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RBI's Q2 2011-12 Monetary Policy: Expectations

RBI is scheduled to announce its second quarter 2011-12 monetary policy review on October 25, 2011. We expect RBI to increase Repo rate by 25 bps based on recent food inflation data and hawkish comments from both RBI officials and other policymakers. Just a fortnight ago, the camp of analysts was divided into pause vs. 25 bps increase. With the recent spate of communications from the key executives, quite a few in the pause camp have shifted to the 25 bps hike camp.

In this note, we look at the background under which the policy is to be made and our expectations from the policy.

I. Background to the Policy – This Time is (no) Different

It is amazing how the complexity of economic situation is rising in each subsequent monetary policy. Each time analysts think that complexity will decline as we will see lower inflation going ahead and growth will slowdown. One also assumes the global economies will stabilise which will lead to lower volatility in Indian markets due to external factors. But the fresh set of numbers just reverse the sentiment and indicate inflation remains persistent as ever and there is no conclusive evidence of a slowdown. The global growth story also takes a new turn with either extreme optimism or extreme pessimism.

This time is no different.

II. Global Economy Continues to Weaken

The global economic conditions have turned worse since Aug-11. The revised US GDP data showed growth was much lower in previous quarters than what was assumed from the provisional numbers. The unemployment data refuses to improve. Additionally, two major risks have emerged. First, is the rise in debt and deficit levels and second is the absence of political leadership & emergence of serious governance issues in world's largest economy.

The chaos factor in European crisis keeps rising. The huge imbalance within the EMU members just keeps widening with core countries like Germany and France getting stronger and periphery countries like Greece and Ireland getting weaker. Moreover, the large EMU economies like Italy and Spain which should be part of the core are being increasingly pushed to the periphery. The European crisis has deeply exposed the flaws in the design of the monetary union. Despite the monetary union, it is the fiscal policy which dominates and there is no union on thoughts on the fiscal front. There is a growing realization amidst the developed world that coming out of the global crisis will take much longer than even the most pessimistic forecasts. The developed world is expected to grow at a very slow pace.

Given this state of affairs, the onus has increasingly shifted to the central banks. The central banks in advanced economies are looking for ways to stimulate their economies. Federal Reserve keeps coming out with new tools to stimulate the US economy. The Bank of England surprised markets with its MPC voting unanimously to increase its Asset Purchases Program further from GBP 200 bn to GBP 275 bn. European Central Bank is the only advanced economy central bank that has increased policy rates in Apr-11 and Jul-11 policies. It is under pressure to reverse its policy given the pressure on EMU economies.

Based on these rising global risks, central banks in emerging economies have either preferred to pause and some like Bank of Indonesia and Brazil Central Bank have lowered policy rates.

III. Indian Economy – Inflation Remains 'The Concern'

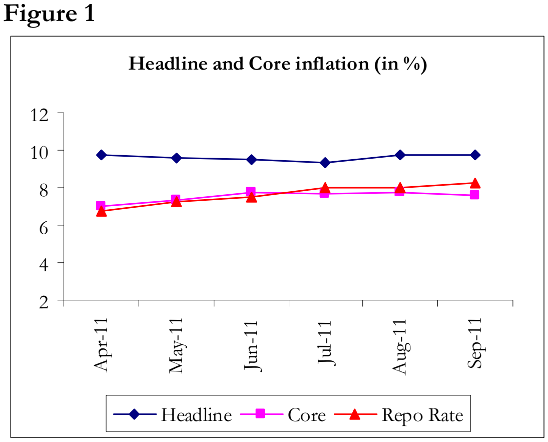
Though Indian economy has become increasingly global over the years, domestic demand and supply conditions continue to be drivers of Indian economy. This was seen at the peak of the global crisis as well. India's growth did decline from 9% levels but was still robust given substantial declines and negative growth in other countries. Moreover, the economy recovered sharply as the crisis conditions eased. With rising growth, inflation came across as the central concern. Persistent inflation has most of the time led RBI to differ from the other central banks in terms of policy stance. This time again persistent inflation will force RBI to increase rates when other central banks are pausing or lowering the policy rates.

1. Inflation

RBI has raised Repo rate by 350 bps since Mar-10. There has been twelve continuous rate hikes since Mar-10 with just one pause in Dec-10. FY 2011-12 alone ahs seen hike of 150 bps when most analysts estimated that RBI would raise policy rates by 75-100 bps in the whole year.

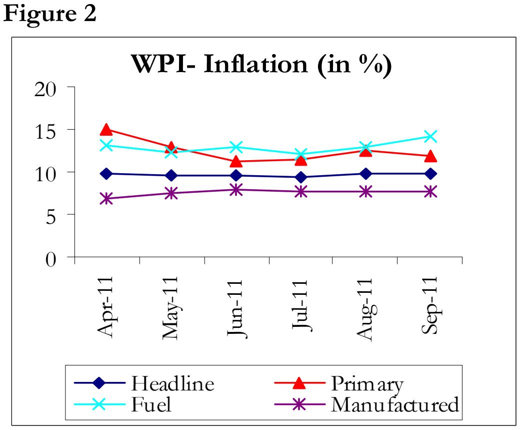
Despite these frequent and large rate increases, inflation levels remain persistent. In Mar-10 inflation was 10.4%, in Apr-11 it was 9.74% and in Sep-11 it remains at 9.72%. The Repo rate remains lower than headline inflation and around core inflation (Figure 1). In terms of headline inflation, real rates remain negative. Primary articles inflation has declined from 15% in Apr-11 to around 12% in Sep-11 (Figure 2). Food inflation has declined from 10% to 7.6% in Jun-11 and has remained around 9%. It has started rising in last few weeks. Major decline is seen in non-food articles from 26% in Apr-11 to 14% in Sep-11. Fuel has remained around 12-14% for most of the period. Manufactured Products inflation remains sticky at around 7.6-7.9%.

Figure 1



Source: Commerce Ministry

Figure 2



Source: Commerce Ministry

Deepak Mohanty, Executive Director of RBI has divided the current inflation trend in four sub-phases. Based on that division, if we look at the sources of inflation, we can see how sources of inflation have changed (Table 1). The early phase was driven by primary articles and within primary protein based items contributed nearly 50% of the primary articles inflation. Now the inflation is more because of rise in core inflation showing how inflation has become generalised and broad-based. The contribution of fuel items has also risen tracking rise in global oil prices and deregulation of petrol market.

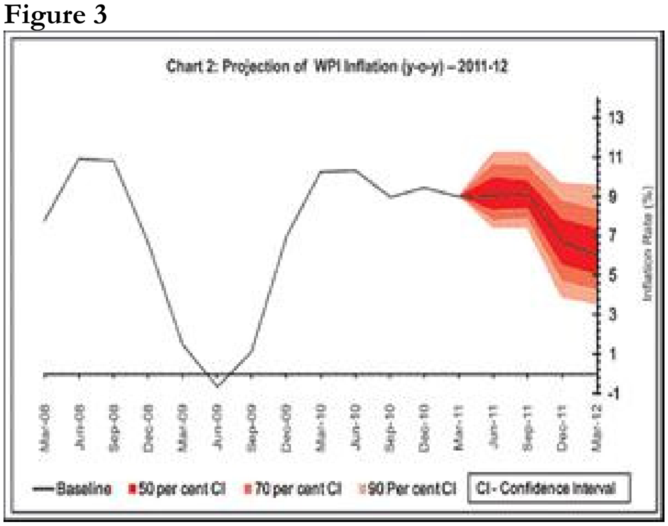
Table 1: Contribution to Headline Inflation

		Contribution (in %)				
	Headline Inflation Average	Primary	Protein	Fuel	Mfd.	Core
Oct-09 to Mar-10	7.06	66.5	31.8	-1.5	35.6	5
Apr-10 to Jul-10	10.4	44.9	20.4	19.8	35.3	28.1
Aug-10 to Nov-10	8.92	45.4	17.3	19.4	35.2	31.4
Dec-10 to Sep-11	9.58	37	7.2	20	43.1	38

Source: STCI PD Research

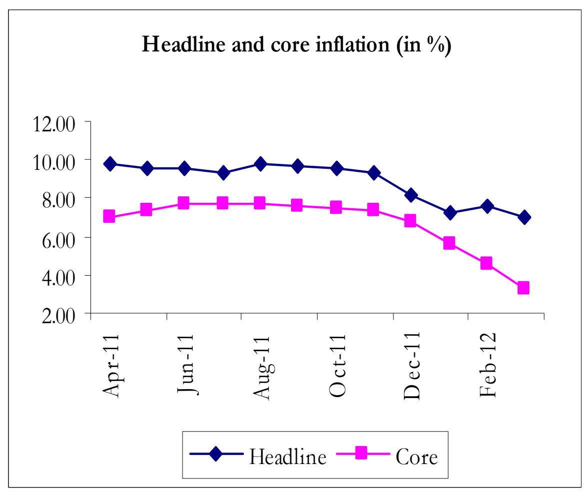
The current inflation trajectory is in line with RBI's forecast for the year (Figure 3). However, RBI had assumed a few factors for this trajectory of inflation like deregulation of oil markets and rationalization of subsidies. Barring deregulation of petrol prices, none of the factors have materialized but still inflation remains elevated.

Figure 3



Source: RBI

Figure 4



Source: Commerce Ministry, STCI-PD Research

Our projections (Figure 4) also indicate that inflation is expected to ease from Dec-11 onwards. It is expected to be around 7% by Mar-11. The core inflation is expected to be even lower at around 3-3.5% by Mar-12. The decline in inflation is mainly because of huge base-effect and there is no real qualitative decline in inflation.

Two risks have emerged to this inflation outlook. First is the recent rise in food inflation. Despite good monsoons and expected record food production in 2011-12, food inflation has again started to rise in last few weeks. The food articles index has risen for nine consecutive weeks and inflation is back to 10% plus levels after declining to 7.5% levels in Jul-11. In India's case, food inflation forms bulk of the inflationary expectations and a rise in food prices leads to rise in inflation expectations which then leads to generalized inflation as seen in Table 1. The households' inflationary expectations survey by RBI shows the expectations remain elevated. In Jun-11 people expected higher inflation compared to Mar-11 over next twelve months.

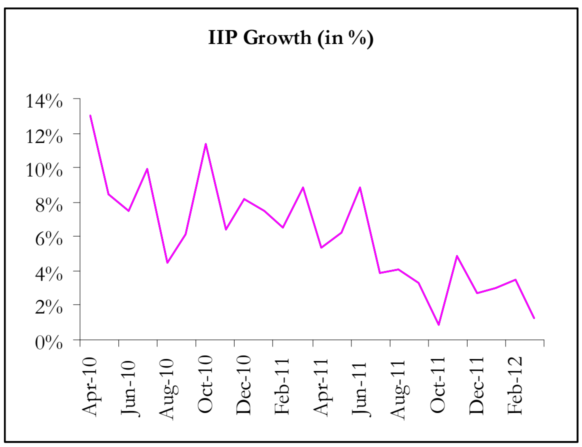
Second is the shock depreciation in Rupee by almost 10% since Aug-11. This will lead to costlier oil imports and further rise in fuel inflation depending on the scale of pass through by oil companies.

2. Growth

GDP for Q1 2011-12 was placed at 7.7%, lower than 8.8% in Q1 2010-11. The slowdown was particularly sharp in industry. Services growth declined from 10% in Q1 2010-11 but was still robust at 8.9%. The investments growth picked up in Q1 2010-11 after declining in previous two quarters. This was surprising as one would expect investments to decline post sharp rate increases. Going forward, most analysts and economists have lowered the growth forecast for FY 11-12 at around 7% - 7.5%. Hugh inflation, tight monetary policy, lose fiscal policy and lack of policy reforms are the major reasons for the lower growth forecasts.

Monthly IIP data continues to be volatile and quality of data remains a concern. RBI itself has been questioning the volatility in data especially in capital goods sector. In the Sep-11 mid-quarter review, RBI even mentioned that it was looking at IIP growth ex- capital goods. Given these limitations, IIP growth has remained low at around 3-4% between Apr-11 and Aug-11 and is expected to follow the same trajectory. The festival season in 2011-12 might lead to higher growth rates in months of September to November.

Figure 5



Source: CSO, STCI-PD Research

3. Monetary Indicators

The monetary indicators show that rate increases have not really had the desired impact on monetary factors. The growth in money supply remains higher than RBI projections and even credit growth rates remain robust. There are expectations that these numbers will be in line with RBI's projections till Mar-end as monetary transmission works with a lag.

Table 3: Monetary Indicators (in %)

	RBI Projections for Mar-12 end	Apr- 11	Sep-11
M3	15.5	17.5	16.8
Credit	18	22	19.9
Deposit		17.5	17.5

SLR		26.93	28.04
Money Multiplier		4.8	4.9
CD Ratio		71.5	74
Source: RBI, STCI-PD Research			

4. State of Fiscal Position

RBI has been highlighting the risk of loose fiscal policy and has mentioned that meeting this year's fiscal targets will be a challenge. Most analysts even after the Union Budget raised concerns and said that a fiscal target of 4.6% was too ambitious and unlikely to be met. The tax receipts were overestimated and subsidies underestimated leading to much favorable fiscal deficit for the year.

These concerns have come true and loose fiscal policy remains the biggest risk for the Indian economy. It has a negative impact on investments, interest rates and even inflation. RBI's countercyclical policies are negated by the procyclical fiscal policy of the government.

The government announced a steep increase in borrowing for H2 2011-12 by Rs 52,800 cr mainly on account of shortfall in Small Savings scheme. The markets were highly surprised by the move as most expected higher borrowings on account of higher subsidies and lower tax receipts. The fiscal accounts for Apr-Aug 11 shows revenue receipts till Aug-11 are just 22% of BE compared to 43% last year. The expenditures are being controlled by cutting down on plan expenditure and hence there is lesser stress on fiscal deficit which stands at 75% of BE compared to 36% of BE.

Table 4: Fiscal Accounts (in Rs Cr)

	2011-12 BE	Apr - Aug 11	Apr - Aug 11 (% of BE)	Apr-Aug 10 (% of BE)
Total Receipts	844912	198694	24%	41%
Revenue Receipts	789892	188550	24%	43%
Tax Revenue (Net)	664457	144895	22%	26%
Non-Tax Revenue	125435	43655	35%	103%
Non-Debt Capital Receipts	55020	10144	18%	12%
Disinvestment	40000	1145	3%	5%
Total Expenditure	1257729	472217	38%	40%
Non-Plan Expenditure	816182	340215	42%	42%
Plan Expenditure	441547	132002	30%	37%
Fiscal Deficit	412817	273523	66%	40%
Revenue Deficit	307270	230000	75%	36%
Source: CGA				

The markets expect fiscal deficit for 2011-12 at around 5.2-5.8% of GDP depending on their forecasts on receipts and economic conditions. This will again put more pressure on the monetary policy as higher fiscal deficits will keep inflation elevated.

IV. Policy Stance of RBI and Expectations

Given the global economic situation and state of domestic economy, RBI is again being confronted with conflicting scenarios. The pause camp favored RBI pausing on rate hikes mainly because of global factors and lag in monetary transmission. However, given the recent food inflation numbers and hawkish commentary from key policymakers, the expectations have set in for a 25 bps hike. Infact, most in the hike camp believe this might be the last rate hike but the comments point that such pause in stance is nowhere near the corner.

The policy statement will continue to be hawkish and press on the elevated and persistent inflation levels. It is expected that RBI will lower the growth forecast for FY 2011-12 to around 7.5% indicating the impact of rate hikes and global slowdown. Apart from this there are expectations that RBI might announce a roadmap for opening up new private sector banks and permitting corporate sector to set up banks.

RBI may also raise the debate on growth and inflation trade-off in India. RBI economists recently released papers on threshold level of inflation. Threshold level of inflation is the level till which inflation acts as a grease on growth and when inflation crosses the threshold it becomes like a sand in the growth wheels. Two papers from RBI economists show threshold level for inflation in India is around 6%. The research points that target should be lower than threshold because of lags in monetary transmission. Hence preferred range for RBI is 4.5%-5.5%. Not surprisingly, this is the range of inflation RBI mentions as its comfort zone in each policy.

The problem with these India studies is that most of the time-period used relates to times when India had low growth. Hence, one sees threshold levels at around 6% and the relation with growth. The structure of Indian economy has changed in the last ten years and we have seen high growth rates of around 9%. However, with high growth rates we have also seen high inflation which has remained persistent. So to have inflation around 4.5% - 5.5% inflation, growth has to be much lower till supplies improve. There seems to be a threshold level of growth as well beyond which inflation will only rise given current state of limited supplies. This relation between growth and inflation has to be explained better to markets.

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