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RBI's Monetary Policy Q1 2012-13: Review

In First Quarter Review of Monetary Policy 2012-13, RBI kept policy rates unchanged. The policy decision is in line with our expectations (report dated 27-Jul-12).

- **Policy Rate Decisions**
  - Repo rate unchanged 8%
  - Reverse Repo rate and Marginal Standing Facility (MSF) Rate automatically remain unchanged at 7% and 9% respectively.
  - CRR remains unchanged at 4.75% of NDTL.
  - In a surprise move, RBI lowered the SLR from 24% of NDTL to 23% of NDTL.

- **Economic Projections**
  - GDP growth for 2012-13 lowered from 7.3% to 6.5%
  - Inflation projection for Mar-13 increased from 6.5% to 7%.
  - Growth in Money Supply and Non-food credit remain unchanged for 2012-13 at 15% and 17% respectively.

- **Forward guidance statement**
  - In the current circumstances, lowering policy rates will only aggravate inflationary impulses without necessarily stimulating growth. As the multiple constraints to growth are addressed, RBI will stand ready to act appropriately.
  - RBI will respond to any liquidity pressures in the system, including using OMOs.
  - RBI stands ready to respond to any global shocks

I. Background to Policy Decision

Growth

RBI has lowered the growth projections for 2012-13 from 7.3% to 6.5%. In Apr-12 policy, RBI had projected GDP growth at 7.3% assuming a normal monsoon and improvement in industrial activity. However, both these assumptions did not hold. The monsoon has been deficient and industrial activity for April-May suggests continued weakness.

RBI has emphasized that post-crisis, potential growth rate for economy has declined from 8% to 7.5%. Without strong supply-wide reforms, a push to higher growth than 7.5% will only lead to higher inflation. RBI added that risks to growth have intensified in recent times on account of two factors:

- First, global growth and trade volume are now expected to be lower tracking weaker global growth rates. The impact of rupee depreciation could partly offset the impact on exports.
- Second, growth in services sector is going to be impacted because of slowdown in manufacturing sector.

In our monetary policy expectations report, we had indicated RBI is likely to review its growth projections lower to around 7% with a downward bias. The revision is much sharper and in line with the recent revisions done by other forecasters and rating agencies. In the recently released RBI's

Survey of Professional Forecasters (SPF) in Jul-12, the private sector forecasters lowered the growth from 7.2% to 6.5%.

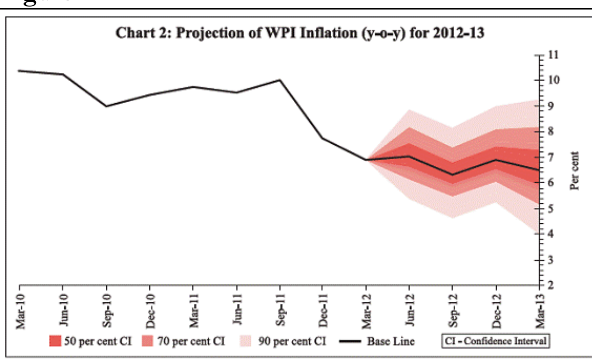
Table VII.3: Agencies' Projections for 2012-13 (in %)				
	Latest Projection		Earlier Projection	
	GDP Growth	Month	GDP Growth	Month
Economic Advisory Council to the PM	7.6	Feb-12	-	-
Finance Ministry	7.6 (+/0.25)	Feb-12	-	-
IMF* (calendar year)	6.1	July-12	6.9	Apr-12
World Bank	6.9	Jun-12	7.5	Mar-12
OECD*	7.3	May-12	7.5	Nov-11
ADB	6.5	Jul-12	7.0	Apr-12
NCAER	7.3	Apr-12	-	-
RBI	6.5	Jul-12	7.3	Apr-12
RBI's SPF	6.5	Jul-12	7.2	Apr-12

** GDP at market rates.*
Source: RBI

Inflation

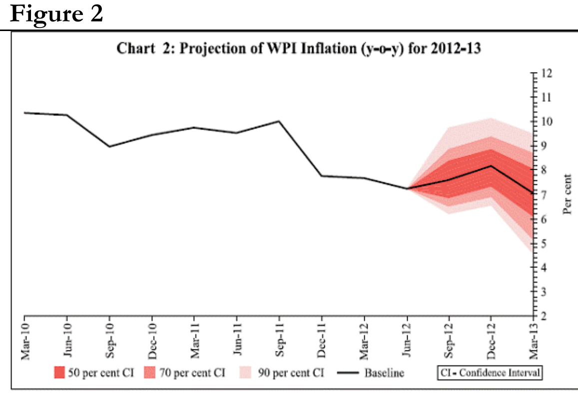
RBI has increased WPI inflation projection for Mar-13 to 7% from 6.5% given in Apr-12 policy. The overall inflation trajectory for the whole year has been revised upwards. Figure 1 shows the inflation projection given in Apr-12 and Figure 12 shows the projections in Jul-12 policy. We can see inflation remains around 6.5% -7% for most part of the year which has been raised to 7.5% -8% for remaining year. This is significant upward revision in just one quarter.

Figure 1



Source: RBI

Figure 2



Source: RBI

The projections have been raised upwards tracking couple of developments:

- Monsoon has been weak and will have adverse impact on food inflation.
- Despite some recent moderation, oil prices remain elevated. Depreciation of the rupee also puts upward pressure on oil inflation.
- Embedded risks of suppressed inflation remain in the economy and are likely to be passed on to the consumers.
- Decline in core inflation has not been commensurate with moderation in growth. Further core inflation may rise tracking rise in input prices like coal, minerals and power.

The statement adds that CPI inflation based on new series remains in double-digits in Q1 of 2012-13. This is driven by both food and non-food prices. There is wide divergence between WPI and CPI inflation on account of two factors.

- First, CPI indices have higher weights of commodities especially of food items. As food prices have risen sharply, this has led to higher CPI inflation.
- Second in certain items, inflation was higher in CPI than seen in WPI. This suggests that besides the incidence of higher service taxes, lower prices have not yet been transmitted to the consumer level. The rate of increase in the prices of services, which is included in CPI but not in WPI, was also high.

RBI also noted that as per the latest household survey, inflation expectations increased slightly in Q1 of 2012-13 after a decline in the previous quarter. Wage inflation in rural and urban areas has moderated recently but still remains relatively high.

Monetary and Liquidity Conditions

As nominal growth remains broadly at the level projected in the Apr-12 Policy, RBI has kept projections of monetary indicators similar to the projections given in Apr-12 policy (Table 2). The nominal growth remains same as basically the levels of growth and inflation have interchanged. Earlier nominal growth was pegged at around 14% with growth at 7.3% and inflation at 6.5%. Now also nominal growth is around 14% with growth at 6.5% and inflation at 7%.

Table 2: Monetary Aggregates Projections (in %)

	Apr-12	Jul-12
M3 (Mar-end)	15	15
Deposit (Mar-end)	16	--
Credit (Mar-end)	17	17

Source: RBI

The liquidity conditions have eased considerably since the Apr-12 Policy. The turnaround in liquidity conditions was because of following factors:

- Decline in government cash balances with RBI
- Injection of liquidity by way of OMO purchases of securities
- Increased use of the export credit refinance facility by banks after the increase in the limit from 15% to 50% in the June Mid-Quarter Review.

In a surprise move, RBI lowered the SLR from 24% of NDTL to 23% of NDTL. Ideally, this should free resources worth nearly 68,000 Cr in the system but is unlikely to be the case. Earlier the ratio was prescribed at 24% but banks were maintaining SLR consistently at around 27-28%.

In the press conference post-policy, RBI officials explained that SLR was lowered for two purposes:

- First, it will release funds which could then be given as credit to productive sectors of the economy.
- Second, it also provides some liquidity cushion to banks in case they face tight liquidity conditions. A CRR cut would have led to increase in liquidity across the board and move systemic liquidity away from RBI's target zone of deficit 1% of NDTL. But SLR is a more selective measure to help certain banks which face tight liquidity conditions.

Some analysts have opined that lower SLR also serves as a signal to government. RBI has been pointing out several times that high fiscal deficit is a major concern for Indian economy. High fiscal deficit is one of the main reasons for persistent inflation and crowding out of private sector investments which in turn leads to lower growth. By lowering SLR, it has not just tried to free resources from the banking system but also signal that the cost of government borrowing could be higher than current market rates. The higher interest rates in turn might lead to some fiscal discipline as despite record borrowing program, surprisingly the yields remain soft.

II. RBI Policy Stance

Containing inflation and anchor inflation expectations has again become the top priority for RBI. After briefly shifting its policy stance towards growth briefly in Apr-12 policy, the focus is again back on inflation.

Table 2: Policy Stance of RBI in recent Monetary Policy Reviews

Jan-11	Apr-12	Jul-12
▪ **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.	▪ **Contain inflation and anchor inflation expectations;** ▪ Support a sustainable growth path over the medium-term; and ▪ Continue to provide liquidity to facilitate credit availability to productive sectors.

Source: RBI

III. Going Forward

RBI's policy statement is far more hawkish than expected by markets. The focus is on containing inflation and inflation expectations. RBI has clearly indicated that high interest rate is just one of the factors for lower growth. The real rates (measured by weighted average lending rate) are lower than seen during 2003-08, when investment cycle peaked.

In its forward guidance, it explicitly suggests that lowering policy rates at this juncture will only aggravate inflationary impulses without necessarily stimulating growth. It has also said that "as the multiple constraints to growth are addressed, the Reserve Bank will stand ready to act appropriately."

Given this statement and forward guidance, it looks unlikely that RBI will lower policy rates in near future. With inflation projections being revised upwards and much above RBI's threshold levels, it will cut rates only when inflation shows signs of decline. India remains an outlier in world economy where in latter both growth rates and inflation have trended lower. In India, growth has trended lower but inflation continues to remain elevated. Hence, policy prescriptions from other parts of the world do not apply here. In the advanced economies, there are suggestions that central banks should create higher inflation to stimulate their respective economies. In India, inflation remains a major barrier towards achieving potential growth.

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