Review of the Third Quarter Monetary Policy Statement 2010-11

Meghna Patel
meghna@stcipd.com
022 66202229

Key Highlights:

- Repo rate hiked by 25 bps from 6.25% to 6.5%
- Reverse Repo rate hiked by 25 bps from 5.25% to 5.5%
- CRR kept unchanged at 6%
- SLR kept unchanged at 24%
- Bank rate kept unchanged at 6%
- GDP growth projection for FY 2010-11 kept unchanged at 8.5%, however an upward bias added to earlier projections
- FY 2010-11 March end WPI inflation projection revised upwards to 7% from 5.5%

Contrary to the extremely hawkish stance reflected in the macroeconomic and monetary developments report released a day earlier, the Third Quarter Review of the Monetary Policy statement FY 2010-11 reveals the fact the RBI has chosen to tackle the current macroeconomic scenario with the aid of gradual monetary tightening treading ahead with baby steps. The Review retains a hawkish stance and reiterates the need for the domestic monetary policy to curb inflationary pressures whilst the global recovery appears to be improving.

Backdrop of the Policy Review:

- Inflation key concern

The RBI Governor unveiled the Third Quarter Review of Monetary Policy statement 2010-11 amidst recognition of the consolidation in recovery in the advanced economies and the inflationary pressures in the emerging economies. The policy notes the firm economic activity on the domestic front. It highlights concerns over the transitory as well as the structural components of inflation and its impact on inflationary expectations in a growing economy. The policy asserts that the current rate of inflation is clearly the dominant concern and hence continues the process of taming inflationary pressures.

Domestic outlook:

The policy mulls concern over the reversal in WPI trend from a slowdown till November to a rise recently. It attributes the spike in food prices as transitory, however cautions against structural factors such as demand-supply mismatches. It highlights upside risks to headline inflation going ahead in all the three major components of WPI. Rising food prices globally would put
Pressure on domestic primary articles inflation. The policy notes the rise in oil prices even with a sluggish global recovery and expects the same on an uptrend in case recovery gains momentum. The RBI expresses concern over the demand side pressures in the domestic economy leading to spillover of rising food and fuel prices into core inflation. Amidst the strong domestic growth momentum the review mentions the pricing power with workers and producers hinting at a wage price spiral. It highlights factors such as the sticky nature on non-food manufacturing inflation, rising domestic demand, capacity constraints and increase in household inflationary expectations that could lead to an uptrend in inflation. Accordingly, the baseline projection for WPI inflation for end March 2011 is revised to 7% from the 5.5% projected in the earlier policy.

The Central Bank recognises the firm and broad-based consolidation in domestic growth, operating close to its pre-crisis trend growth rate. It highlights the robustness in growth tracking strong domestic demand, specifically the private consumption and investment and improving external demand. The policy highlights the improved sentiment reflected in the robust corporate sales, large tax revenues, bank credit being above the projected trajectory, improved leading indicators for services sector, good kharif harvest, a promising rabi crop, greater rural demand in wake of higher agriculture growth and improved export performance. The policy adds an upward bias to the earlier projection of 8.5% GDP growth for FY 2010-11.

The policy lays emphasis on price stability without disrupting growth. The Central Bank recognises that domestic economy is on a strong footing and inflation remains high and uncomfortable. The RBI however adopts a cautious stance stating that growth in emerging economies may moderate due to tightening of monetary policy (in a bid to tame inflation) and the waning impact of stimulus measures provided post crisis. The RBI mentions the moderation in the overall business expectations for Jan-Mar 2011 expected by the Industrial Outlook Survey as well as the moderation in the pace of manufacturing growth observed in December 2010. The Central Bank mentions that going ahead growth may stabilize and GDP growth rate may decline as agriculture reverts to its trend. The RBI thus refrains itself from raising rates by a steep 50 bps. The Central Bank, thus, deems appropriate to raise the Repo and Reverse Repo rate by 25 bps each.

The policy notes that M3 growth at 16.5% remains close to its projection in wake of measures taken to inject primary liquidity into the system and faster currency expansion. It also recognizes
that the growth in credit at 24.4% has far outpaced the deposit growth as well as the indicative projections. The review highlights the need for credit to moderate to the projected trajectory as the same cannot be sustained without a commensurate increase in deposits. The RBI retained its M3 growth projection for FY 2010-11 at 17% and non-food credit at 20%.

**Monetary Policy Stance:**

Considering the growth inflation dynamics the policy stance lays emphasis on balance of risk tilting towards intensification of inflation. With positive outlook on growth, the RBI has chosen to hike rates to tame price pressures. With this stance, the Central Bank intends to contain the spill-over from rise in food and fuel prices to generalized inflation and rein in rising inflationary expectations while not disrupting growth.

The Review thus explicitly highlights the policy stance as follows:

1. Contain the spill-over of high food and fuel inflation into generalised inflation and anchor inflationary expectations, while being prepared to respond to any further build-up of inflationary pressures
2. Maintain an interest rate regime consistent with price, output and financial stability
3. Manage liquidity to ensure that it remains broadly in balance, with neither a surplus diluting monetary transmission nor a deficit choking off fund flows

The stance is on similar lines to that mentioned in the November policy. The specific change being, the January policy also mentions the need to contain the spill-over effect of inflation due to several transitory factors into generalised and prolonged inflationary pressures. The same reflects a great concern over the chances of taming inflation being a challenge for quite some time going ahead.

The RBI reaffirms that tight liquidity aids effective monetary transmission. The RBI indicates that liquidity is expected to ease as Government draws down on its cash balances.
**Risk factors:**

The policy highlights several risk factors pertaining to the Indian economy:

- **Inflation:** Upside risks in inflation tracking several reasons cited earlier. Higher and widespread food prices increasing the prospect of it spilling over to general inflation. Increase in demand side pressures in wake of sticky and persistent non-food manufacturing inflation operating close to capacity levels.

- **Current account deficit:** The widening deficit remains a concern. Higher global commodity prices may further make imports costlier and accentuate the current account deficit. Amidst improving prospects for global growth, the extent of capital flows that currently fund the domestic deficit may decline and lead to a greater current account deficit.

- **Fiscal Consolidation:** The current year has marked several windfall gains on the revenue front which have helped contain the fiscal deficit. Amidst rising prices, the RBI perceives inflation management to get complicated going ahead and hence mentions the need for fiscal consolidation for monetary policy to work efficiently.

**The way ahead:**

The policy marks a hawkish stance, aiming to tame inflation while at the same time allowing the growth trajectory to be maintained. The policy mentions several upside risks to inflation amidst a well anchored growth going ahead. The policy highlights the limitations of the Central Bank to tame supply side pressures amidst a loose fiscal scenario. In a bid to further tame inflation, we expect the RBI to probably continue with the tightening process in its mid-quarter policy in March by a 25 bps hike in the key rates.