agencies have also lowered India's growth outlook considerably from their previous forecasts. We have also lowered our GDP growth outlook for 2012-13 from 6.5% to a range of 5.5% to 6%.

Table 2: GDP Expectations (in %) by key agencies		
Agency	**Growth rate**	**Recent Revisions**
RBI	6.5 (Jul-12)	--
PM's EAC	7.6	6.7
Finance Ministry	7.6 +/- 0.25 (Mar-12)	--
IMF	6.2 (Jul-12)	4.9 (Oct-12)
World Bank	6.9 (Jul-12)	6.0 (Oct-12)
ADB	6.5 (Jul-12)	5.6 (Oct-12)
Source: Various Agencies		

2) Index of Industrial Production (IIP): IIP despite exhibiting continued volatility shows declining trend. Though, there were some improvements in Aug-12 when IIP grew by 2.7% surprising most analysts. The average growth in Apr-Aug 12 is 0.4%, much lower than average growth of 5.6% in Apr-Aug 11. Within IIP, growth in capital goods has contracted for six straight months though frequency of decline has been lower in recent months. As a result, IIP growth ex capital goods has been around overall IIP growth in past few months.

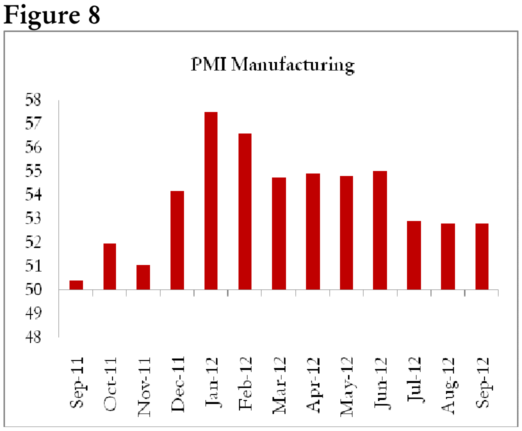
The other lead indicator Purchasing Mangers Manufacturing Index (PMI) shows the index at around 52.8-52.9 levels since Jul-12.

Figure 7



Source: CSO

Figure 8



Source: Newswires

IV. Fiscal Position

The five month data till Aug-12 shows that fiscal deficit is at around 65% of Budgeted Estimate (BE) for FY13. It is lower than last year figure of 66.3%. Total receipts remain in line with last year trends backed by strong growth in direct tax revenues. Direct tax revenues run rate is 27.8% till Aug-12 compared to BE of 13.9% for full year. Indirect taxes growth is lower at 11.8% compared to budgeted 26.7%. Targets for non-debt capital receipts will depend on disinvestment (Rs 30,000 Cr) and non-tax revenues (Rs 40,000 Cr) on 2G auctions. The government has proposed several PSUs for disinvestment and 2G auction is likely to be held in November.

Table 3: Government's Accounts (% of BE)		
	Apr-11 to Aug-11	Apr-12 to Aug-12
Total Receipts	23.5	23.3
Net Tax Revenue	21.8	22.7
Non Tax Receipts	34.8	29
Non-debt Capital Receipts	18.4	12.2
Total Expenditure	37.5	37.9
Plan Expenditure	29.9	28.4
Non-Plan Expenditure	41.7	43.0
Fiscal Deficit	66.3	65.7
Revenue Deficit	74.9	79.2
Source: CGA		

On the expenditure front, we see same trends as seen last year. Spending on plan expenditure is lower and higher on non-plan expenditure front. Non-plan expenditure including subsidies continues to remain a major concern for addressing fiscal deficits. As per Kelkar committee, fiscal deficit for 2012-13 is likely to be 6.1% of GDP if the government does not initiate any reforms. One of the major reform proposed by the committee was cutting subsidies which will lower the overall expenditure levels and fiscal deficit. If the government initiated the reforms proposed fiscal deficit likely to be around 5.2% of GDP. The government did take some steps to ease the subsidy burden by increasing diesel prices and capping LPG subsidy. However, the impact on overall subsidy outlay is going to be limited as still the amount of under-recovery is high.

Hence, there are some positives compared to previous policy outlook but still much more needs to be done. We expect fiscal deficit to be around 5.5% of GDP leading to a short-fall of around Rs 40-50,000 Cr. It will be interesting to see whether this is raised via additional market borrowing or other resources.

V. External Sector

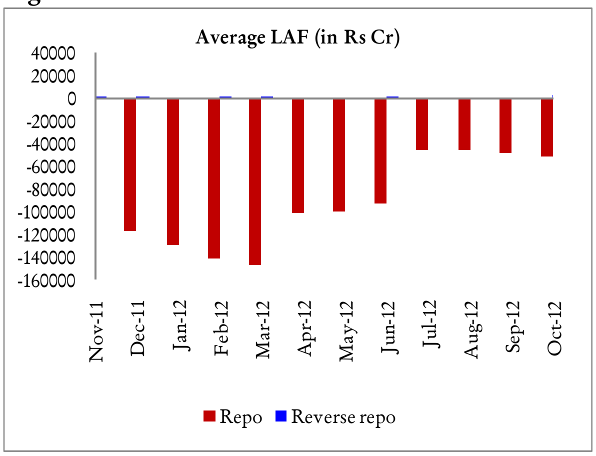
RBI has expressed widening twin deficit as a serious concern in previous policy. Current Account Deficit for Q1 2012-13 was at 3.9% of GDP. Though, the figure was lower than Q4 11-12 CAD of 4.5% of GDP, it is much higher than comfort zone of around 2.5-3% of GDP. Gold formed around 75% of Current Account Deficit in 2011-12 and declined to 55.6% in Q1 2012-13. There are chances that this ratio declines in Q2 2012-13 and again picks up in Q3 tracking rise in festive demand. Overall, gold continues to form significant part of India's CAD. This is likely to remain as with persistent uncertainty in global and domestic economic conditions, investment in gold remains a preferred asset class. This will likely keep CAD at elevated levels of around 3.5% of GDP.

The recent trade data shows trade deficit in Apr-Sep 12 is around $89.3 bn similar to last year's figure for same period of $88.9 bn. Growth of both exports and imports has remained in negative for last five months Within imports, non-oil imports has contracted in each of the last five months just like exports whereas oil imports have shown positive growth barring Jun-12 and Jul-12.

VI. Liquidity and Monetary Indicators

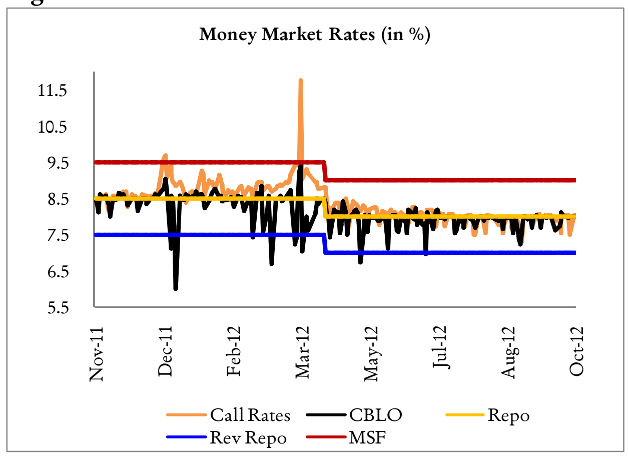
Liquidity conditions eased significantly in second quarter. FII inflows coupled with RBI's measures taken to ease liquidity since Nov-11 had a favorable impact on liquidity. Net LAF borrowing from Repo window has been lower than 1% of NDTL leading to call rate trading lower than Repo rate in previous quarter.

Figure 9



Source: RBI

Figure 10



Source: RBI

However, liquidity has again tightened around October as the impact of measures has waned away. Reserve money growth as on 12-Oct-12 is 2.7% on YoY basis and -0.3% on financial year basis. This is very low as calculations show reserve money growth for 2012-13 should be around 12.5%-13% to support RBI's money supply projection of 15%. Growth in monetary indicators like credit, deposit and M3 has been lower than RBI's projections. Credit growth which was around 16-17% till H1 has slipped to 15.5% as per latest fortnight data ending on 5-Oct-12.

Table 4: Monetary Projections and Growth rates (in %)

	Projections for FY 13	Growth rate as on 5-Oct-12
Deposit	16	14
Non Food Credit	17	15.5
M3	15	13.6
CD Ratio		75.02

It will be very difficult for banks to meet RBI's projections for monetary aggregates given in Apr-12 policy. We expect RBI to lower the growth projections of monetary aggregates by around a percent each. This will also lower the supply of reserve money RBI needs to create to support the economy.

VII. Policy Expectations and Conclusion

The background for this policy continues to be ridden with complexities and trade-offs. RBI will again be pushed into deciding whether to focus on growth or on inflation, both of which continue in opposite directions. In Apr-12 policy RBI chose to focus on growth and eased policy rates by 50 bps surprising markets. In Jun-12 review, RBI brought back focus to inflation and maintained policy rates. It has maintained this view in Jul-12 policy and Sep-12 review though easing liquidity conditions by cutting SLR and CRR.

Given this uncertainty, we believe RBI is likely to keep repo rate unchanged at 8%. Inflation remains much above RBI's comfort zone and there are several upside risks to the inflation outlook. Other central banks have eased policy rates but higher inflation in India limits RBI's choices in the same direction. The government has taken some measures but most of them still need to be implemented and will require a large political will. Hence, it will be premature for RBI to move on policy rates.

On liquidity front, we expect RBI to take some measures to ease liquidity in the system going forward. Even if RBI lowers its monetary growth projections there is likely to be an additional need of liquidity of around Rs 60,000-80,000 Cr net of LAF repo borrowing. Hence, RBI is expected to either ease CRR or do OMO purchases or a combination of both. OMOs and CRR both have their positives and negatives. Banks have been favoring a CRR cut over OMO purchases as it provides immediate liquidity. Hence, RBI is likely to ease CRR by 25-50 bps and do OMOs depending on the evolving liquidity situation.

On macroeconomic parameters, we expect RBI to revise its GDP growth projections lower to 6% and could increase inflation projections for Mar-13 from 7% to 7.5% with upside risks.

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