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

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

- **Increase policy rates by 25 bps in line with our expectations**
 - ✓ Repo rate increased from 8.25% to 8.5%
 - ✓ Reverse Repo automatically adjusts to 7.5% from 7.25%.
 - ✓ Marginal Standing Facility (MSF) Rate at 9.5%
 - ✓ Bank Rate and Cash Reserve Ratio (CRR) remain at 6% each
- **Economic Projections**
 - ✓ RBI lowered the growth forecast for 2011-12 from 8% to 7.6% (in line with our expectations)
 - ✓ Inflation forecast is kept at 7% by Mar-12 end.
 - ✓ Money supply and Credit growth maintained at 15.5% and 18% respectively.
- **Forward guidance statement**
 - ✓ RBI says that “the likelihood of rate action in December’s review is relatively low”.
- **Development and Regulatory Policies**
 - ✓ In a landmark move, RBI deregulated the Savings Bank deposit rate of 4%
 - ✓ Issue guidelines on cash-settled 2 year and 5 year Interest Rate Futures
 - ✓ Set up a working group to deepen G-sec and interest rate derivative market

I. RBI Policy Decision - Growth vs. Inflation

In its Macroeconomic and Monetary Development Report released a day before the Monetary Policy, RBI mentioned that future monetary policy trajectory will be guided by emerging growth-inflation dynamics and ongoing impact of previous rate actions. The report highlighted that growth had moderated and inflation remains persistently sticky. The report highlighted in particular the moderation in growth of investments. Investments are the most crucial variable in India’s 8% and above growth plans. The document summed up saying the current state of economic affairs adds to further complexity in monetary policy.

In today’s monetary policy statement, RBI has broadly followed the tone of the macroeconomic report.

Growth

RBI has lowered the growth projection for FY 2011-12 from 8% to 7.6% factoring the impact of previous policy actions and slowdown in investments. In the macroeconomic report, RBI mentioned that slowdown in investments is because of multiple factors apart from rise in interest rates:

- With signs of global and domestic economy slowing down, firms are reluctant to expand capacities.
- The impact of perceived governance issues
- Business confidence has weakened due to wealth effects of the correction in equity prices.
- The embedded valuations for planned investment have turned lower than the irrational pricing seen in the past. This has also contributed to new corporate fixed investment falling.
- The decline in current investments could lead to decline in pipeline investments in coming years.

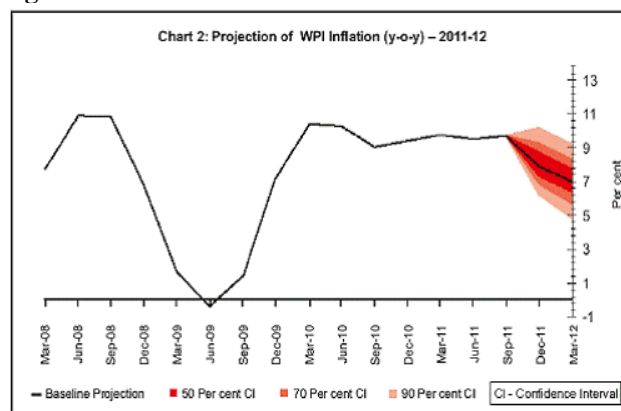


In the Monetary Policy, RBI has listed the same factors as reasons for decline in growth rate of investment in Indian economy. Slower global growth is also likely to lead to lower growth via the trade, finance and confidence channels. However given the strong growth in services and record agriculture production, RBI expects growth to remain around 7.6% for the FY 2011-12. This is broadly in line with our projections of growth for the year at 7.5%.

Inflation

Keeping in view the domestic demand-supply conditions and global trends in commodity prices, RBI has kept the baseline projection for WPI inflation for March 2012 unchanged at 7 per cent. It expects current elevated inflationary pressures to ease from Dec-11 onwards, though uncertainties about sudden adverse developments remain.

Figure 1



Source: RBI

Risks for both inflation and growth

- A major downside risk to growth emanates from the global macroeconomic environment. This could impact inflation as well on the downside.
- The future trajectory of crude oil prices and commodity prices to determine inflation. The weakening of global recovery has led to softening of crude prices but commodity prices remain elevated. The impact on growth and inflation will depend accordingly.
- The additional Government borrowing program can potentially crowd out more productive private sector investment. If the fiscal deficit is higher than the budgeted level it will have additional implications for both growth and inflation.
- Structural imbalances in protein-rich items such as egg, fish and meat will persist. In particular, production of pulses this year is expected to be lower than last year. Consequently, food inflation is likely to remain under pressure.
- Depreciation of the rupee has emerged as another risk for inflation. RBI analysis shows that Indian crude basket has declined by 7.9% between Jul-11 and Oct-11. However, Rupee has depreciated by 10.7% leading to a net rise of 2% in prices of oil imports.
- Indian economy continued to face suppressed inflation as prices are administered in petroleum sector. An increase in administered petroleum prices and electricity prices could lead to further rise in inflation.

Overall, the Policy has tilted more towards growth concerns in this policy. This was seen in yesterday's Macroeconomic and Monetary Developments Report and comes to light in the current policy. The policy stance (discussed later) also points to this shift in stance towards growth.



Monetary Aggregates

RBI highlights that current trends in money supply (M3), deposit and credit growth are above the indicative trajectories of the Reserve Bank. It expects that monetary aggregates will evolve along the projected trajectory indicated in the First Quarter Review of Monetary Policy. Projections for growth of M3 and non-food credit have been retained at 15.5% and at 18% respectively.

Based on above, RBI projections in three reviews in 2011-12 are given in Table 1.

	May-11	Jul-11	Oct-11
Growth (2011-12)	8	8	7.6
Inflation (Mar-12)	6 with upward bias	7	7
M3 (Mar-12)	16	15.5	15.5
Deposit (Mar-12)	17	--	--
Credit (Mar-12)	19	18	18
<i>Source: RBI</i>			

II. RBI Policy Stance

RBI has changed its policy stance in Oct-11 policy. The first point of the stance on inflation remains unchanged from May-11 but there is a change in the remaining two points on growth and liquidity.

- Growth:** In Jul-11 statement RBI stance was to manage the risk of growth falling significantly below trend indicating sacrifice in growth is needed to tame elevated inflation levels. This was suggested by the RBI officials in multiple forums as well. However, in Oct-11 the stance has shifted to stimulate investment activity to support raising the trend growth. This is important as RBI wants investments growth to increase pushing India's trend growth higher in medium and long term. However, RBI cannot really stimulate investment activity apart from lowering policy rates. The multiple factors highlighted above that have lowered investments have warranted this change in policy stance.

May-11	Jul-11	Oct-11
<ul style="list-style-type: none"> Maintain an interest rate environment that moderates inflation and anchors inflation expectations. Foster an environment of price stability that is conducive to sustaining growth in the medium-term coupled with financial stability. Manage liquidity to ensure that it remains broadly in balance, with neither a large surplus diluting monetary transmission nor a large deficit choking off fund flows. 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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.
<i>Source: RBI</i>		



- **Liquidity:** The liquidity stance changes from maintaining liquidity in balance in May-11 to ensuring that liquidity remains in moderate deficit to enable effective monetary transmission. RBI has earlier indicated that it plans to keep deficit in deficit of be 1% of NDTL which is around 60,000 Cr. This is consistent with RBI statements that monetary transmission is more effective in liquidity deficit. If liquidity turns into surplus mode RBI could use Market stabilisation scheme (MSS) bonds and cash reserve ratio (CRR) to bring it back in deficit. Alternatively, if it crosses the moderate deficit zone to a more excessive one, it might use Open Market Operations to bring it back to moderate deficit levels.

III. Forward Guidance Statement

It is always a dilemma for central banks on whether and how much to disclose in respect of future calibrations of Monetary Policy. In its October 2010 Policy, RBI had indicated:

Based purely on current growth and inflation trends, the Reserve Bank believes that the likelihood of further rate actions in the immediate future is relatively low. However, in an uncertain world, we need to be prepared to respond appropriately to shocks that may emanate from either the global or domestic environment.

This was followed by a pause in Dec-10 Mid Quarter Review as WPI inflation for Nov-10 declined from 9.1% in Oct-10 to 8.2% in Nov-10. This led to expectations that inflation will moderate going forward leading to inflation of around 5.5% by Mar-11. However, Nov-10 inflation was just a one time number and inflation reversed to touch 9% in Dec-10 and end the year at 9.68%, much higher than RBI's revised projection of 8%. The sudden shock came from rise in food prices which persisted leading to a more generalized inflation.

In Oct-11 policy, RBI has issued a near similar statement:

".....notwithstanding current rates of inflation persisting till November (December release), the likelihood of a rate action in the December mid-quarter review is relatively low. Beyond that, if the inflation trajectory conforms to projections, further rate hikes may not be warranted. However, as always, actions will depend on evolving macroeconomic conditions."

This time RBI expects inflation to decline a month later viz. from Dec-11 onwards. But overall economic conditions remain broadly as last year. Food prices have again started to rise in the past few weeks and some key commodities like cotton prices are rising which will feed into manufactured textiles. The government has also raised Minimum Support Prices (MSP) feeding further into food inflation. The pulses production in 2011-12 is expected to be lower than last year and pulses form a major portion of the protein inflation. This food inflation is expected to remain elevated and could actually increase given that resolving supply side issues takes a long time. The food inflation then leads to rise in inflation expectations which then results in a more generalized inflation.

RBI in a welcome change has become more transparent in its communications, which is in line with best practices adopted by global central banks. However, central bank transparency is not an island and needs support of many other factors and policies. With questions over credibility of statistical system, loose fiscal policy and several governance issues, the future guidance is difficult to interpret despite the best intentions of Central Bank.



IV. Deregulating Savings Bank Deposit Interest Rate

In a significant move, RBI decided to deregulate the interest rate offered on savings deposits with immediate effect. This along with Small Savings Schemes forms the administered interest rate products. There have been reports of Government looking at deregulating the small savings schemes as well. This together with bank deposit deregulation will usher in an environment of complete deregulation of interest rate markets in India.

RBI announced that banks are free to determine their savings bank deposit interest rate, subject to the following two conditions:

- First, each bank will have to offer a uniform interest rate on savings bank deposits up to `1 lakh, irrespective of the amount in the account within this limit.
- Second, for savings bank deposits over `1 lakh, a bank may provide differential rates of interest, if it so chooses. However, there should not be any discrimination from customer to customer on interest rates for similar amount of deposit.

In a concept paper released in Apr-11 RBI discussed deregulation of this interest rate product. The major advantage would be it will help in better transmission of monetary policy as all interest rates will move in tandem with policy rates. If one interest rate market is regulated or administered, it impedes monetary transmission. Savings accounts form 22% of total deposits and the rates have not changed since 2003. This implies the changes in policy rates have not transmitted to savings deposit rates. It is also likely to make savings deposits more attractive to customers and usher product innovations. The cons are it could lead to unhealthy competition amidst banks to garner more deposits by offering higher rates and lead to asset liability mismatches as banks use these to fund long-term projects.

Over a short term, this measure will pose problems to the banking system as their cost of deposits likely to rise which could be translated to higher credit rates as well. This will also indirectly help in monetary transmission as rates tighten further. Over a long term, international experience shows that deregulation of this product leads to more effective monetary transmission. There will be some initial glitches with respect to its implementation but is likely to benefit both banks and customers.

V. Summing Up

RBI's policy of raising Repo rate by 25 bps was on expected lines. The change in this policy has been the clear shift towards slowing growth and RBI's concern for the same. Within growth parameters, it is slowdown in investments which is a major concern for RBI as investments are key to India's 9% plus growth plans. Though, task of taming inflation is still not in the bag and could easily resurface and complicate the policy outlook. RBI has indicated that probability of rate action in Dec-11 review is low, but inflation could easily overturn this expectation.



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