STCI
Primary Dealer Ltd

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

In Third Quarter Review of Monetary Policy 2012-13, RBI lowered its key policy rates. The policy decision is in line with our expectations (report dated 24-Jan-13)

- **Policy Rate Decisions**
  - Repo rate lowered by 25 bps to 7.75% from 8%.
  - Reverse Repo rate and Marginal Standing Facility (MSF) Rate automatically lowered by 25 bps each to 6.75% and 8.75% respectively.
  - CRR lowered by 25 bps to 4% of NDTL to be effective from fortnight beginning Feb 9, 2013.
  - SLR unchanged at 23% of NDTL.

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

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

- **Economic Projections**
  - GDP growth for 2012-13 lowered from 5.8% to 5.5%.
  - Inflation projection for Mar-13 decreased from 7.5% to 6.8%.
  - Growth in Money Supply lowered from 14% to 13%. Non-food credit projection retained at 16%.

- **Forward guidance statement**
  - There is an increasing likelihood of inflation remaining range-bound around current levels going into 2013-14.
  - This provides limited space for monetary policy to give greater emphasis to growth risks.

## I. Background to Policy Decision

### Growth

RBI has lowered the growth projections for 2012-13 further from 5.8% to 5.5%. This is the third successive lower revision of growth projections. RBI started the year with GDP growth projected at 7.3% for 2012-13. This was revised lower to 6.5% in Jul-12 policy and to 5.8% in Oct-12 policy. The growth rate in Q3 review has been revised lower on account of following factors:

- Global growth risks continue to inhibit improvement in services sector.
- Though sowing of rabi crop has picked up, severe winter in certain parts have endangered crop prospects.
- Despite recent government measures investment demand remains sluggish and likely to pick up only overtime.

In our monetary policy expectations report, we had indicated RBI likely to keep its growth projections at 5.8%. Our expectations were based on the fact that government had pegged the growth around the same levels of 5.7-5.9% in its mid-year review. The recent RBI revision is in line with the recent revisions done by other forecasters (Table 1).

| Table 1: Various Agencies' Growth Projections for 2012-13 | | | | |
|---|---|---|---|---|
| | **Latest Projection** | | **Earlier Projection** | |
| | **Real GDP Growth (in %)** | **Month** | **Real GDP Growth (in %)** | **Month** |
| PMEAC | 6.7 | Aug-12 | 7.6 | Feb-12 |
| Ministry of Finance | 5.7 to 5.9 | Dec-12 | 7.6 (+/-0.25) | Mar-12 |
| IMF* | 5.4 | Jan-13 | 5.6 | Oct-12 |
| World Bank | 5.4 | Jan-13 | 6.0 | Oct-12 |
| OECD** | 4.4 | Nov-12 | 7.3 | Jun-12 |
| ADB | 5.4 | Dec-12 | 5.6 | Oct-12 |
| NCAER | 5.9 | Nov-12 | 6.4 | Jul-12 |
| RBI-SPF | 5.5 | Jan-13 | 5.7 | Oct-12 |

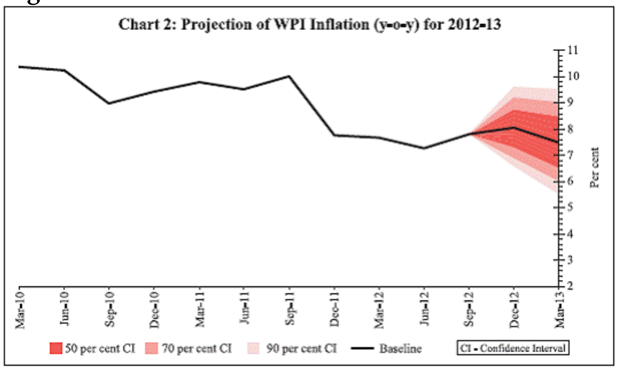
**: Corresponds to the World Economic Outlook update of January 2013 projection of 4.5 per cent for GDP at market prices for the calendar year 2012, The growth for 2013-14 is projected at 6.0 per cent, both at factor cost and market prices.*
***: GDP at market prices.*
*Source: RBI*

**Inflation**
Though growth has been revised lower, inflation has been revised lower as well. This is a welcome change as usually inflation is revised higher in Quarterly Policy meetings (Table 2).

| Table 2: Comparing RBI Projections with Actual Growth (in %) | | | | | |
|---|---|---|---|---|---|
| **2010-11** | | | | | |
| | **Annual Policy** | **Q1** | **Q2** | **Q3** | **Actual** |
| GDP | 8.0 with upward bias | 8.5 | 8.5 | 8.5 with upward bias | 8.4 |
| Inflation (Mar-end) | 5.5 | 6 | 5.5 | 7 | 9.7 |
| **2011-12** | | | | | |
| | **Annual Policy** | **Q1** | **Q2** | **Q3** | **Actual** |
| GDP | 8.0 | 8.0 | 7.6 | 7.0 | 6.5 |
| Inflation (Mar-end) | 6.0 with upward bias | 7.0 | 7.0 | 7.0 | 7.69 |
| **2012-13** | | | | | |
| | **Annual Policy** | **Q1** | **Q2** | **Q3** | **Actual** |
| GDP | 7.3 | 6.5 | 5.8 | 5.5 | - |
| Inflation (Mar-end) | 6.5 | 7.0 | 7.5 | 6.8 | - |

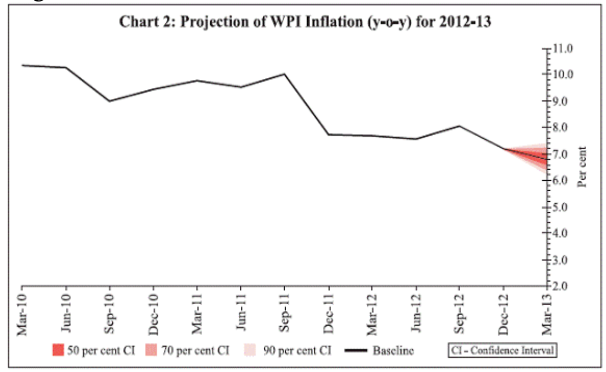
RBI has lowered WPI inflation projection for Mar-13 from 7.5% to 6.8%. Overall inflation trajectory has sifted significantly lower compared to projections given in Oc-12 policy (Figure 1 & 2).

**Figure 1**




*Source: RBI*

**Figure 2**




*Source: RBI*

RBI suggested that substantial easing of core inflation over Q3 suggests that inflation has come off its peak. This is tracking slower growth and excess capacity in some sectors. Though, RBI expects inflation to be range-bound around current levels due to persisting food inflation, the pass-through of diesel price adjustments and the possibility of adjustment in other administered prices. The Review mentions that for a sustained reduction in inflation pressures, alleviation of supply-side constraints and fiscal consolidation is imperative.

**Monetary and Liquidity Conditions**

RBI has lowered the growth projections for money supply by 1% (Table 3). It has maintained the credit growth projection at 16%. M3 growth projection has been lowered seeing the evolving trends which have showed lower than earlier expected growth so far. With lower interest rates, there is a possibility that deposit growth slows further leading to lower growth in money supply as well.

**Table 3: Monetary Aggregates Projections for Mar-13 end (in %)**

| | Apr-12 | Jul-12 | Oct-12 | Jan-13 |
|---|---|---|---|---|
| M3 | 15 | 15 | 14 | 13 |
| Deposit | 16 | -- | 15 | -- |
| Credit | 17 | 17 | 16 | 16 |

*Source: RBI*

The liquidity conditions tightened in Q3 2012-13 compared Q2 2012-13. Following reasons are cited for recent tightening of liquidity:

- Build-up in the Centre's cash balances
- Festival-related lumpy increase in currency demand
- Structural pressures because of widening wedge between deposit and credit growth rates.

In order to ease liquidity conditions, RBI reduced CRR further by 25 bps to 4% of NDTL (to be effective from fortnight beginning Feb 9, 2013). This will infuse liquidity worth Rs. 18,000 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.

However, easing CRR by 25 bps is unlikely to ease tight liquidity conditions expected ahead. Hence, expectations over RBI resuming OMO purchases will remain in the markets. Based on our projections, there could still be a need to create additional liquidity to the tune of around Rs 40,000 Cr in Q4.

## II. RBI's Policy Stance and Risk Factors

There are some changes in sequencing of RBI's policy stance. As inflation risks have subsided, growth concerns have taken top priority.

**Table 4: Policy Stance of RBI in recent Monetary Policy Reviews**

| *Apr-12* | *Jul-12* | *Oct-12* | *Jan-13* |
|---|---|---|---|
| ▪ Adjust policy rates to levels consistent with the current growth moderation.<br>▪ Guard against risks of demand-led inflationary pressures re-emerging.<br>▪ Provide a greater liquidity cushion to the financial system. | ▪ Contain inflation and anchor inflation expectations;<br>▪ Support a sustainable growth path over the medium-term; and<br>▪ 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;<br>▪ reinforce the positive impact of government policy actions on growth as inflation risks moderate; and<br>▪ maintain an interest rate environment to contain inflation and anchor inflation expectations. | ▪ provide an appropriate interest rate environment to support growth as inflation risks moderate;<br>▪ contain inflation and anchor inflation expectations; and<br>▪ continue to manage liquidity to ensure adequate flow of credit to the productive sectors of the economy. |

*Source: RBI*

Apart from above, RBI mentioned several risk factors for Indian economy:

- Widening of Current Account Deficit to historically high levels poses risks of financing the CAD with increasingly risky and volatile flows. This increases the economy's vulnerability to sudden shifts in risk appetite and liquidity preference. Further alongwith large fiscal deficit and slowing growth, it exposes the economy to the risks from twin deficits.
- Global risks remain elevated with the potential for spillovers on the Indian economy through trade, finance and confidence channels.
- In the absence of an effective supply response, inflationary pressures likely to return causing an adverse impact on the economy.
- There is a need for sustained revival in investment. This requires number of factors such as bridging the infrastructure gaps, especially in power and transport, hastening approvals, removing procedural bottlenecks, and improving governance.
- Asset quality in banking has become an issue leading to lower credit outflow. RBI said that alongwith repair of asset quality, banks should ensure adequate credit flow to productive sectors of the economy.

## IV. Going Forward

RBI has finally eased rates meeting market expectations. The last rate cut was seen in Apr-12 policy when RBI surprisingly eased Repo rate by 50 bps. Since then there have been five RBI policy reviews expecting rate cuts but RBI instead chose to pause on policy rates. The bond markets had already factored a rate cut with 10-year easing to 7.85% levels in Jan-13 from 8.15% levels in Dec-12. If RBI did not cut rates, it would have led to sudden hardening of bond yields. RBI's quarterly economic report released yesterday did hint that RBI might not cut rates. The report cited several risks such as wide CAD and elevated inflation and suggested RBI to take calibrated steps. This however was not the case and RBI did cut rates providing relief to the markets.

Though, RBI did disappoint markets via its forward guidance. It indicated there is space for monetary policy to look at growth (meaning easy policy) but this space is limited. It expects inflation to remain rangebound at 7% levels on account of factors indicated above. So, clearly one can expect rate cuts going ahead but they are going to be limited.

It was also surprising that RBI did not mention the widening gulf between WPI and CPI inflation trends. In previous policy reports, RBI did take note of CPI levels which in previous policy trended around 9% - 9.5%. Recent reading show CPI inflation much higher above 10.5%. There is a sequential decline in CPI indices as well but a reading of 10.5% and above should have been flagged as a concern.

Going by current inflation trajectory, we expect RBI to ease Repo rate further by 25 bps in its Mid-Quarter Review to be held on 19-Mar-13. However, inflation has usually increased in Q4 in previous fiscal years. There is also confusion over factoring dual pricing in diesel and LPG in WPI inflation numbers. Hence, one can never be sure of the inflation outlook and this will continue to have a bearing on RBI's future 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](http://www.stcipd.com)