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RBI's Monetary Policy Q1 2012-13: Expectations

RBI's Monetary Policy for First Quarter 2012-13 is scheduled to be announced on 31-Jul-12. Like previous policies, this one also remains a highly anticipated event. The expectations are once again divided over rate cut vs. rate pause camps. The first camp believes RBI should ease policy rates noting decline growth. The second camp believes rates should only be cut when there are signs of inflation easing.

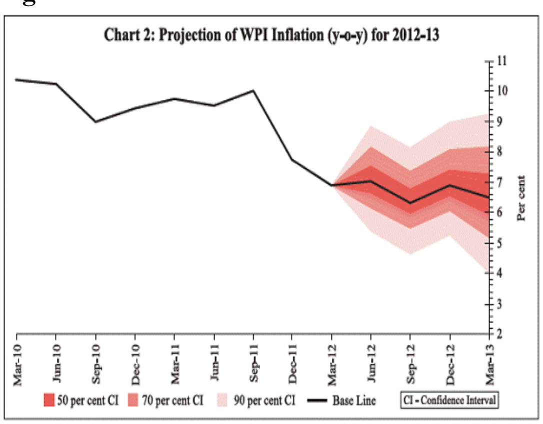
We belong to the second camp and believe RBI should hold policy rates in the upcoming policy. With WPI inflation remaining way above RBI's comfort zone of 5% - 5.5%, there is little room for rate cuts as of now. There are still significant upside risks to inflation on account of weak monsoon and incomplete pass-through of fuel prices which need to be revised upwards. In a way we are fortunate not to be following CPI as otherwise we might be debating whether RBI should be raising policy rates.

In the above backdrop, we will first analyse the recent macro economic developments since Jun-12 mid-quarter review. In the second section, we will discuss RBI's policy choices and our expectations.

I. Inflation

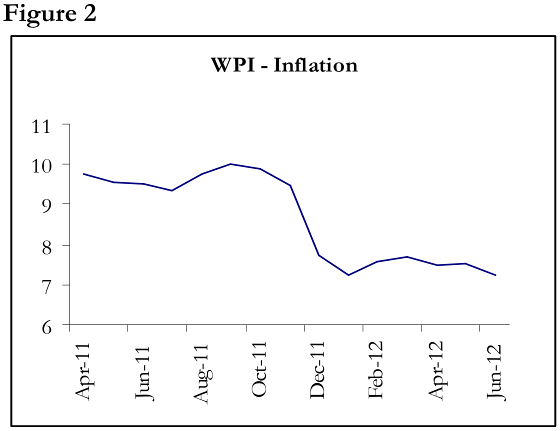
The average inflation for Q1 FY-13 is 7.43%, much higher than RBI's baseline projections of around 7% during the same period (Figure 1). The numbers for May-12 and Jun-12 are yet to be revised. Based on current trend, revision is likely to be upwards by around 0.25-0.5%. This would imply Q1 FY-13 inflation to be over 7.5% levels. Core inflation has averaged around 4.9% levels and has been sticky around these levels.

Figure 1



Source: RBI

Figure 2



Source: Commerce Ministry

The higher than expected inflation is again on account of rising primary articles. The primary articles inflation has increased from 2.8% in Jan-12 to 10.46% in Jun-12. The average inflation in primary articles in Q1 FY-13 is more than 10%. The primary articles inflation in turn has risen because of rising prices of food articles (particularly protein items). After declining to -0.68%, foods articles inflation has averaged more than 10% since Mar-12. Contribution of primary articles in overall inflation has risen from 10.2% in Jan-12 to 37.2% in Jun-12.

Table 1: Contribution to Headline Inflation (in %)			
	Primary Articles	**Fuel**	**Core**
Jun-11	30.1	20.6	40.7
Jan-12	10.2	35.8	46.6
Apr-12	33.2	25.2	32.9
Jun-12	37.2	22.3	32.7
Source: Commerce Ministry, STCI-PD Research			

Food prices are expected to rise further as monsoon has been weak in the year so far. The monsoon situation in 2012 so far is quite similar to the situation in 2009 drought. In Jun-12, rainfall received was 77% of LPA better than 53% of LPA in Jun-09. However in Jul-12, rainfall received is at 78% of LPA (till 18-Jul-12) worse than 96% of LPA in Jul-09 The average rainfall in Jun-Jul 12 is 77.5% o LPA similar to 74.5% of LPA in Jun-Jul 09.

Table 2: Actual Rainfall as a % of Long Period Average				
	2009	**2010**	**2011**	**2012**
June	53	84	112	77
July	96	103	85	78
August	73	106	110	
September	79	113	106	
Overall	77	102	101	
Source:IMD				

Moreover, past trends show that rainfall in South-west monsoon season peaks in July and declines thereafter. In order to make up for the deficit the overall rains in August and September will have to be much higher than LPA which is against the overall trend. Though, we can still have heavy rains in remaining monsoon season as seen in 2010 and 2011. Another positive is that North-west region which is critical for Kharif crop has better irrigation coverage. So it might not have an impact on paddy crop which was the case in 2009 as well. But other crops like oilseeds and pulses which are grown in the central region are likely to be impacted negatively. Pulses forms part of protein items (along with eggs and meat items) and a decline in production of pulses will likely lead to continued rise in protein inflation.

Food inflation also contributes majorly to inflation expectations as suggested by RBI's household survey of inflation expectations. Rising food prices will also lead to rise in inflationary expectations which is the most important concern for a central bank.

Apart from food prices, the incomplete pass through of fuel prices is also leading to suppressed inflation. The calculations show that amount of suppressed inflation is around 3.4% (Table 3). This is a very large adjustment. If we passed this whole adjustment in Jun-12 inflation, the WPI inflation would have been 11% instead of 7.25% reported otherwise. This is just the direct impact on inflation and with second round effects it will lead to higher core inflation and inflationary expectations as well.

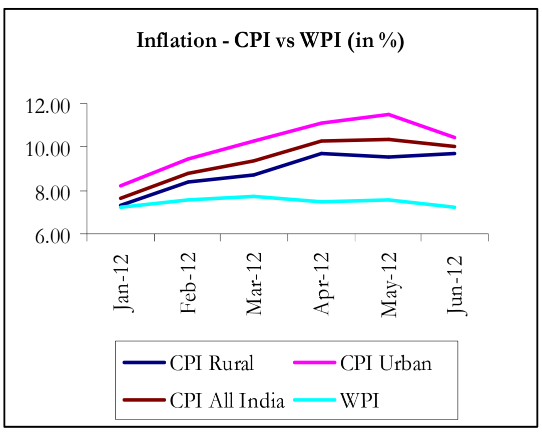
Table 3: Estimated impact of complete pass through of fuel prices on WPI inflation		
	Under-recovery w.e.f. 16-Jul-12 (in Rs.)	**Impact on WPI (in %)**
Diesel	9.95 /lt	1.13
PDS Kerosene	27.2/lt	1.57
Domestic LPG	319/ cylinder	0.73
Total		3.43
Source: Petroleum Planning and Analysis Cell, STCI-PD Research		

Inflation based on CPI indices is already in double digits. CPI inflation remains higher than WPI because food items have higher weight in CPI index. This once again shows the importance of food prices in inflation management in India.

The new CPI series is gradually becoming the preferred measure for measuring consumer inflation. The new series has inflation data only from Jan-12 onwards which has risen sharply in recent months. In Jan-12, CPI – Combined inflation was 7.65% and increased to touch 10.3% in Apr-12 and 10.02% in Jun-12. The CPI-Urban inflation has been higher than CPI rural because of housing prices which is not included in CPI-Rural series.

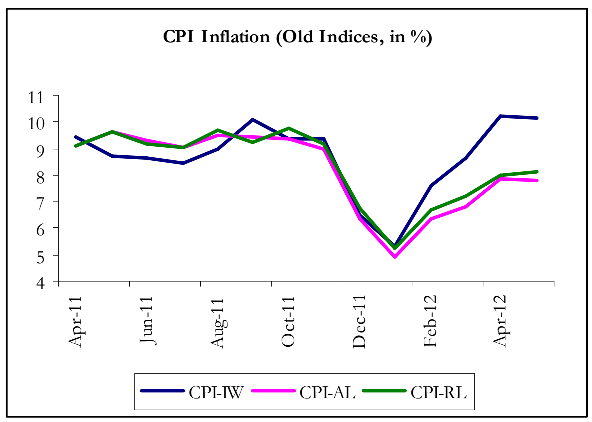
In the old CPI series, we see similar trend as observed in new series. CPI-Industrial Workers has risen from 5.3% in Jan-12 to 10.16% in Jun-12. CPI-Agricultural Labour and CPI-Rural Labour has increased from 4.9% to 7.8% and 5.3% to 8.1% respectively in the same time period.

Figure 3



Source: CSO, Commerce Ministry

Figure 4



Source: Labour Bureau

Going forward, there is tremendous uncertainty on inflation outlook with both upside and downside risks. Upside risks emerge from weak monsoon, rising oil prices, weak currency and suppressed inflation. Downside risks emerge from global uncertainty leading to weakness in commodity and oil prices.

Based on the baseline scenario, we expect inflation to remain around 7.5% for most part of the year . In case the monsoon is weak and there is some pass-through of oil prices inflation could be higher in the range of 8% - 8.5%. However in case we see intensification of global crisis, the inflation levels could ease sharply just as we saw during Lehman crisis.

II. Growth

There has been no new GDP data release since Jun-12 policy review. GDP growth in Q4 11-12 was noted at 5.3% leading to FY-12 GDP at 6.5%. This was lower than market expectations of FY-12 GDP of 6.8%.

Policymakers had projected the FY-13 GDP at around 7.5%. However, private sector forecasters and other agencies have revised their India GDP growth outlook lower from previous estimates. In its Jul-12 World Economic Outlook update, IMF sharply revised GDP growth forecasts lower from 7.3% to 6.5% for 2012.

Table 4: Growth Projections by different Agencies (in %)

	Growth Rate in %	Time of release
Reserve Bank of India	7.3	Apr-12 (Annual Policy)
PM's EAC	7.5-8.0	Feb-12
Budget	7.6 +/- 0.25	Mar-12
International Monetary Fund	6.5	July-12 (earlier 7.3%)
World Bank	6.9	Jun-12 (earlier 7.5%)
Asian Development Bank	6.5	July-12 (earlier 7.0%)

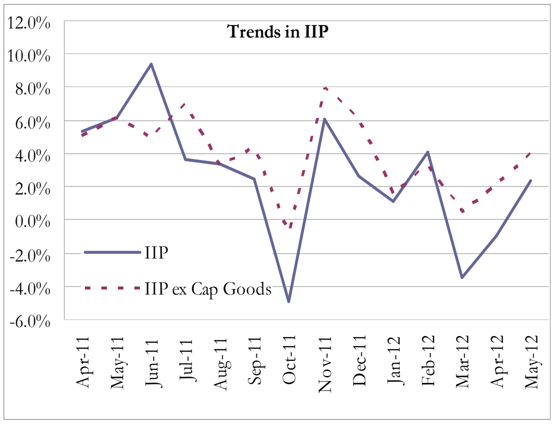
Source: Various websites

We have also lowered our GDP growth outlook for 2012-13 from 7%-7.25% to 6.5%.

2) Index of Industrial Production (IIP): IIP despite exhibiting continued volatility shows declining trend. The average growth in Apr-May 12 is 0.8%, much lower than average growth of 5.8% in Apr-May 11. Within IIP, growth in capital goods has contracted in nine out of eleven months. As a result, IIP growth ex capital goods has been higher than overall IIP growth.

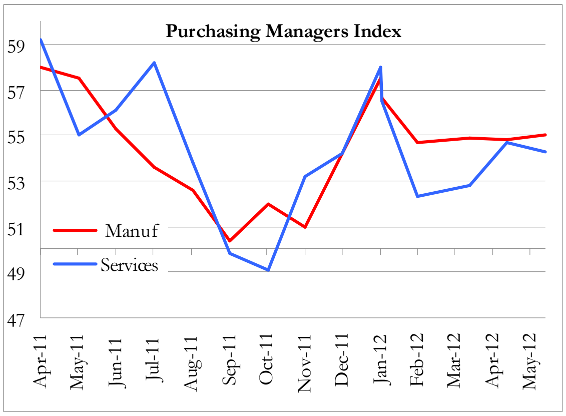
The other lead indicator Purchasing Mangers Manufacturing Index (PMI) shows the index at around 55 levels since Mar-12. PMI-services index has also remained above 50 and has increased from 52.3 in Mar-12 to 54.3 in Jun-12. PMI reading above 50 shows expansion and below 50 shows contraction in business activity.

Figure 5



Source: CSO

Figure 6



Source: Newswires

III. Fiscal Position

RBI policymakers in speeches at various forums have stressed on the need for fiscal consolidation. Without fiscal consolidation, inflation control will be a difficult task to accomplish. Tight monetary policy along with lose fiscal policy leads to former becoming much less effective.

We have only two months of data on public finances and the trend is in line with the previous years. However, the budgeted total revenue growth target of 22.7% looks ambitious and difficult to achieve. Finance Ministry had pegged GDP growth for 2012-13 at 7.6% in Union Budget 2012-13, which is expected to be much lower. This by itself will lead to pressure on revenues especially tax revenues which have been pegged at a growth of 20%. The capital markets have been highly volatile which will test the budgeted disinvestment target of Rs. 30,000 Cr. Sale from proceeds from 2-G spectrum have been pegged at Rs 40,000 Cr but confusion and uncertainty remains with respect to timing and execution.

Table 5: Government's Revenue (in Rs Cr)

	2011-12 RE	2011-12 Actual	2012-132 BE
Net Tax Revenue	642252	631886	771071
Non Tax Receipts	124737	124307	164614
Non-debt Capital Receipts	29751	32520	41650
Total Receipts	796740	788713	977335

Source: India Budget Website

On the expenditure front, the perennial concern over overshooting of subsidies continues. The oil under-recovery for Q1 FY 13 is already at Rs 47,811 Cr, higher than full year budgeted oil subsidy of Rs 43,580 Cr. Finance Minister has put a cap of 2% of GDP on subsidy bill with full subsidy provided for food. The total subsidy bill for the year is Rs. 190,015 Cr and food subsidy is Rs 75,000 Cr. If Food security Bill comes up this could lead to food subsidy rising to above Rs. 1,00,000 Cr. This would imply the other subsidies would have to be cut to maintain the 2% cap. But there is no clear action-plan to cut down other subsidies. There is a strong possibility that overall subsidies are again higher than the budgeted amount as seen last year (revised from Rs 1.43 lakh Cr to Rs. 2.16 lakh Cr).

IV. Current Account Deficit

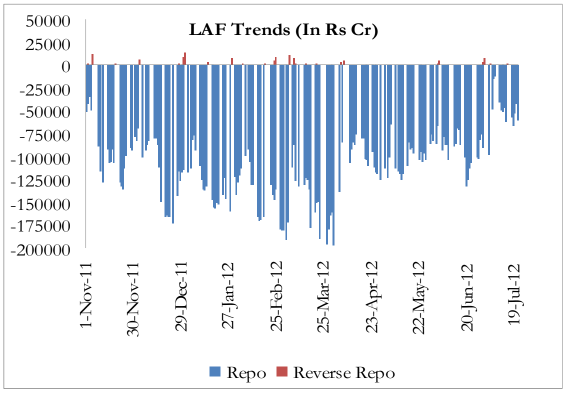
Current Account Deficit was the highest in the year in terms of both absolute numbers ($ 78 bn) and in terms of percentage of GDP (4%). The rise in CAD was mainly because of inelastic demand for gold and oil which continued despite prices rising sharply in 2011-12. The capital account inflows increased from 2010-11 levels which is a huge positive, considering the amount of negative news-flow Indian economy received last year.

The recent trade data shows decline in trade deficit as gold imports have declined on account of lower demand for gold. Oil prices have also eased recently providing some comfort, though both could be temporary. CAD remains a serious challenge and RBI is likely to continue to press its concerns over widening of CAD and financing the same.

V. Liquidity and Monetary Indicators

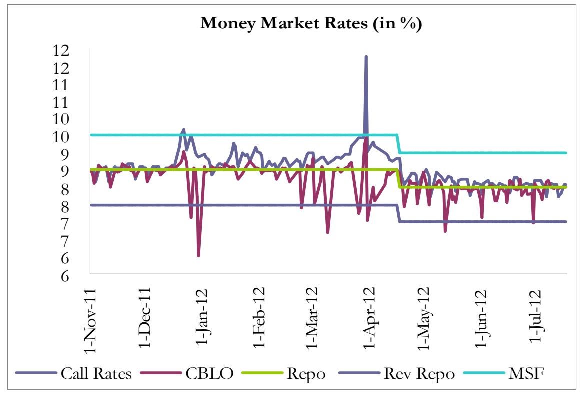
Liquidity conditions have eased recently tracking FII inflows, coupon and G-sec redemption payments, increase in export credit refinance (ECR) limit from 15% to 50% of outstanding credit and government spending. Net LAF borrowing from Repo window currently is lower than 1% of NDTL, the comfort zone of RBI. As a result, call rate has been around the Repo rate in recent times.

Figure 7



Source: RBI

Figure 8



Source: RBI

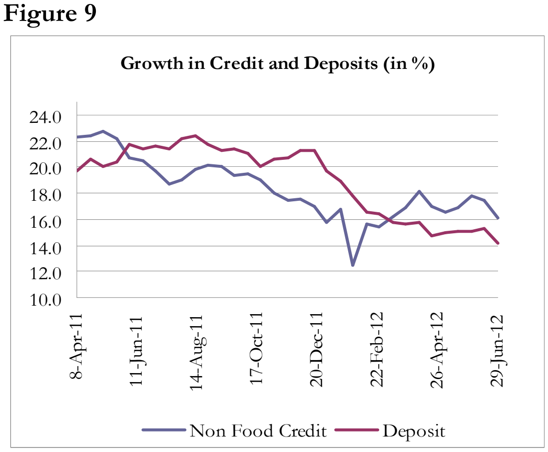
In other monetary indicators like deposit and M3, growth has been lower than RBI's projections. Deposits growth picked up in recent fortnight (ending on 12-Jul-12) from 13.5% to 14.9%. Non-food credit growth has remained around 17% which is around RBI's projected growth for the year. SLR has been around 27.5% and adjusted SLR has been 28.5% levels. Adjusted SLR has eased from 29-29.5% levels seen during Q4 FY-12 as borrowing under LAF Repo has declined in Q1 FY-13.

Table 6: Monetary Indicators (in %)

	RBI Projection for Mar-13	Apr 12 to 12-Jul-12 (average)
Aggregate Deposits	16	14.1
Non-Food Credit	17	17.1
M3	15	13.7

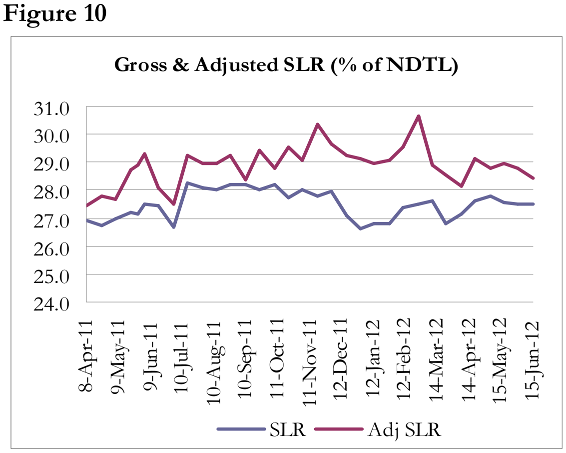
Source: RBI

Figure 9



Source: RBI

Figure 10



Source: RBI, STCI PD Research

VI. Policy Expectations and Conclusion

The background for this policy is again ridden with complexities and trade-offs. RBI will again be pushed into deciding whether to focus on growth or on inflation, both of which are moving in opposite directions. In Apr-12 policy RBI chose to focus on growth and eased policy rates by 50 bps surprising markets. In Jun-12 review, RBI brought back focus to inflation and maintained policy rates. This move again surprised the markets which were expecting sharp rate cuts after the GDP data. Not much has changed since Jun-12 review with inflation sticky at 7.5% levels and growth remaining weak.

Given this uncertainty, we believe RBI is likely to keep policy rates unchanged. Keeping inflation in check and anchoring inflation expectations is the primary responsibility of any central bank. Other Asian central banks have eased policy rates as inflation has been lower in these economies. This is not the case in India and there are significant upside risks to inflation. CPI inflation is already in double digits with large percentage of inflation still remaining suppressed on account of administered oil prices.

Growth concerns are important but RBI has clearly stated that interest costs are just 3% of the total company costs. It has also showed that currently the real weighted lending rate is lower than rate seen during 2003-07 phase when investment activity scaled high peaks. So, it not that interest rates alone have impacted the investment cycle and led to slowdown the economy.

On macroeconomic parameters, we expect RBI to revise its GDP growth projections lower from 7.3% to 7% with a downward bias. It could also increase inflation projections from 6.5% to 7-7.5% with upside risks.

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