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RBI's Q3 2011-12 Monetary Policy: Expectations

RBI is scheduled to announce its Third Quarter 2011-12 Monetary Policy Review on January 24, 2012. We expect RBI to maintain status quo and keep policy rates unchanged. There were expectations of a policy rate cut but is unlikely to be the case with continued high core inflation data and surprise surge in IIP.

This policy will look at two issues apart from the traditional growth-inflation trade-off. These two issues are persistent deficit in liquidity conditions and Rupee movement going forward. Like the growth-inflation trade-off there are trade-offs with respect to liquidity-rupee. In this context, there are differences in views on whether RBI should cut the Cash reserve ratio (CRR). In this note, we look at the background under which the policy is being made and our expectations from the same.

I. Global Economy Developments

There have been some improvements in US economy in the last months of 2011. The economic data particularly unemployment indicators have come lower showing signs of gradual recovery. The initial jobless claims have consistently remained lower than 400,000 which is seen as a magical number for employment trends. Research shows that if jobless claims are lower than 400,000 for sustained period, it is a sign for better labour market conditions going forward. However, in last quarter we also had the festival and holiday season boosting market sentiment. Hence we cannot be sure whether the trends are temporary and permanent. We have seen earlier as well, how quickly the sentiment shifts in markets. There have been reports that show that employment numbers have become better as there has been a rise in temporary jobs to manage the demand for the holiday season. Hence, we need to wait for data of subsequent quarters to assess whether recovery was short-lived or is gradually taking shape.

Amidst expectations of improving US economy, gloom over the European economy only keeps worsening. S&P downgraded France from its AAA rating and also lowered ratings of other European countries. S&P even lowered ratings of bonds of European Financial Stability facility from AAA+ to AA+. Germany remains the only country in European Monetary Union with a coveted AAA rating. Though, other agencies like Fitch and Moody's have maintained their ratings on France. It could just be a matter of time before they also follow S&P and lower France's ratings. This has weakened the core of Europe with Germany remaining the only strong member of the club. There have been many summits to find a solution to Eurozone crisis but there has been too much opaqueness with respect to its implementation. Moreover, the gains made in previous meetings are undone subsequently.

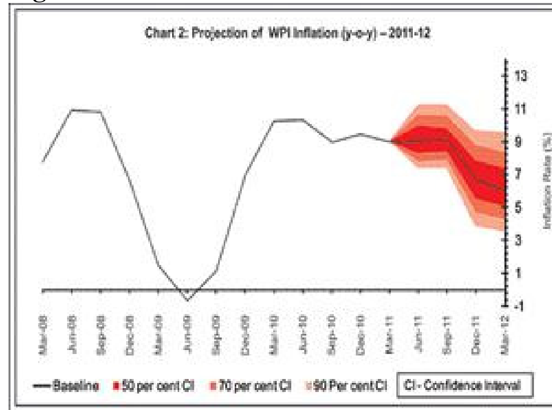
Given this state of affairs, the focus continues to remain on central banks. Federal Reserve maintains that it will keep policy rates at 0-0.25% till mid-2013 amidst opposition from some regional Fed members. European Central Bank has brought back policy rate to 1% as soon as Mario Draghi took over the President of ECB in Nov-11. ECB also is infusing huge liquidity in the system to prevent funding crunch in banking system.

Overall, there are hardly any changes in global economic prospects since previous RBI Policy review baring some ray of hope coming from US economy.

II. Indian Economy Developments

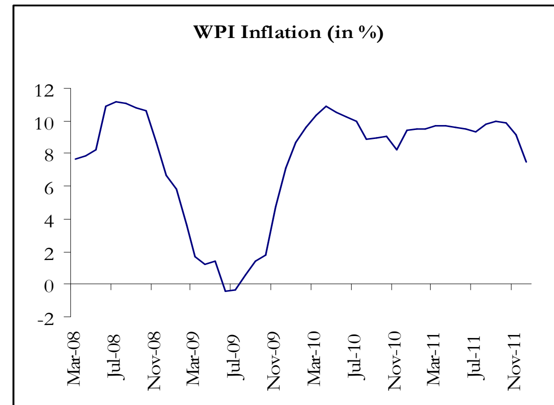
1. Inflation: One major positive in 2011-12 has been that the inflation trajectory is in line with overall inflation projection for FY 2011-12. If we compare RBI's benchmark scenario for 2011-12, it is broadly in line with actual inflation (figure 2). This has been a big positive as inflation has so far not had any major element of surprise as seen in the previous years. This has helped RBI manage its monetary policy better.

Figure 1



Source: RBI

Figure 2



Source: Commerce Ministry

However, what also matters is the drivers of this recent decline in inflation. Inflation has come down mainly because of decline in prices of primary articles on account of base effect and decline in prices of food articles. Fuel inflation and manufactured product inflation remains higher than seen last year. Even in terms of contribution, one sees higher contribution coming from manufactured products and core inflation.

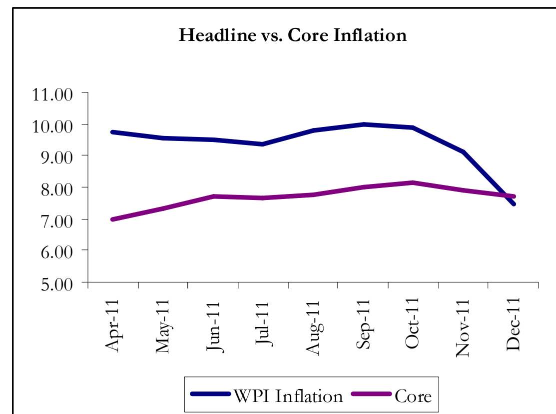
Table 1: Inflation Trends (in %)

Average	WPI Inflation	Primary Articles	Fuel & Power	Manufactured Products	Core
Apr-Dec 10	9.58	18.49	12.38	5.48	5.62
Apr-Dec 11	9.38	10.89	13.60	7.66	7.69
Contribution					
Apr-Dec 10		45.5	19.4	35.2	30.0
Apr-Dec 11		29.2	22.7	48.2	40.3

Source: Commerce Ministry, STCI PD Research

It is interesting to note the trends of headline and core inflation. Average core inflation is higher in 2010-11 by 2%. In Dec-11 the core inflation is higher than headline inflation (Figure 3).

Figure 3



Source: Commerce Ministry, STCI PD Research

Analysis of sub-sectors of core index shows that average inflation in Apr-Dec 11 is higher in all eleven sectors except textiles compared to Apr-Dec 10. This is a concern as core inflation indicates demand side of inflation and policy rates are expected to lower demand side of inflation. However, what has been happening in 2011-12 is decline in inflation related to supply side on account of regular monsoons and limited supply shocks. Core inflation seems to be higher on account of both demand factors and rupee depreciation which raises costs of imported goods.

The households' inflationary expectations survey by RBI shows the expectations remain elevated. In Sep-11, people expect inflation to increase from 11.8% to 12.2% in next three months and remain same at 12.9% over next twelve months. It has been seen that inflation expectations are driven by actual inflation and within inflation it is food inflation which is the main contributor of expectations. With lower inflation especially food inflation, inflation expectations should also ease going forward.

Going forward, we expect inflation to go as per trajectory and touch around 6.5-7% levels by Mar-end. Core inflation is likely to trend around 5.5%.

2. Gross Domestic Product: GDP for Q2 2011-12 was noted at 6.9%, lower than 7.7% in Q1 2011-12. Growth in H1 2011-12 stands at 7.3% lower than H1 2010-11 growth of 8.6%. The slowdown has been particularly sharp in industry. Agriculture growth remains stable and services has remained relatively robust.

Table 2: GDP Growth (in %)

	HI 2010-11	H1 2011-12
Agriculture	3.9	3.6
Industry	8.5	4.7
Services	9.7	8.8
GDP	8.6	7.3
Private final consumption expenditure	9.2	6.1
Government final consumption expenditure	6.5	3.1
Gross fixed capital formation	10.7	3.6
Exports	10.1	25.9
Less Imports	10.1	25.9

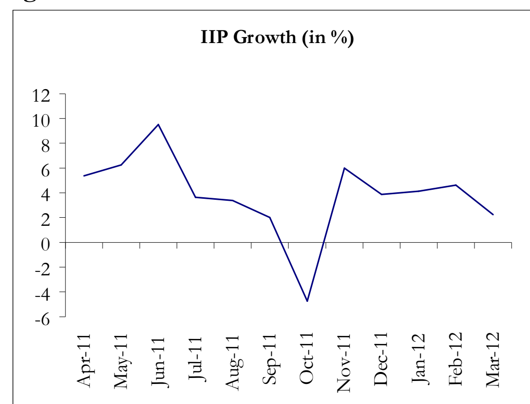
Source: CSO

From the expenditure side, growth has declined in both private consumption and investments. The movement is particularly sharp in investments, which declines by 0.6% in Q2 2011-12. The first half of 2011-12 shows average growth in investments by 3.6% compared to 10.7% in H1 FY 11. RBI mentioned declining growth rate in investments as a major policy concern in Q2 2011-12 policy and these concerns have only become elevated with Q2 2011-12 numbers. High inflation, tight monetary policy, loose fiscal policy, lack of policy reforms and global uncertainty have together contributed to lower growth.

As sentiment has worsened in subsequent quarters, we expect GDP to be around 7% in GY 11-12 from our earlier estimate of around 7.5%. This implies growth in H2 could be lower at around 6.7%.

3. Index of Industrial Production: Monthly IIP data remains highly volatile and quality of data continues to be a concern especially in capital goods sector. In Oct-11, IIP growth slumped to -5.1% (revised later to -4.7%) pointing to greater than expected decline in industry. In Nov-11 it jumped back to show a growth of 5.9%, reversing the sentiment of Oct-11. The huge volatility in these numbers make it extremely difficult to estimate any trend in industrial growth.

Figure 4



Source: CSO, STCI-PD Research

Both mining and manufacturing register lower growth rates comparing Apr-Nov 11 with Apr-Nov 10. Electricity shows higher average growth rates. Mining has growing in negative rates since Aug-11 due to land acquisition issues in the country. In use-based classification, we see lower growth rates in capital goods, intermediate goods and consumer durables in Apr-Nov 11 compared to Apr-Nov 10. Consumer non-durables and basic goods grow at a higher rate in Apr-Nov 11 compared to Apr-Nov 10. IIP growth ex capital goods is lower than Apr-Nov 10 levels.

Table 2: IIP-Sector Wise Growth Rates (in %)

	Apr-Nov 10	Apr-Nov 11
Mining	7	-2.5
Manufacturing	9	4.1
Electricity	4.5	9.5
IIP	8.4	3.8
Basic Goods	5.5	6.1
Capital Goods	18.2	-1
Intermediate Goods	8.1	-0.3
Consumer Goods	8	5.1
Durables	14.6	5.3

Non - Durables	2.8	4.9
IIP ex-capital Goods	6.8	4.7
Source: CSO		

3. Monetary and Liquidity Indicators: The monetary indicators show that credit growth has been lower in 2011-12 compared to 2010-11. RBI's projection for 2011-12 is 18% which looks like unlikely to be achieved. Deposit growth and money supply are in line with the trends seen last year. SLR investments have risen sharply this year. One major concern is much lower growth in reserve money which in a way is also leading to the liquidity crunch we are currently witnessing.

Table 2: Monetary Aggregates

	Incremental % (FY)		YoY %	
	Apr-Dec 10	Apr-Dec 11	30-Dec 10	30-Dec 11
Aggregate Deposits	11	11.9	16.8	16.9
Bank Credit	16	10.7	24.5	15.9
Investments	4.6	12.8	2.3	16.9
M3	11.1	10.8	16.9	15.6
Reserve Money	8.1	2.6	23.5	13.1
Source: RBI				

The average liquidity deficit since previous Oct-11 policy is more than Rs 1 lakh crore. RBI has mentioned that it is comfortable with a liquidity deficit of around 1% of NDTL (Net demand and Time liabilities) which is around Rs 63,532 Cr. In Jan-11 the average liquidity deficit has even been higher at around 1.18 lakh crore and has consistently touched Rs 1.5 lakh crore figures in last few days. Banks have also been assessing the Marginal Support Facility window in case of urgent need for funds. Total borrowing under MSF has been around Rs 20,790 Cr from 20-Dec-11 onwards. So clearly we are witnessing very high deficit liquidity conditions and much above RBI's comfort zone.

To alleviate liquidity pressures, RBI has even been engaging in aggressive buying in its OMO auctions and has brought securities worth Rs. 61,000 Cr in OMO against a notified amount of Rs. 76,000 Cr. However, the measures have not been adequate as high deficit liquidity conditions have persisted and have actually risen.

4. State of Fiscal: The question is not whether government will miss its fiscal targets but by how much will the targets be missed. Fiscal accounts for Apr-Nov 11 shows total revenue receipts are just 49.7% of BE compared to 69.9% last year. The expenditures are being controlled by cutting down on plan expenditure. Fiscal deficit stands at 85.6% of BE compared to 48.9% of BE seen last year.

Table 3: Public Finances (% of BE)

	Apr-Nov 2010-11	Apr-Nov 2011-12
Total Receipts (i + ii)	**69.3%**	**48.2%**
(i) Revenue Receipts	69.9%	49.7%
Tax	55.5%	48.2%
Non Tax	121.6%	57.7%
(ii) Non Debt Capital Receipts	60.8%	26.4%
Total Expenditure (i+ii)	**62.3%**	**60.5%**
(i) Non Plan Expenditure	65.2%	66.1%

(ii) Plan Expenditure	56.5%	50.1%
Fiscal Deficit	48.9%	85.6%
Revenue Deficit	50.7%	91.3%
Source: CGA		

The government has already announced additional borrowing of Rs 92,800 cr taking the net borrowing to Rs 4.35 lakh crore. T-Bill outstanding is likely to be at around Rs 1.14 lakh crore against the budgeted outstanding of Rs. 15,000 Cr. Even amount of T-bill outstanding forms a source of financing the fiscal deficit. Based on additional net borrowings and T-Bills, fiscal deficit for 2011-12 stands at around 6% of GDP compared to the BE of 4.6% of GDP.

Table 4: Government Borrowing (in Rs Cr)	
Net G-sec announced in Budget	343000
Additional Borrowings:	
Sep-2011	52800
Dec 2011	40000
Total	**435800**
Net Borrowing completed (% completed)	355033 (82%)
T-Bill announced in Budget	15000
Actual T-Bill outstanding on Mar-end	114050
Source: RBI	

III. Policy Trade-offs for RBI

- **Growth vs. Inflation:** In H1 2011-12, RBI policy looked at managing the trade-off between growth and inflation with importance given to inflation. This changed in Oct-11 policy with growth taking over inflation as we can see from the statement on growth in Oct-11 policy stance. Forward guidance in Apr-11 and Jul-11 indicated continuation in anti-inflation strategy and indicated that rate hikes to continue. This also changed in Oct-11 policy as RBI indicated that rate hike cycle likely to end from hereon provided inflation remains in line with projections.

Table 5: RBI's Policy Stance on Growth and Forward Guidance

Apr-11	**Jul-11**	**Oct-11**
Policy Stance on Growth		
Foster an environment of price stability that is conducive to sustaining growth	Manage the risk of growth falling significantly below trend.	Stimulate investment activity to support raising the trend growth.
Forward Guidance		
…Reserve Bank will continue to persevere with its anti-inflationary stance.	…A change in stance will be motivated by signs of a sustainable downturn in inflation.	Notwithstanding current rates of inflation persisting till November (December release), the likelihood of a rate action in the December mid-quarter review is relatively low.
Source: RBI		

As inflation remained as per RBI projections and growth even slipped higher, RBI paused in its Dec-11 review. There were expectations that RBI might start cutting policy rates after Oct-11

IIP numbers were released. However, Nov-11 IIP and Dec-11 inflation numbers suggested that economic conditions are not as bad as they appeared earlier. Core inflation still remains very high indicating both demand pressures and pricing power. This has led to revised expectations that RBI will still wait and see how things evolve before cutting policy rates.

So, inflation-growth trade-off has weakened with growth taking precedence over inflation. But still, RBI will wait till core inflation decline before its starts cutting policy rates.

- **Liquidity vs. Rupee:** In this policy, RBI will have to look at a new trade-off between rupee movement and liquidity. As indicated above, liquidity has been above RBI's comfort zone of -1% of NDTL since Oct-11 meeting. Meanwhile, Rupee has depreciated by 20% since Aug-11. On, 25-Oct-11 it was 49.51 and reached almost 54.4 levels in Dec-11. It has appreciated to touch Rs 50.3 levels mainly because of ease in capital inflow restrictions like deregulation of NRE deposit etc. However, as capital flows can easily reverse given global conditions RBI might have to intervene in forex markets to stem the depreciating pressure on Rupee. As Rupee levels have improved, RBI will be more worried over liquidity as it has become a structural problem.

  This leads to a trade-off. If RBI tries to support rupee by supplying US Dollars from its forex reserves, depreciation pressure by selling forex reserves and buying rupees, it worsens liquidity.

  RBI's Deputy Governor, Dr Subir Gokarn in a recent speech (An assessment of recent macroeconomic developments, 3-Dec-11) explains the policy options for RBI:

  - **Rupee:** India's forex reserves mainly comprise short-term flows and are because of current account deficit. In countries like China, accretion in forex reserves is because of current account surplus. Hence, it cannot be used as an active option in India. He adds that easing capital controls which allows more capital inflow is a better option. The effort has been on these grounds with ease of restrictions in NRI deposits, higher FII in G-sec, attempts to raise FDI etc. Though there has also been some forex intervention by RBI in last few weeks.

  - **Liquidity:** OMO is the first preference, followed by SLR cut and finally CRR cut. SLR is prescribed at 24% of NDTL, but banks maintain it at nearly 29% and lowering it any further unlikely to help in easing liquidity. For CRR, he says it is a monetary tool as well. A cut in CRR will be seen as easing of policy rates.

  Given this background, a cut in CRR is unlikely and OMO purchases will continue to address liquidity conditions. In case liquidity situation does not change much ahead of advance tax flows in March, RBI might look at easing CRR even before its mid-quarter review in March.

IV. Our Expectations

Based on above analysis, we expect the following:

- Repo rate unchanged at 8.5%.
- CRR and SLR unchanged at 6% and 24%
- RBI's GDP projection to be revised lower from 7.6% to around 7%
- Inflation projection maintained at 7%
- Indication that OMOs to continue to aid liquidity.

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