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RBI's Third Quarter Review of Monetary Policy 2011-12

In Third Quarter Review of Monetary Policy 2011-12, RBI has taken following key measures:

- **Policy Rate changes**
  - Cash Reserve Ratio (CRR) cut by 50 bps to 5.50% of NDTL w.e.f 28-Jan-12.
  - Repo rate unchanged at 8.5%
  - Reverse Repo rate and Marginal Standing Facility (MSF) Rate automatically stands unchanged at 7.5% and 9.5% respectively.

- **Economic Projections**
  - RBI lowered the growth forecast for 2011-12 to 7.0% from 7.6% (in line with our expectations)
  - Inflation forecast is kept at 7% by end Mar-12.
  - Money supply growth projection for 2011-12 has been retained at 15.5%
  - Credit growth lowered to 16.0% from 18%.

- **Forward guidance statement**
  - According to RBI, reduction in CRR "can also be viewed as a reinforcement of the guidance that future rate actions will be towards lowering them."
  - Lack of fiscal consolidation will constrain RBI from lowering policy rate in response to declining growth.

I. Background to Policy Decision

Growth

In its Macroeconomic and Monetary Development Report (MMDR) released a day before the Monetary Policy, RBI mentioned that growth in the current fiscal has softened more than estimated earlier. The decline is on account of both domestic and global factors. GDP growth for the Sep-11 quarter slipped below 7% to 6.9%, the slowest growth in nine quarters. The half year 2011-12 growth softened to 7.3% compared to 8.6% in the same period last year. RBI in its assessment has cited various domestic and global factors behind the slowdown in growth apart from the impact of the rate tightening:

Based on the recent developments, RBI lowered the growth projection from 7.6% to 7% for FY 2011-12. RBI has lowered the growth forecast for the second time in the current fiscal. From its initial estimate of 8.0% GDP in May-11, the growth projection was revised downwards to 7.6% in Oct-11 and now to 7%.

RBI while admitting that partly the slow down in the domestic economy is on account of global factors via increasing linkages, domestic policy also needs to be supportive of investment climate. In the absence of a conducive investment environment, the trend rate of growth may further deteriorate.

Inflation

As per MMDR, recent decline in food inflation is attributable to high base and seasonal fall in prices of fruits & vegetables. The report pointed out that fall in food prices could be short lived and upside risk to overall inflation remained. Protein inflation though has continued to be in double digits and may remain so due to structural imbalances. The decline in the Rabi acreage of pulses is also likely to exert an upward pressure on protein inflation. Further, the incomplete pass through of administered fuels like diesel, kerosene and LPG also pose a threat of high fuel inflation going forward. On the manufacturing side, risk to inflation emanate from imported items as the exchange rate remains vulnerable to the interplay of many domestic and global factors.

Keeping in view the expected moderation in non food manufactured products inflation, domestic supply factors and global trends in commodity prices, RBI has kept the baseline projection for WPI inflation for March 2012 unchanged at 7 %.

Monetary Aggregates

The impact of growth slowdown and increasing risk aversion by banks can be clearly seen in the moderating growth in non food credit at 15.7% by end Dec-11 against RBI's indicative projection of 18%. Deposit growth on the other hand has remained healthy at 16.9% by end Dec-11 comparable to 16.8% seen in the same period last year. Keeping in view the increased government borrowings and slow down in private credit demand, M3 has been retained at 15.5% while non food credit has been scaled down to 16%.

Table 1 summarizes the changes in RBI projections in 2011-12.

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

	May-11	Jul-11	Oct-11	Jan-12
Growth (2011-12)	8	8	7.6	7
Inflation (Mar-12)	6 with upward bias	7	7	7
M3 (Mar-12)	16	15.5	15.5	15.5
Deposit (Mar-12)	17	--	--	-
Credit (Mar-12)	19	18	18	16

Source: RBI

II. RBI Policy Stance

In the monetary policy expectations report (dated 20-Jan-12), we had mentioned RBI faces two trade-offs.

- Growth vs. inflation: We had indicated that this trade-off had weakened as growth was much lower than expected and inflation was in line with RBI projections. In this policy, RBI also maintains growth is lower than expectations but continues to remain more hawkish on inflation. It remains the first point in RBI's policy stance statement.

Table 2: Policy Stance of RBI in FY 2011-12		
Jul-11	Oct-11	Jan-11
▪ Maintain an interest rate environment that moderates inflation and anchors inflation expectations. ▪ **Manage the risk of growth falling significantly below trend.** ▪ Manage liquidity to ensure that monetary transmission remains effective, without exerting undue stress on the financial system.	▪ 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**

Source: RBI

Liquidity vs. Rupee: The trade-off which appeared this time was liquidity deficit vs. rupee depreciation. However, as pressure on rupee depreciation abated because of rise in FII inflows, focus was on liquidity. Within liquidity, the issue was which measure will RBI use to ease liquidity deficits. RBI had mentioned that tools to address liquidity in order of preference were OMO, SLR and then CRR.

Though, CRR is a more potent tool to address liquidity RBI had deferred its use as it was also seen as a monetary tool. Hence, we had also expected RBI not to change CRR as core inflation still remained high and it was still too early to reverse policy stance. MMDR also mentioned that money multiplier has increased and there is a need to balance provision of liquidity and inflation control. This also reaffirmed market beliefs that CRR was unlikley to be changed as lower CRR leads to both higher money multiplier and higher inflation.

However, RBI still chose to lower CRR by 0.50% to 5.5%. The policy document mentions that policy stance as high deficit liquidity conditions hurts monetary transmission and hinders credit flow to productive sectors. A lower CRR could also be seen as a reinforcement that future rate actions will be of easing nature.

This change in policy stance over CRR has confused the markets. There is however no clarity over whether OMOs will continue. RBI Governor Dr Subbarao mentioned in post policy interaction with Media that it will see how CRR pans out going ahead and will decide whether further OMOs are needed to address the liquidity conditions.

III. Going Forward

Though the trade-off between inflation and growth has weakened it appears that RBI will not lower its guard on inflation unless core inflation eases. Hence, rate reversal in the coming months will be very gradual and in calibrated baby steps. We expect RBI to ease policy rates from April policy onwards. The tight liquidity condition is likely to remain a policy priority and one can expect RBI to lower CRR again if the liquidity deficit widens because of advance tax-flows in March.

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