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RBI's Annual Monetary Policy 2012-13

In Annual Monetary Policy 2012-13, RBI surprised markets by easing Repo rate by 50 bps to 8%. The consensus market expectations were for a cautious 25 bps cut.

- **Policy Rate changes**
  - Repo rate lowered by 50 bps to 8%
  - Reverse Repo rate and Marginal Standing Facility (MSF) Rate automatically lowered by 50 bps at 7% and 9% respectively. Further, RBI increased borrowing under MSF from 1% of NDTL to 2% of NDTL. Banks with excess SLR can also borrow under MSF.
  - CRR remains unchanged at 4.75% of NDTL.

- **Economic Projections**
  - RBI pegged the growth forecast for 2012-13 at 7.3% vs. 7.0% projection for 2011-12
  - Inflation projection lower at 6.5% in Mar-13 lower than 7% in Mar-12
  - Money supply growth for 2012-13 pegged at 15% slightly lower than 15.5% for 2011-12
  - Credit growth increased to 17% for 2012-13 compared to 16% for 2011-12

- **Forward guidance statement**
  - RBI indicates that space is limited for further reduction in policy rates given growth-inflation dynamics.
  - Administered prices of petroleum products should be increased to reflect their true cost of production.
  - Liquidity conditions are expected to be stable and move to RBI's comfort zone of 1% of NDTL. The increase in MSF limits will also help banks. In case the situation changes, appropriate steps will be taken.

I. Background to Policy Decision

Growth

RBI has kept the growth projections for 2012-13 at 7.3%. higher than the estimated 7% growth of 2011-12. This is lower than the growth rate projected by the Finance Ministry, PM's Economic Advisory Council and World Bank but higher than IMF and ADB. Clearly, most agencies expect recovery to be slow and gradual.

Table 1: GDP Projections for 2012-13 by various Agencies (in %)

Economic Advisory Council to the PM	7.6
Finance Ministry	7.6 (+/- 0.25)
IMF	7.0
World Bank	7.5
ADB	7.0
RBI	7.3

Source: RBI

An interesting development in this policy is RBI's reference to India's potential growth rate being lower than pre-crisis growth rates. The pre-crisis growth rate in the period 2003-08 averaged around 9% which was expected to continue post-crisis as well. This thinking seems to have changed based on the trend in 2011-12. RBI has not defined this post-crisis potential growth rate but in the post policy meeting with Media, RBI Governor remarked that currently India's noninflationary growth rate is about 7.5% or so. The non-inflationary growth rate is the key as India can achieve higher growth rates but it will come at higher inflation rates as well.

Taking 7.5% as India' potential non-inflationary growth rate, expected annual growth rate in 2012-13 is around the same number. The quarterly growth rates have declined with Q3 2011-12 clocking GDP growth at 6.1%. Hence, RBI adds in the statement that deviation from the potential growth rate is modest. This along with upside risks to inflation projection, limits the room for further monetary policy easing.

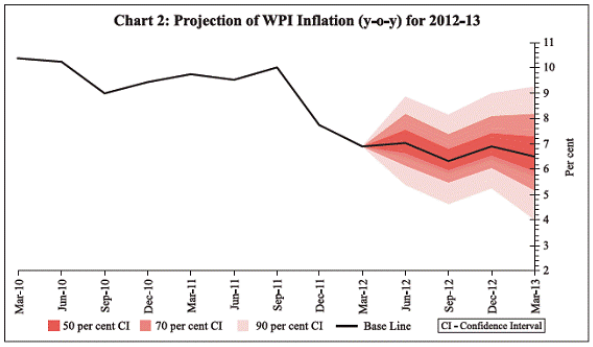
RBI also stresses that slowdown in India's trend growth rate is because of emergence of significant supply constraints (infrastructure, energy etc) which requires a strong policy response. Without a strong supply push, a push to higher growth than 7.5% will only lead to higher inflation.

Inflation

RBI has pegged WPI inflation projection for Mar-13 at 6.5% and expects inflation to remain range-bound during the year. This is in line with our projections as well. However, when we look at inflation fan chart, we see inflation over RBI's threshold level of 4%-6% for the whole year. In Q1 2012-13, inflation expected at around 7% which declines to 6.5% in Q2 2011-12. It is expected to again rise in Q3 to around 7% levels before declining to 6.5% by Mar-end.

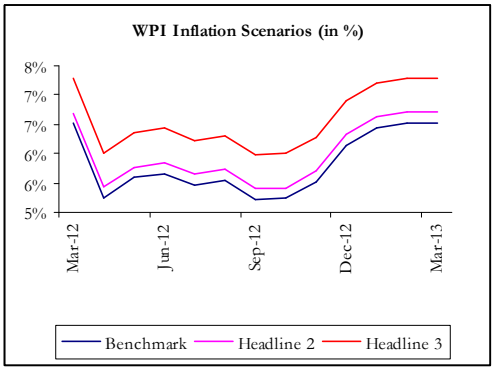
In our baseline projections (Figure 2), we expect inflation to average around 5.5% -6% in H1 2012-13 and then rise to 6.5%-7% levels. The RBI projections are more like our Headline Scenario 3 where we project inflation to grow at a much higher average rate. This is especially true in H1 2012-13 with RBI's projection looking quite similar to our Headline 3 scenario.

Figure 1



Source: RBI

Figure 2



Source: STCI-PD Research

We had estimated that RBI was likely to ease policy rates by 50-75 bps in Q1 2012-13 as inflation was expected to be around RBI's threshold levels. However, RBI has cut policy rates more aggressively by 50 bps in this policy itself and that too amidst higher inflationary expectations. Moreover, RBI continues to mention suppressed inflation via administered fuel prices, coal and electricity as a major upside risk. It also expects crude oil prices to remain high with increased concerns from geo-political uncertainties and disruption in supplies.

RBI even mentions the appropriate monetary policy response to rising food and commodity prices should be based on whether the higher prices translate into generalised inflationary pressures. This is a surprising statement as so far we have come to believe that these prices do lead to overall inflation pressures. Households inflationary expectations surveys have showed that inflation expectations in India mainly depend on food prices and if latter goes up, the former also shifts upwards. This rise in inflationary expectations in turn leads to rise in overall inflation.

It is perplexing to see RBI not mentioning the recent rise in food prices as a significant risk to the inflation outlook. The food inflation ahs again galloped in Feb-12 and Mar-12 numbers and trends are likely to persist. It just mentions that inflation in protein based items remained high amidst demand-supply mismatches. Even in the recent episode of high inflation, inflation was first driven by food prices which then shifted to core inflation. And once food prices declined in Nov-11, core inflation followed as well. There is little doubt that core inflation is very important and has declined recently warranting a more dovish outlook, but it could easily again rise if food inflation persists. RBI assumes monsoons in 2012-13 to be normal but is always a risk given large supply constraints in the Indian economy.

Twin Deficits

RBI mentions the persisting fiscal and current account deficits (CAD) as a risk. It says that though the Union Budget projects fiscal deficit to be lower in 2012-13, there are several upside risks to the budgeted fiscal deficit. It is likely that at present level of international crude prices, the oil subsidy burden will likely be higher than the required amount. Any slippage in the fiscal deficit will have implications for inflation and crowding out of private sector investment. RBI says CAD levels as % of GDP are at unsustainable levels and need to be contained. With global capital flows to emerging markets projected at lower levels in 2012, financing of the CAD will continue to pose a major challenge.

Monetary Aggregates

RBI has pegged projections of various monetary indicators at a higher level than in 2011-12. The lower policy rates are expected to be transmitted by banks to its customers.

Table 1 summarizes the RBI projections in 2012-13.

Table 1: RBI Projections in Monetary policy Reviews (in %)

	2011-12	Actual	2012-13
Growth (annual)	7	--	7.3
Inflation (Mar-end)	7	6.89	6.5
M3 (Mar-end)	15.5	13	15
Deposit (Mar-end)	16	13.4	16
Credit (Mar-end)	16	16.8	17

Source: RBI

II. RBI Policy Stance

RBI's policy stance has clearly shifted towards growth with reviving growth becoming the top priority. Inflation has been priority since Mar-10 but has shifted towards growth since Oct-11 policy. After not cutting policy rates on three occasions since Oct-11, RBI has chosen to cut rates in Apr-12 policy.

Table 2: Policy Stance of RBI in recent Monetary Policy Reviews		
Oct-11	Jan-11	Apr-12
▪ Maintain an interest rate environment to contain inflation and anchor inflation expectations. ▪ **Stimulate investment activity to support raising the trend growth.** ▪ Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.	▪ Maintain an interest rate environment to contain inflation and anchor inflation expectations. ▪ Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission. ▪ **Respond to increasing downside risk to growth**	▪ **Adjust policy rates to levels consistent with the current growth moderation.** ▪ Guard against risks of demand-led inflationary pressures re-emerging. ▪ Provide a greater liquidity cushion to the financial system.
Source: RBI		

III. Going Forward

RBI's Macroeconomic and Monetary Development Report (MMDR) released on 16-Apr-2012 stated that "monetary policy has to tread with care in working towards reviving growth, while not exacerbating inflation and other risks." The MMDR report also hinted that though RBI is likely to cut rates the approach is expected to be calibrated and cautious. A cut in CRR was almost ruled out with MMDR predicting a favorable liquidity outlook around 1% of NDTL in the next quarter.

However, RBI has chosen to be more aggressive cutting rates by 50 bps. RBI states that the reduction in Repo us based on assessment of growth being lower than post-crisis levels which has led to moderation in core inflation. It highlights inflation risks like fiscal slippages and ignores others like monsoons. Even the inflation outlook for Q1 2012-13 is higher than that of most market participants and RBI's threshold inflation levels. The recent food inflation and weak monsoons could easily lead to a higher generalized and core inflation as seen in the recent past.

The stance of the policy statement is far more dovish than what most market participants expected. RBI has already indicated that space to cut rates in future is rather limited given the inflation and fiscal outlook. Going forward, there is a very slim chance that RBI cuts rates any further and could actually turn more hawkish on inflation. The rate trajectory is contingent on future economic data releases.

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