RBI's Monetary Policy Review Q3 2012-13: Expectations

Amol Agrawal
amol@stcipd.com
+91-22-66202234

Neetika Shridhar
neetika@stcipd.com
+91-22-66202229

RBI's Monetary Policy Review for Third Quarter 2012-13 is scheduled to be announced on 29-Jan-12. Till previous monetary policies market expectations were divided between whether RBI should pause on interest rates or cut them. This policy there is a strong expectation of rate cut from RBI among market participants.

We also believe RBI is likely to cut policy rates in the upcoming policy. The most important reason for this change in expectations is surprise decline in WPI inflation trajectory from previous policy in October. Though CPI inflation remains elevated above 10% but sequential rise in CPI index has also been declining in the last few months. More importantly, the government has stuck to its resolve to consolidate its finances and maintains fiscal deficit target for FY13 at 5.3% of GDP. There were apprehensions over meeting this target when it was announced in Sep-12 but government has belied these fears. There have been positive changes on oil subsidy front by partially deregulation of diesel.

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

I. Global Economy

The Global economic outlook continues to remain highly volatile.

IMF recently released its update for World Economy. It again revised its World economy growth projection for 2012 from 3.3% in Oct-12 outlook to 3.2% in Jan-13 Update. It had pegged global growth higher at 3.5% in its Jul-12 update. The growth for both 2013 and 2014 is lower by 0.1% to 3.5% and 4.1%. The growth has been revised lower for advanced economies in 2013 and 2014. Whereas for emerging and developing economies, growth has been revised lower for 2013 but kept unchanged for 2014. Within developing economies, India's growth for 2012 has been revised further lower from 4.9% to 4.5%. India's growth for 2013 has been revised lower from 5.6% to 5.5% and kept unchanged for 2014 at 5.9%.

Table 1: IMF's Growth Projections (in %)

	Outlook given in Oct-12			Outlook given in Jan-12		
	2012	*2013*	*2014*	*2012*	*2013*	*2014*
World	3.3	3.6	4.2	3.2	3.5	4.1
Advanced	1.3	1.6	2.3	1.3	1.4	2.2
US	2.1	2.1	2.9	2.3	2.0	3.0
Euroarea	-0.4	0.1	1.1	-0.4	-0.2	2.0
Emerging & Developing	5.3	5.6	5.9	5.1	5.5	5.9
India	4.9	6	6.4	4.5	5.9	6.4
China	7.8	8.2	8.5	7.8	8.2	8.5

Source: IMF

The plight of world economy remains divided between struggling fiscal policy and adventurous monetary policy. Fiscal policy in most economies continues to struggle and remains directionless. US policymakers delayed negotiations over fiscal cliff till the last hour. As world economy saw this tension subside, there emerged another challenge as US Congress again has to review and raise debt ceiling which is likely to reach its limit in Feb-13. There are some signs of improvement in US economy with bottoming out of housing sector and slow improvement in labour markets. Though, one should be wary of considering the lower US unemployment rate as a barometer for improvement in labour markets. The rate has trended lower as workforce has dropped out from the labour markets leading to shrinking of denominator and lower unemployment rate.

Europe and UK policymakers grapple over issue of slow growth with recession in former.

Central Banks continue to remain central figures in this chaos over economic policy.

- The Federal Reserve surprised markets by tying its policy to both inflation and unemployment rate. The Federal Reserve has a dual mandate of managing both inflation and unemployment unlike most other advanced economy central banks that only target inflation. In Dec-12 FOMC, Fed officials said that the central bank would maintain easy policy as long as the unemployment rate remains above 6.5% and inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal. Further, the Fed started QE3 by agreeing to purchase longer-term Treasury at a pace of $45 billion per month.
- ECB’s Outright Monetary Transactions program has been successful in lowering the spreads without the program having even started. However, the fundamental issues with European economy remain.
- Bank of Japan in its policy held on 22-Jan-13 adopted an inflation target of 2%. BoJ will keep its policies easy till it achieves this inflation target. As Japan already has zero interest rates, BoJ also announced open-ended Asset Purchasing Program under which it will purchase a certain amount of financial assets without setting any termination date. This monthly amount presently has been kept at 13 trillion yen out of which 2 trillion would be in JGBs and 10 trillion Yen in T-Bills. Though this asset buying program is to begin in Jan-2014 as BoJ will first complete the existing asset buying program. The current asset buying program is close-ended where the central bank intends to infuse liquidity worth 36 trillion yen in 2013.

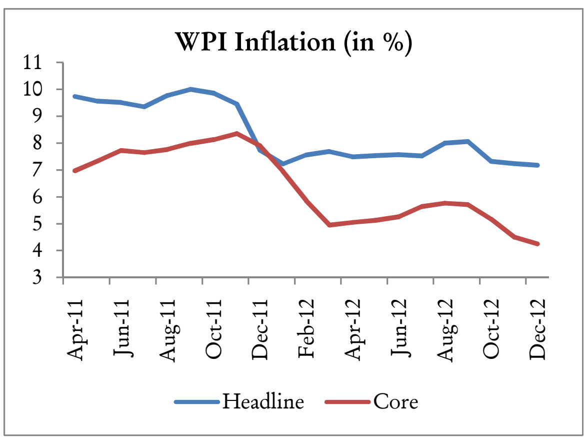
These developments have led economists to question the independence of central banks. Experts have dubbed this central banks’ large-scale bond buying issued by their respective governments as fiscalisation of monetary policy. Japan in particular raised concerns as its new Prime Minister Shinto Abe spoke of asking BoJ to ease policies to support growth. Fed’s tying its policy to unemployment has also been criticized as a political move.

II. Indian Economy

Inflation trajectory in Q3 12-13 has been a huge surprise for markets. The inflation reported lower than market expectations for all the months in the third quarter. Average inflation in Q3 was reported at 7.25% compared to 7.9% in the second quarter. In Dec-12, headline inflation was 7.18%, the lowest reading since Dec-09. Core inflation in Q3 reported an average of 4.6%, more than 1% lower than the average of 5.7% in Q2. Core inflation in Dec-12 was reported lowest since Mar-10.

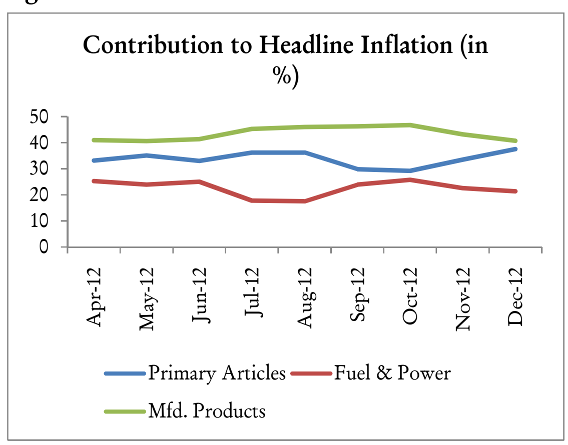
Primary articles contributed around 33% of WPI inflation in Apr-12 which has risen to 37.6% in Dec-12 tracking higher contribution of non-food articles. The contribution of fuel products has declined from 25.2% in Apr-12 to 21.4% in Dec-12. This is surprising as post revision of diesel prices and partial deregulation of LPG, this should have risen atleast temporarily. Share of manufactured products which rose from 41% in Apr-12 to 47% in Oct-12 has declined sharply to 40.8% in Dec-12. This is again surprising as diesel price hike should have led to rise in prices of manufactured products as diesel is a major intermediate product used for logistics. It is this sharp decline in manufactured products inflation and share of the same which has led to much lower than expected WPI inflation.

Figure 1



Source: Commerce Ministry, STCI PD

Figure 2

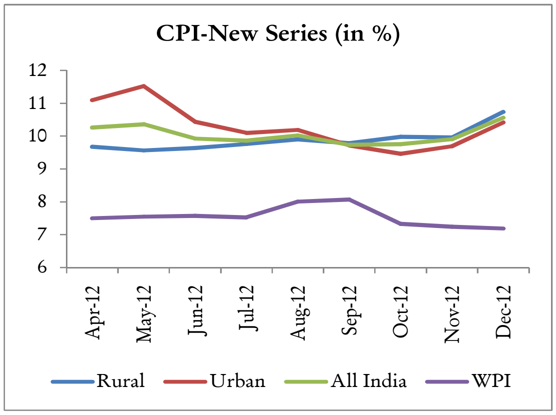


Source: Commerce Ministry, STCI PD

Inflation based on various CPI indices has a different story. WPI trends lower both but CPI has risen in last two months and is back in double digits. In the new series, CPI – Combined was at 10.56% in Dec-12 higher than 9.9% in Nov-12. CPI-Urban and CPI-Rural were noted at 10.42% and 10.74% respectively. The average CPI-combined inflation in Q3 12-13 was 10.07% higher than 9.88% in Q2 12-13. Though sequentially, there has been a decline in growth in CPI indices indicating we could see lower YoY figures going ahead.

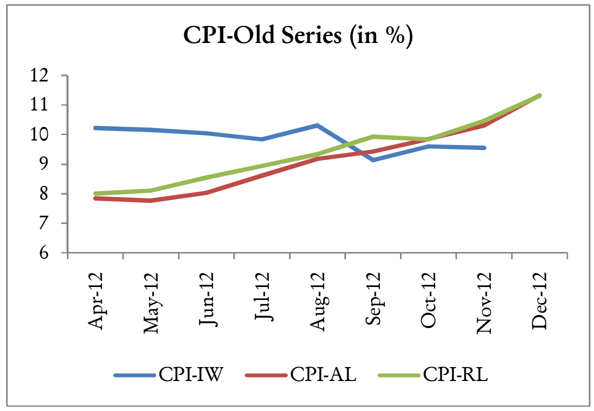
In the old CPI series, CPI-Industrial Workers in Nov-12 was 9.55% and CPI-Agricultural Labour and CPI-Rural Labour were 11.33% and 11.31% respectively.

Figure 3



Source: CSO, Commerce Ministry

Figure 4



Source: Labour Bureau

Going forward, inflation has clearly surprised markets with its lower trajectory. At the time of the previous policy in Oct-12, markets had expected Dec-inflation around 8-8.25% which was reported nearly 1% lower at 7.18%. It is really surprising to see decline in core inflation as it was expected to stay elevated post diesel price hike in Sep-12. The dual pricing regime in LPG has clearly masked the impact on headline inflation numbers. Inflation for Oct-12 inflation was even revised lower from 7.45% to 7.32% perplexing economists.

The inflation trajectory in Q3 has pushed WPI inflation significantly lower for Q4. Inflation is expected to be around 6.5-6.75% in Mar-13 compared to 7.5% projection given by RBI. Even in the two months of Jan & Feb inflation is likely to be lower than 7%, provided there are no major revisions. There is a possibility RBI also lowers its inflation projection for Mar-13 lower at 7%. From 2010-11 onwards, RBI has mostly revised its inflation projections for Mar-end upwards. This could be the first time RBI actually lowers its inflation projection for Mar-end lower.

In Jan-13, government took one step forward and couple of step backwards with respect to fuel subsidies. It partially deregulated diesel allowing Oil Marketing Companies to revise diesel prices by small amounts till they completely wipe away the under-recovery of Rs 9 per litre. If this was a positive step ahead there was a negative step backwards. Just like LPG, government has allowed dual pricing in diesel as well. For bulk buyers of diesel like corporates and railways it has completely deregulated the price immediately. This means we have two kinds of consumers – bulk consumers who pay market prices and retail consumers for whom there is partial deregulation. This leads to dual pricing and development of black markets in subsidized diesel. This dual pricing also makes it difficult to factor the rise in diesel prices in WPI inflation.

Another backward step is increase in cap of subsidized LPG cylinders to nine cylinders per household per year from 6 cylinders announced earlier. This is going to raise subsidy on account of LPG.

RBI is likely to take these developments positively as it helps remove suppressed inflation from the economy. Some experts opine that these measures have led to lower suppressed inflation and hence lead to lower inflation. This is not right as it is just transfer of inflation from one head to the other. Suppressed inflation led to higher fiscal deficit which led to higher demand for money supply from the government leading to higher inflation indirectly. As the suppressed inflation is removed and prices are decontrolled, this inflation will show up in actual inflation numbers directly. The positive is that this direct inflation will show up in inflation for short-run compared to suppressed inflation which can continue indefinitely. Though, this is another puzzling story that removal of suppressed inflation has not led to higher inflation even over a short-run.

III. Growth

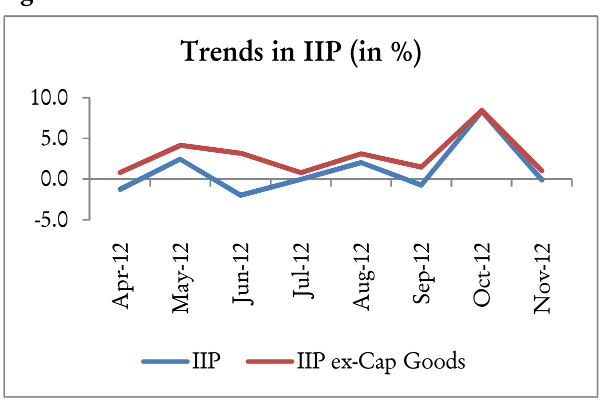
GDP growth in H1 12-13 has averaged around 5.4%. Finance Ministry in Mid-Year Review lowered the growth projection from 7.6% to around 5.7% - 5.9%. This is in line with RBI's RBI GDP growth for 2012-13 in at 5.8%. Finance Ministry also indicated that perhaps growth has bottomed out.

Index of Industrial Production (IIP) showed signs of bottoming out as it posted growth of 8.5% in Oct-12 reading. However, this jump was on account of festival season and the growth dipped to -0.1% in Nov-12 print. Growth in IIP ex-capital goods has been consistently higher than actual IIP growth indicating the volatility of capital goods sector. The average IIP growth in Apr-Nov 12 period has been 1% lower than 3.8% noted in same period previous year.

The other lead indicator Purchasing Mangers Index - Manufacturing (PMI) shows that activity ahs picked up in last few months. The latest PMI reading in Dec-12 was at 54.7, higher than 52-8-52.9 range seen between Jul-12 and Oct-12.

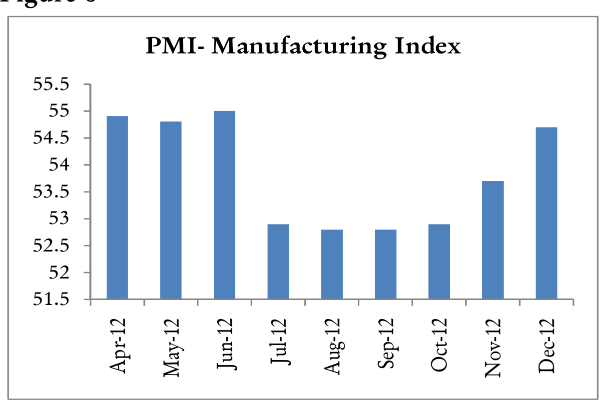
There are some emerging signs of pick up in industrial activity as per PMI index but one is not sure seeing the readings in IIP. We will have to wait and see future readings in IIP to ascertain whether growth has bottomed out at all in industrial sector.

Figure 5



Source: CSO

Figure 6



Source: Newswires

IV. Fiscal Position

The five month data till Aug-12 shows that fiscal deficit is at around 80% of Budgeted Estimate (BE) for FY13. It is lower than last year figure of 85.6%. Revenue deficit which has remained higher as a % of BE for most part of the year is now lower at end Nov-12. It stands at 91.2% of BE compared to 91.3% of BE seen in the same period last year.

Total receipts are lower than last year's trends mainly because of lower growth in non-tax revenues and disinvestment receipts. The government has lowered the base price for spectrum auction and is making attempts to meet the Rs 40,000 Cr target for the year. It is also expected to announce disinvestment in select PSUs like Oil India etc to meet its disinvestment target of 30,000 Cr. The tax revenues are in line with previous year trends.

Table 2: Government's Accounts (% of BE)

	Apr – Nov 2011-12	Apr – Nov 2012-13
Total Receipts	48.2	46.5
Net Tax Revenue	48.2	47.9
Non Tax Receipts	57.7	46.3
Non-debt Capital Receipts	26.4	21.4
Total Expenditure	60.5	58.2
Non- Plan Expenditure	66.1	64.4
Plan Expenditure	50.1	46.7
Fiscal Deficit	85.6	80.4
Revenue Deficit	91.3	91.2

Source: CGA

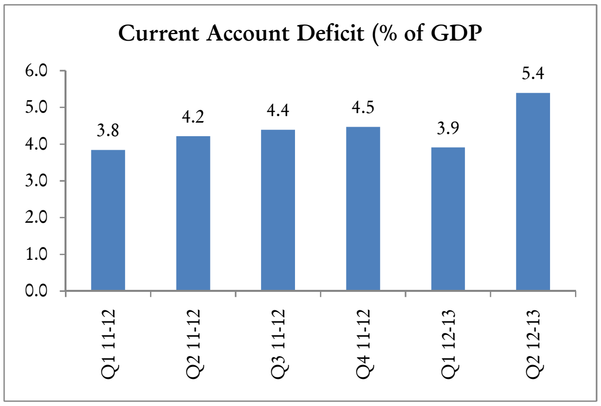
On the expenditure front, we see lower spending compared to last year. Spending on plan expenditure has been lower throughout the year and now the expenditure is lower on non-plan front as well. The government took measures in September to control fuel subsidies which is showing in the numbers. It has further taken measures in January which will lead to complete undoing of oil subsidy on LPG account.

Along with inflation, there is progress on fiscal front as well. The government has stuck to its target of 5.3% of GDP despite apprehensions from market participants. The markets expected government to announce additional borrowing towards December and if not via dated securities then via T-Bill route (as seen last year). However, there was no additional borrowing and excess borrowing via T-Bill was just to the tune of Rs 16,000 Cr. Overall, government is confident of meeting its fiscal deficit target of 5.3% of GDP on account of large cash surpluses.

V. External Sector

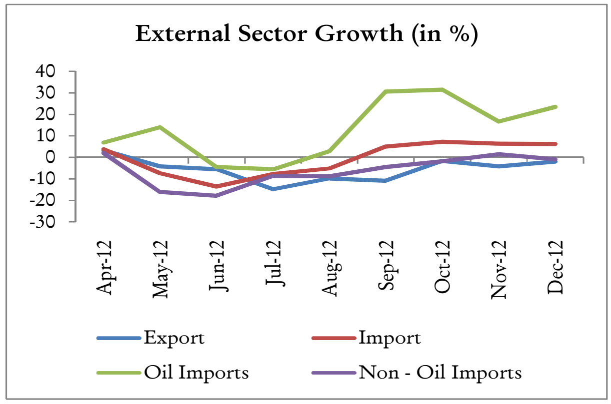
Current Account Deficit remains a serious challenge for the economy. In Q1 2012-13, CAD was at 3.9% of GDP which widened to 5.4% of GDP in Q2 12-13. These are much higher than comfort zone of around 2.5-3% of GDP. Gold formed around 75% of Current Account Deficit in 2011-12. This ratio declined to 55.6% in Q1 2012-13 and further to 47% in Q2 12-13. Overall, gold continues to form significant part of India's CAD. The government has recently raised the import duty on Gold from 4% to 6% trying to curb import demand for gold. Capital flows improved in Q2 12-13 tracking rise in FII and FDI flows but due to widening CAD, led to a marginal decline in forex reserves.

Figure 7



Source: RBI, CSO

Figure 8



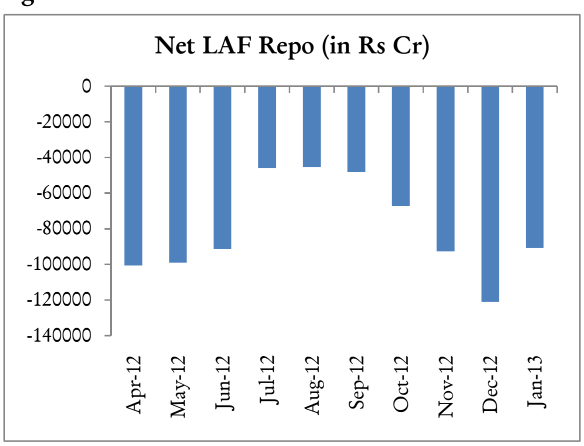
Source: Commerce Ministry

The recent trade data shows trade deficit in Apr-Sep 12 is around $147 bn higher than $137 bn seen in same period previous year. Growth in exports has remained negative in eight of the nine months in the Apr-Dec period. Imports which showed negative growth till Aug-12, has shown average growth around 6% leading to widening of trade deficit. Within imports, oil imports have grown in the range of 20-30% in the last four months contributing to positive import growth. Non-oil imports have contracted in seven of the nine months in the period barring Nov-12 and Apr-12.

VI. Liquidity and Monetary Indicators

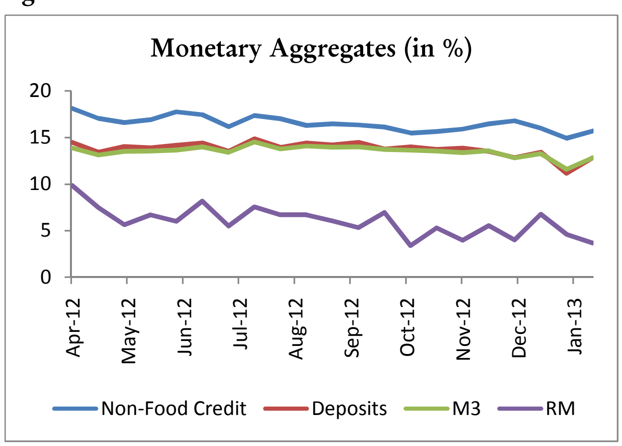
Liquidity conditions tightened in Dec-12 ahead of advance tax-flows and eased in Jan-13. The average LAF infusion in Q3 was around Rs 94,000 Cr compared to an average influsion of Rs 46,000 Cr in Q2 12-13. The average infusion in Jan-13 so far has declined slightly from Q3 average to around Rs 90,000 Cr. Net LAF borrowing from Repo window has been more than 1% of NDTL around Rs 70,000 Cr) in previous quarter. RBI announced OMOs in Dec-12 to ease liquidity conditions and has purchased OMO securities worth Rs 46,900 Cr in the period. Total OMO purchases in the year are Rs 1,01,475 Cr compared to Rs 1,29,252 Cr in 2011-12.

Figure 9



Source: RBI

Figure 10



Source: RBI

Reserve money growth as on 11-Jan-13 is just 3.2% on financial year basis compared to 3.1% in same period in 2011-12. This is very low as calculations show reserve money growth for 2012-13 should be around 10% to support RBI's money supply projection of 14%. RBI might have to either ease CRR or purchase securities under OMO purchases to meet these projections.

Table 3: Monetary Projections and Growth rates (in %)

	Projections for FY 13	Growth rate 11-Jan-13	Growth Rate 13-Jan-12
M3	14	12.8	16.0
Deposits	15	12.8	17.2
Non Food Credit	16	15.7	16.7

Source: RBI

Alternatively, RBI could lower its monetary projections as till Dec-12, actual growth numbers are much lower than RBI projections. It is going to be difficult to meet these projections especially deposits and money supply. It is likely that RBI again lowers its monetary projections for these two variables. Inflation has declined along with subdued growth leading to lower overall nominal growth and demand for financial resources.

VII. Policy Expectations and Conclusion

The background for this policy seems to be more benign compared to the previous policy which faced stiff trade-offs between growth-inflation. Markets have already discounted a repo rate cut by 25 bps as 10-year yields eased from 8.15% in Dec-12 end to 7.85% levels currently. The markets are now debating whether RBI will ease policy rates by 50 bps. We however don't think RBI will ease policy rates by 50 bps. First, Dr. Subbarao in his recent statement noted that though inflation has declined it remains high. Two, RBI would want to see the outcome of the Union Budget 2013-14. Three, CPI inflation numbers still remain very high and actually make a case for a rate increase. Four, deposit growth has slowed considerably and cutting rates sharply will aggravate further concerns on deposit growth.

On liquidity front, it is a difficult call. Even if RBI lowers its monetary projections, it will need to create additional reserve money which is at a very low level. Hence, RBI could either ease CRR or resume OMO purchases or do a combination of both. Banks have been favoring a CRR cut over OMO purchases as it provides immediate liquidity. Earlier, RBI preferred CRR as it cut the ratio by 25 bps each in Jul-12 and Sep-12 policy. However, in Dec-12 ahead of tightening liquidity RBI chose to do OMOs and not ease CRR. So, it has been mixed experience with respect to OMO vs. CRR.

On macroeconomic parameters, we expect RBI to keep its GDP growth projections at 5.8% and lower inflation projections for Mar-13 to 7% from 7.5% projected in Oct-12 policy.

STCI Primary Dealer Ltd.
A/B1- 801, A Wing, 8th floor, Marathon Innova, Marathon Next Gen Compound,
Off. Ganpatrao Kadam Marg, Lower Parel (w), Mumbai 400013.

Dealing Room: (022) 66202217-20 Settlements: (022)66202262-64, Fax (022) 66202288
Delhi Office: (011) 47676555-570 Bangalore Office: (080) 22208891
Please mail your feedback to stcipd@stcipd.com Website: http://www.stcipd.com