STCI
Primary Dealer Ltd.

Review of the First Quarter Monetary Policy Statement 2011-12

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Key Highlights:

- Repo rate hiked by 50 bps from 7.5% to 8%
- Reverse Repo rate stands hiked to 7% from 6.5% (dependent variable on the Repo rate – 100 bps below the Repo rate)
- CRR kept unchanged at 6%
- SLR kept unchanged at 24%
- MSF stands calibrated at 9% (100 bps above the Repo rate)
- GDP growth projection for FY 2011-12 kept unchanged at around 8%
- FY 2011-12 March end WPI inflation baseline projection revised upwards to 7% from the earlier 6% with an upward bias
- M3 growth projection revised downwards to 15.5% from 16% and non-food credit growth at 18% from 19% earlier
- Bank rate kept unchanged at 6%

The Macroeconomic and Monetary Developments released by RBI ahead of the monetary policy review highlighted the need to tame inflation via a continued anti-inflationary stance. However, coming in as a surprise and in an absolute hawkish stance, the RBI took extremely stiff action to support its assessment of the economy. The RBI in its First Quarter Review of Monetary Policy 2011-12 raised the Repo rate by a steep 50 bps, marking a second 50 bps hike in a single quarter and a cumulative of 125 bps within a span of 3 months since May. The policy recognizes a marginal slowdown in growth, however, highlights several upside risks to inflation and hence deems appropriate the 50 bps hike.

Backdrop of the Policy Review:

- Inflation dominant concern

The broad contours that have shaped the RBI's First Quarter Review of Monetary Policy are based on the inflation and growth dynamics in the economy, with emphasis on the discomforting inflation. RBI recognizes the strong demand pressures that become evident in the high non-food manufacturing inflation. The policy states that despite the expectation of high inflation for the first half of the fiscal in the Annual Policy, the actual price pressures have remained higher. The Central Bank further fears upside risks to inflation on the food and the fuel front. On the growth front, the RBI notes the slowdown, however deems it not sharp enough or broad based to not persevere with the anti-inflationary stance. It mentions the gradual slowdown in several growth parameters such as tax collections, corporate sales and earnings and demand for bank credit. It however concludes that demand side inflationary pressures prevail and demand action. The review highlights that high inflation harms investments and hence is unfavorable for growth. The RBI strongly believes that controlling inflation is imperative both for sustaining growth over the medium term and for increasing the potential growth rate. It believes that moderating growth will help ease inflationary pressures.

Domestic outlook:

- Inflation projection for March end FY 2011-12 revised upwards to 7%

The policy mulls that since the May 3rd policy, several upside risks to inflation have materialized and led to price pressures, viz. hike in petrol, diesel and kerosene prices which apart from the direct impact would going ahead have second round effects. Other factors such as a possible rise in the minerals category due to higher crude prices would also lead to higher fuel inflation. On the food inflation, the hike in the MSPs of some agricultural products would exert upward pressure. Further on the manufactured products side pass through of higher commodity prices into more generalized inflation remains significant.

Apart from the existing price pressures, going ahead the inflation would face upside risks from the pan out of monsoon, the global crude oil price, the containment of the fiscal deficit in terms of the fiscal slippage on the subsidy front, and probable rise in administered prices such as that of electricity. The RBI expects the inflation to remain high going ahead in wake of high global commodity prices, stronger demand in emerging economies and inadequate supply response with regards to food items on the domestic front. Accordingly, the baseline projection for WPI inflation for end March 2012 is revised higher to 7% as against 6% with an upward bias projected earlier.

- GDP growth forecast for FY 2011-12 retained at 8%

On the growth front, the Central Bank points towards signs of moderation that have emerged in the Indian economy. The RBI expects GDP growth to moderate in wake of several reasons, viz. 1. Slowdown in global growth and sluggishness in advanced economies tracking weak labour and housing market 2. Lingering soveriegn debt crisis 2. High oil and other commodity prices 3. Anti-inflationary monetary stance to weigh on growth in terms of lower investments 4. Decline in business sentiment reflected from surveys 5. Uncertainty with regards to external demand if global recovery slackens. The RBI however also highlights several parametrs that mark a strong performance, viz. exports and imports, the IIP growth rate as tracked by the new base, the foreign direct investment and the overall accreation to the Balance of payments. The RBI affirms that the slowdown in growth would be moderated by the overall buoyant consumption (in wake of higher wages). The real GDP growth projection is thus retained at around 8% (broadly projected in the range of 7.5% and 8.3% as against 7.4% and 8.5% projected in May).

- M_3 growth projected at 15.5%

- Non-food credit growth at 18%

Bearing in mind the evolving growth inflation dynamics the M3 growth projection has been revised downwards to 15.5% from 16%. Non-food bank credit growth is also revised downwards to 18% from 19% projected in the annual policy.

Monetary Policy Stance:

Considering the growth inflation dynamics the policy stance lays primary focus on moderating inflation and anchoring inflation expectations whilst assuming a marginal slowdown in growth. The Review thus explicitly highlights the policy stance as follows:

1. Maintain an interest rate environment that moderates inflation and anchors inflation expectations
2. Manage the risk of growth falling significantly below trend
3. Manage liqudity to ensure that monetary transmission remains effective, without exerting undue stress on the financial system

The stance has been altered substantially from the May policy with respect to the domestic growth. The current policy hints that slowdown in growth is a given and the measures are aimed at limiting the downfall.

Policy Measures:

- Repo rate hiked by 50bps to 8%

The policy lays emphasis on how inflation has remained persitently high and much above the comfort level of RBI. Citing several factors that would keep the inflationary pressures high in the Indian economy going ahead, the policy states that there is a clear need to persist with the anti-inflationary stance. The Central Bank, thus, deems appropriate to raise the Repo rate by 50 bps.

As per the operating procedure of Monetary policy the Reverse Repo rate stands adjusted upwards by 50 bps to 7% (fixed at 100 bps below the Repo rate). Similarly the the Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, stands recalibrated at 9% with immediate effect. The CRR remains unchanged at 6%.

The way ahead:

The policy marks a highly hawkish stance, aiming to tame inflation amidst some moderation in growth. The policy mentions several upside risks to inflation amidst downside risks to growth going ahead. The policy hints that further action from the RBI would be highly dependent on the pan out of inflation and growth data. The expectations from the policies ahead become difficult to gauge at the current juncture, with the economy being subjected to stiff tightening in a short span. The impact of earlier measures and the pan out food and fuel prices would have to be assessed before taking a call on the mid-quarter review in September. However, a 25 bps hike going ahead seems most likely given that inflation pressures would continue to persist tracking the global commodity prices.

Fixed Income & Macro-Economic Research

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