STCI
Primary Dealer Ltd

RBI's Mid-Quarter Monetary Policy Review: Dec 2012

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In its Mid-Quarter Review of Monetary Policy held on 18-Dec-12, RBI kept all the policy rates unchanged:

- **Policy Rates**
  - Repo rate unchanged at 8%. Reverse Repo rate and Marginal Standing Facility (MSF) Rate automatically stands unchanged at 7% and 9% respectively.
  - Cash Reserve Ratio (CRR) remains at 4.25% of Net Demand and Time Liabilities (NDTL).

- **Forward guidance statement**
  - In view of inflation pressures ebbing, monetary policy has to increasingly shift focus and respond to the threats to growth from this point onwards.
  - Overall, recent inflation patterns and projections provide a basis for reinforcing RBI's October guidance about policy easing in the fourth quarter. However, risks to inflation remain and accordingly the policy stance will remain sensitive to these inflationary risks.

I. Growth-Inflation Dynamics

Most RBI monetary policy decisions are based on the trade-off between growth and inflation. While former has been on a downward trajectory, latter keeps surprising markets with its upward trajectory. However, in the previous two readings of Oct-12 and Nov-12 inflation has surprised markets with lower than expected numbers. This led to markets assigning higher probability of RBI easing policy rates in Dec-12 Mid-Quarter Review itself rather than wait for Jan-13 policy.

In this Review, RBI welcomed the decline in both headline and core WPI inflation. RBI also pointed to the fact that seasonally adjusted three-month moving average annualised inflation has trended lower. Though, it expressed concern over difference in trends of WPI and CPI inflation. WPI was showing signs of moderation but CPI inflation remains elevated and even increased in Nov-12 tracking food inflation pressures. The core CPI inflation was also elevated compared to decline seen in WPI core inflation.

On growth front, RBI indicated there are some signs of revival in Q3 12-13. Industrial activity has risen in Oct-12 but this was mainly because of festival demand. More importantly, capital goods production growth was positive after 13 successive months of decline. PMI Manufacturing for November increased tracking expansion of order books. These are initial signs of revival and one needs to see whether they are temporary or more permanent.

In terms of outlook, RBI is hopeful that recent government measures should help the business climate and boost investments. On inflation outlook, the statement added that excess capacity in some sectors is working towards moderating core inflation. Easing of international crude oil prices is expected to lead to some softening bias in overall inflation conditions, if it is not offset by the impact of rupee depreciation.

RBI is closely monitoring the evolving growth-inflation dynamics. It has maintained its inflation and growth projections at 7.5% (for Mar-13) and 5.8% respectively. It will update the formal numerical assessment of its growth and inflation projections for 2012-13 in the third quarter review to be held on January 29, 2013.

II. Liquidity and Monetary Aggregates

Liquidity has tightened significantly in recent days tracking advance tax flows. Even before advance tax-flows, liquidity tightened with LAF repo borrowing from RBI averaging around Rs 1 lakh cr. The statement said that tight liquidity situation is mainly because of large government balances with RBI and the widening wedge between deposit and credit growth.

RBI had lowered the monetary aggregates projections for Mar-13 in Oct-12 policy. The monetary trends since Oct-12 policy show deposit growth has steadily declined and was noted at 13.2% on 30-Nov-12. This led M3 growth to be even lower at 12.8%. However, non-food credit growth has risen to touch 16.8% higher than projection. This wedge has widened the liquidity deficit further. It prompted RBI to undertake two OMO purchase auctions on Dec 4 and 11 infusing liquidity of Rs 23,200 Cr in the system.

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

RBI's WSS shows government has been maintaining surpluses above the mandatory Rs 100 Cr in six of the eight weeks since Oct-12. Government sources has maintained that it will be able to meet its fiscal deficit target of 5.3% of GDP based on its large cash surpluses. Though, this is contributing to tightening liquidity in the system.

Markets expected RBI to ease CRR to ease tight liquidity conditions going ahead. As RBI has not eased CRR, there are expectations that RBI will continue with OMOs. This is positive for bond markets.

III. Going Forward

Once again RBI chose to disappoint markets by pausing rather than cutting policy rates. Though, pre-policy polls indicated that most analysts did not expect a rate cut but there were some outside hopes. The hopes had risen particularly following the decline in WPI inflation trends.

RBI has chosen to be cautious learning from its previous experiences. India's inflation has geared up suddenly after showing initial promises of decline in the past. Interestingly, it is usually during this part of the year that inflation shows a decline pointing to lower inflation trends going ahead. However, this becomes untrue as actual numbers emerge to be higher than projections.

Even the Review Statement does not really indicate aggressive rate cuts going ahead as is widely anticipated. The Review Statement is fairly balanced and maintains that though policy stance has to shift to growth but policy stance will remain sensitive to inflation risks. RBI also believes government measures will help boost growth prospects and might not require aggressive rate cuts.

Overall, we believe RBI is likely to ease policy rates by 25 bps in Jan-13 policy. If inflation trajectory continues as per recent readings, there is a possibility that RBI further cuts policy rates by 25 bps in Mar-13 Mid-Quarter Review as well.

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