STCI
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RBI's Monetary Policy Q2 2012-13: Review

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In Second Quarter Review of Monetary Policy 2012-13, RBI kept policy rates unchanged. The policy decision is in line with our expectations (report dated 25-Oct-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 lowered to 4.25% of NDTL to be effective from fortnight beginning November 3, 2012.
  - SLR unchanged to 23% of NDTL.

- **Economic Projections**
  - GDP growth for 2012-13 lowered from 6.5% to 5.8%.
  - Inflation projection for Mar-13 increased from 7% to 7.5%.
  - Growth in Monetary aggregates revised lower: Money Supply from 15% to 14%, Deposit from 16% to 15% and Non-food credit from 17% to 16%.

- **Forward guidance statement**
  - CRR reduction is intended to pre-empt a prospective tightening of liquidity conditions.
  - Projected inflation trajectory indicates easing in the last quarter suggesting a reasonable likelihood of further policy easing in the fourth quarter of 2012-13. This will obviously depend on the evolving growth-inflation dynamics.

I. Background to Policy Decision

Growth

RBI has lowered the growth projections for 2012-13 from 6.5% to 5.8%. This is the second consecutive lower revision of growth forecast. In Apr-12 policy, RBI had projected GDP growth at 7.3% which was revised lower to 6.5% in Jul-12 on account of both global and domestic factors (weak industrial and slower growth of services). The growth rate in Q23 review has been revised lower on account of following factors:

- Global growth risks have increased further
- Domestic risks have become accentuated by slower investment & consumption demand and continued erosion in export competitiveness.
- Despite better monsoon in August and September, estimated kharif production is going to be lower than last year.

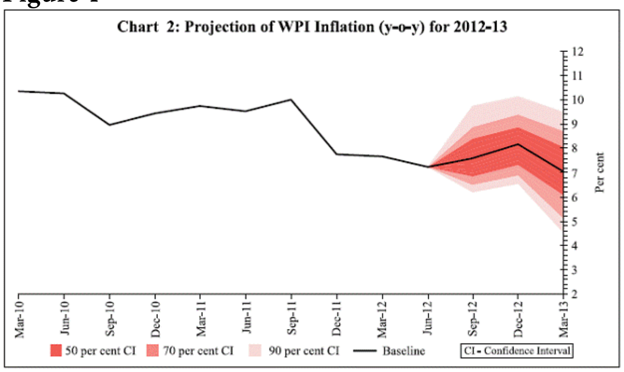
In our monetary policy expectations report, we had indicated RBI is likely to review its growth projections lower to around 6%. The revision is much sharper and in line with the recent revisions done by other forecasters and rating agencies. In the recently released RBI's Survey of Professional Forecasters (SPF) in Jul-12, the private sector forecasters lowered the growth from 6.5% to 5.7%.

Inflation

If growth has been revised lower, inflation has been revised upwards. This has been a consistent story since 2011-12. Unlike the global economies where lower growth has led to easier inflation, in India we only see higher inflation despite lower growth.

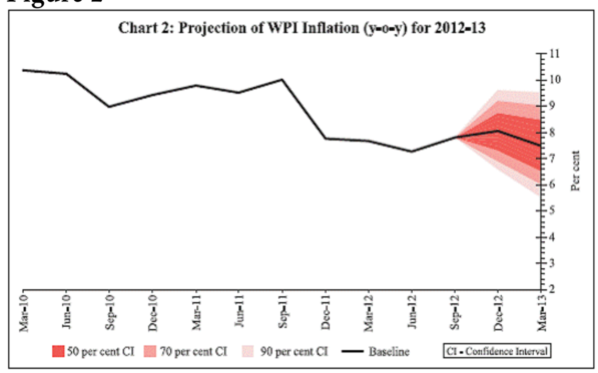
RBI has increased WPI inflation projection for Mar-13 from 7% to 7.5%. In Apr-12 policy inflation projection was given at 6.5% which was revised upwards to 7% in Jul-12 policy. The overall inflation trajectory for the whole year has been revised upwards. Figure 1 shows the inflation projection given in Jul-12 and Figure 2 shows the projections in Oct-12 policy. We can see inflation projections have been raised upwards in Q4 of the fiscal year. Though inflation is expected to decline in Q4 from Q3 but the overall trajectory has been shifted upwards in the latest projections.

Figure 1



Source: RBI

Figure 2



Source: RBI

The statement points that inflation outlook depends on two counteracting forces of upside and downside risks. The downside risks are:

- Slower growth and excess capacity in some sectors will help moderate core inflation.
- Stable or declining commodity prices will help reinforce the trend.
- Appreciating rupee will also help to contain inflationary pressures by bringing down the rupee cost of imports.

The upside risks are:

- Persistent supply constraints may be aggravated as demand revives, resulting in price pressures.
- Rupee depreciation because of global financial instability will add to imported inflation.
- Upsurge in both rural and urban wages is exerting cost-push pressures on inflation and this could continue.
- Correcting suppressed inflation is a necessary step but will result in higher inflation readings.

Monetary and Liquidity Conditions

RBI has lowered the monetary growth projections by 1% each (Table 1). This is in line with slowdown in growth and overall trends in credit and deposits which indicated lower growth in H1 2011-12 than projected. RBI mentions deposit growth has declined with the moderation in rates of term deposits. Credit growth has ebbed with the slowdown in investment demand especially with regard to infrastructure. In our expectations note, we had suggested that RBI should lower its monetary growth projections to align it with real and monetary growth trends.

Table 1: Monetary Aggregates Projections (in %)

	Apr-12	Jul-12	Oct-12
M3 (Mar-end)	15	15	14
Deposit (Mar-end)	16	--	15
Credit (Mar-end)	17	17	16

Source: RBI

The liquidity conditions which were easy In Q2 2012-13 have again started to tighten. Following reasons are cited for recent tightening of liquidity:

- The wedge between deposit growth and credit growth
- Build-up of the Centre's cash balances from mid-September
- Rise in currency demand because of festival-related activities

In order to ease liquidity conditions, RBI has reduced CRR by 25 bps to 4.25%. This will infuse liquidity worth Rs. 17,500 Cr in the system. As per RBI data, we have never had CRR at 4.25% and this is the lowest ratio since 28-Dec-1974 when it was lowered to 4% from 4.5% in 14-Dec-1974. It is important to note that there is no floor for CRR and it could be lowered all the way to 0%.

The monetary projections have been revised lower which eases the pressure on RBI to create reserve money as well. However even with these lower projections and CRR, there will be pressure to create liquidity as reserve money growth has been very low in the year so far. Based on our projections, there could still be a need to create additional liquidity to the tune of Rs 60,000-70,000 Cr (net of 1% NDTL of LAF) for the remaining part of the year.

II. RBI's Policy Stance

We see some changes in sequencing of RBI's policy stance. Maintaining adequate liquidity has emerged as the top priority perhaps because of previous year experiences when liquidity tightened significantly. RBI takes note of recent government actions in boosting growth sentiments and suggests it will reinforce the impact of government actions as inflation moderates.

Table 2: Policy Stance of RBI in recent Monetary Policy Reviews		
Apr-12	Jul-12	Oct-12
▪ 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.	▪ manage liquidity to ensure adequate flow of credit to the productive sectors of the economy; ▪ reinforce the positive impact of government policy actions on growth as inflation risks moderate; and ▪ maintain an interest rate environment to contain inflation and anchor inflation expectations.
Source: RBI		

III. Other Regulatory Policies

April and October monetary policy also covers some important changes in banking and financial system regulatory policies. Some of the key changes in this policy are:

- G-secs and Interest Rate Derivatives Markets: RBI formed a working group to develop the market for G-sec and interest rate derivatives. The committee made several recommendations including consolidation of outstanding G-secs, gradually bringing down the upper limit on the Held to Maturity (HTM) portfolio, steps to promote the term repo market and permitting cash-settled 10-year Interest Rate Futures (IRFs). Some recommendations like truncating the time-window for bidding in the primary auction and re-issuances of existing securities in State Development Loans have been implemented.

  There were expectations and fears that RBI mighty lower the limit on HTM portfolio to align it with SLR. However, RBI has not implemented this suggestion in this policy providing relief to bond markets. However, RBI has decided on following:
  - Change the settlement cycle of the primary auction in Treasury Bills (T-Bills) from T+2 to T+1.
  - Undertake reissuance/introduce fungibility of T-Bills/Cash Management Bills with identical maturity dates.
  - standardise IRS contracts to facilitate centralised clearing and settlement of these contracts.

- To allow scheduled Urban Cooperative Banks (UCBs) with strong financials and sound risk management practices as eligible participants to undertake repo transactions in corporate bonds.
- A Committee has been set up to assess the feasibility of introduction of long-term fixed interest rate loan products by banks. This was done to look at possible ways to protect consumers from fluctuating interest rate costs.
- There is wide divergence between external trade data reported by RBI and Commerce Ministry. The former tracks the data via the banking system and latter via the customs.

The difference arises because of unmatched export transactions between customs and bank reporting which has risen lately. A Working Group was constituted to identify these gaps and it recommended implementation of an IT - based solution using a secured website of the Reserve Bank to update the export database on a real time basis. It has been decided to put in place the envisaged architecture by September 2013. This is a highly welcome step in times when the macroeconomic data reporting has been inconsistent and away from reality.

- NPAs and restructured loans of banks have increasing significantly in recent times and has emerged as a serious concern for the economy. RBI noted that major reason for deterioration in the asset quality of banks is the lack of effective information sharing among the banks. RBI has said that banks should strictly adhere to the instructions regarding sharing of information relating to credit, derivatives and unhedged foreign currency exposures among themselves and put in place an effective mechanism for information sharing by end-December 2012.
- Banks' lending to the infrastructure sector has grown significantly. As a multiplicity of definitions among various regulators gives rise to confusion and difficulties, RBI has proposed to harmonise the definition of infrastructure for the purpose of banks' lending with the master list notified by the Government of India.

IV. Going Forward

RBI's policy has clearly disappointed markets. The yield of 10-year benchmark hardened and equity markets declined post policy tracking RBI's policy. There were expectations earlier as well hoping for a rate cut. However, these got heightened yesterday tracking government's announcement of fiscal consolidation and a dovish reading macroeconomic report released by RBI. Lower growth and promise to cut fiscal deficit to 3% by 2016-17 just before the policy added to huge speculation over rate cuts.

However once again, RBI chose to look at inflation and let the various measures taken by government to fructify. In its forward guidance, it suggests that with inflation expected to moderate from Q4 2012-13 onwards, we could expect rate cuts during Q4. However, this is ironical as not only has RBI increased its inflation projections for Q4 2012-13 but is still going to be much higher than the threshold levels. India remains an outlier with its higher inflation and lower growth trajectory.

Given the economic situation and forward guidance markets are now looking forward to Q4 for rate cut hopes. We think this timeline on probable rate easing was not needed given how the markets have been disappointed with such announcements in the past. In Jan-13 policy, WPI inflation reading is likely to be 8% plus and one does not understand how RBI will ease rates with inflation at such levels. RBI should have instead just stressed on need for inflation to ease before it takes a call on interest rates.

The growth slowdown since 2011-12 was mainly because of various policy issues and corruption scams which reversed the investment cycle. The government has taken some recent measures which did reverse the sentiment and showed the importance of proper government action. Having said that we need to understand that in an election year, the government will find it really difficult to manage both economics and politics.

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