ICRA Comments on the RBI's Third Quarter Review of Monetary Policy for 2011-12 – January 2012

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Highlights of the RBI's Third Quarter Review of Monetary Policy for 2011-12 – January 2012

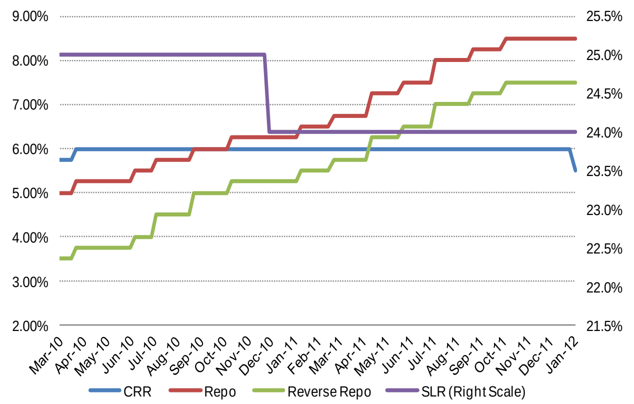
- Cash Reserve Ratio (CRR) reduced by 50 basis points (bps) to 5.5% of net demand and time liabilities (NDTL), with effect from January 28, 2012; to infuse primary liquidity of Rs. 32,000 crore into the system.
- Benchmark Repo Rate maintained at 8.50%; Reverse Repo and Marginal Standing Facility (MSF) stand unchanged at 7.50% and 9.50%, respectively.
- Bank Rate and Statutory Liquidity Ratio maintained at 6% and 24% of NDTL, respectively.
- Monetary policy stance shifts towards growth, while maintaining a focus on containing inflationary pressures.
- Baseline projection for FY12 GDP growth revised further downwards to 7% from 7.6% (indicated in the Second Quarter Review, October 2011) and 8% (indicated in the Annual Policy Document, May 2011).
- Baseline projection for headline inflation for March 2012 retained at 7%, even as various risks highlighted.
- Government of India urged to hasten the introduction of policy measures to improve the investment climate and revert to fiscal prudence in order to contain inflationary pressures in the economy.
- Baseline projection for non-food credit growth for FY12 revised to 16% from 18%, given slowing economic activity, lagged impact of cumulative monetary transmission and increasing risk aversion by Banks.
- Baseline projection for broad money (M3) growth for FY12 retained at 15.5%.

CRR reduced by 50 bps; Repo rate unchanged at 8.5%

Since January 2010, the RBI had raised the benchmark Repo rate 13 times by 375 basis point and the CRR by 100 basis with a focus to contain inflation and anchoring inflationary expectations points. With a slowdown in domestic and global growth, the Reserve Bank of India (RBI) left the policy rate unchanged in its Mid-Quarter Review in December 2011.

However, with systemic liquidity displaying a considerable tightness since mid-November 2011 despite considerable open market purchases of Government securities (G-sec) and heightened concerns on growth, the RBI reduced the CRR by 50 bps in its Third Quarter Review of Monetary Policy.

Chart 1: Movement in Key Rates



Source: RBI

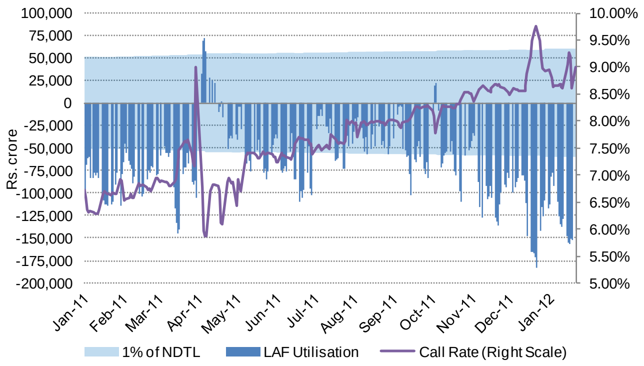
While acknowledging the downside risks to growth, the RBI kept the benchmark Repo rate unchanged at 8.5%, in line with ICRA's expectations, citing upside risks to its projection that headline inflation would moderate to 7% by March 2012. While inflation moderated in December 2011, the risks to inflation remain on the upside because of various factors, including the incomplete pass through of the depreciation of the rupee; anticipated adjustment in prices of fuel items on account of suppressed inflation; and the anticipated increase in fiscal deficit beyond the budgeted levels. The Central Bank indicated that a reduction in the policy rate would take place subsequent to signs of a sustainable moderation in inflation. Consequently ICRA does not expect any reduction in Repo rates in the immediate term.

Systemic liquidity remains substantially higher than RBI's stated comfort zone on account of higher government borrowing and RBI's intervention in the forex markets

Systemic liquidity tightened significantly towards the latter half of November 2011 and LAF utilisation has remained consistently in excess of RBI's stated comfort zone of +/-1% of NDTL. The average LAF utilisation increased to Rs. 120,000 crore in January 2012 from Rs. 117,000 crore in December 2011 and Rs. 92,000 crore in November 2011.

The liquidity deficit reflected the increase in the Government of India's borrowing programme in H2FY12 beyond the budgeted levels, as well as the sale of foreign currency assets by the RBI to stabilise the value of Rupee. Moreover, the liquidity deficit has widened since November 2011 despite the infusion of over Rs. 70,000 crore through open market operations (OMOs) since late-November 2011. The inter-bank call rates remained close to the Repo rate up to November 2011, but exceeded 9.5% (the prevailing MSF rate) in the second half of December 2011. Subsequently, the inter-bank call rates have remained higher than Repo rate.

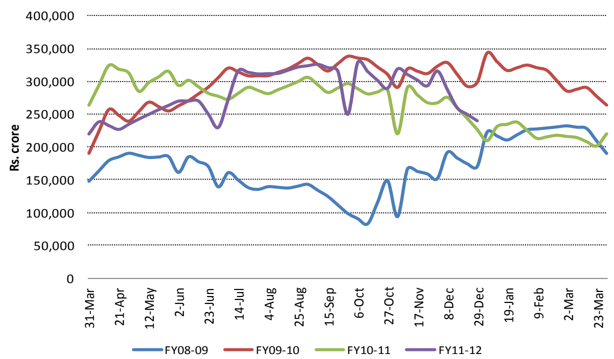
Chart 2: Daily LAF outstanding



Note: Negative amounts indicate injection of liquidity by RBI

Source: RBI

Chart 3: Excess SLR in the Banking System



Source: RBI

The Central Bank highlighted that the substantial systemic liquidity deficit warrants an injection of permanent primary liquidity into the system. While this action would infuse around Rs. 32,000 crore of primary liquidity, the Central Bank stressed that this was not inconsistent with the prevailing stance of monetary policy. The preference for a CRR cut as opposed to further open market operations seems to be aimed at improving the confidence levels of industry and market players given the moderation of economic growth.

The CRR cut in the current policy review would ease pressures on liquidity and RBI may not resort to further through Open Market Operations (OMOs), at least in the current financial year.

Banks average excess SLR investments (including Reverse Repo) dropped marginally to around Rs. 2.5 lakh-crore in December 2011 from 2.7 lakh-crore in H1FY12. The average SLR levels remained around 29% of NDTL as against the mandated 24%.

Baseline projection of real GDP growth for 2011-12 revised to 7.0% from 7.6%

The pace of growth of gross domestic product (GDP) at factor cost (constant prices) moderated to 6.9% in Q2FY12 from 7.7% in Q1FY12, led primarily by a decline in the pace of industrial growth. The Index of Industrial Production (IIP) recorded sluggish 0.5% growth in October-November 2011, lower than the 3.0% growth in Q2FY12, led by a weaker performance of all use-based categories except consumer non-durables.

The Central Bank attributed the slowdown in industrial growth and sluggish investment demand to various domestic factors, such as high interest rates, policy uncertainties, high fiscal deficits etc. as well as concerns regarding the worsening outlook for global growth. The RBI indicated that the services sector too may see some moderation in growth on account of inter-sectoral linkages. The Central Bank indicated that capacity utilisation remained at similar levels in Q2FY12 as compared to Q1FY12, while business expectations improved slightly in Q3FY12. At present, sowing for the *rabi* season remains lower than in 2011. Based on these factors, the Central Bank revised the baseline projection for GDP growth for FY12 for the second time to 7.0%, from 8.0% (as indicated in the First Quarter Review) and 7.6% (as indicated in the Annual Policy Document). The Central Bank indicated that in its baseline scenario, GDP growth may display a modest recovery in FY13.

The RBI emphasised that various domestic issues that have had an adverse impact on the investment climate need to be addressed vide policy actions to support investment, which would support economic growth and also ease some supply side impediments to inflation.

Moreover, the Central Bank highlighted that in the absence of a credible solution to the sovereign debt problems afflicting the European economies, Indian economic growth may be impacted through the trade, finance and confidence channels. Additionally, the RBI emphasized that a fall in the magnitude of capital inflows into India following the uncertain global conditions poses a concern, given the size of the current account deficit, which is characterized by relatively inelastic oil imports.

Overall, ICRA expects the Indian economy to expand by 6.8-7.0% in FY12, similar to the baseline projection of 7.0% GDP growth for FY12 made by the RBI. In our view, economic growth may ease further in the coming fiscal, even if the monsoon conditions are favourable, given the slowdown in concrete announcements of fresh projects and capacity enhancement in the recent months.

Baseline projection of headline inflation easing to 7% by March 2012 maintained despite risks

Headline wholesale price index (WPI) inflation has declined from an average 9.7% in April-October 2011 to 9.1% in November 2011 and 7.5% in December 2011. The Central Bank highlighted that while inflation moderated in December 2011, aided by a decline in primary food inflation led by an easing of vegetable prices, inflation related to non-food manufactured products remained eased somewhat but remained substantially elevated. The rate of inflation related to non-food manufactured products declined somewhat on a year-on-year (y-o-y) basis to 7.7% in December 2011 from 8.1% in October 2011 and 8.0% in November 2011. The index levels increased or remained unchanged for nine of the 11 sub-groups of non-food manufactured products on an m-o-m basis in Dec 2011, highlighting the persistence of inflationary pressures, partly related to the depreciation of the Indian rupee. Moreover, the Central Bank cautioned that based on the past trend, inflation related to non-food manufactured products is likely to be revised upwards for the months of November 2011 and December 2011.

While the RBI cut its baseline projection for economic growth for FY12, it maintained its baseline projection that WPI inflation would ease to 7% by March 2012. The Central Bank highlighted that risks to inflation remain on the upside because of various factors. Such factors include the incomplete pass through of the depreciation of the rupee; anticipated adjustment in prices of fuel items (particularly administered petroleum products and coal) on account of suppressed inflation; possibility of a further increase in crude oil prices given geo-political factors; double-digit inflation related to protein items, which imparts a structural rigidity to food inflation; and the anticipated increase in fiscal deficit beyond the budgeted levels.

ICRA continues to expect headline inflation to ease to around 7% by March 2012, following an anticipated moderation in demand-side pressures in line with the slowing economic growth. However, a reversal in the recent appreciation of the rupee may exacerbate prices of imported commodities and inputs, fuelling inflationary pressures. Food inflation is expected to remain below 1% in January 2012, given the base effect, before rising to around 6-6.5% in March 2012.

Chart 4: WPI Inflation (y-o-y, Monthly)

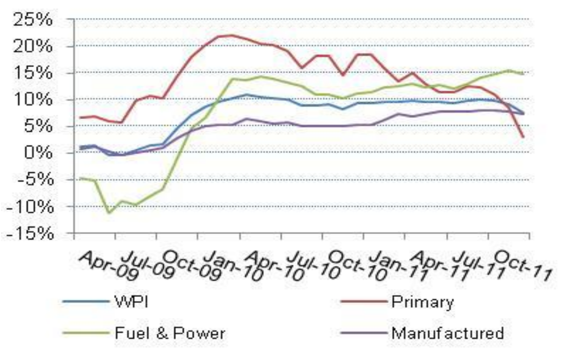


Chart 5: Food Inflation (y-o-y, Weekly)

Source: Office of the Economic Advisor, Ministry of Commerce and Industry, Government of India

The Central Bank indicated that in its baseline scenario, headline inflation may moderate further to an extent in FY13, while remaining susceptible to the aforementioned risks. The RBI emphasized that notwithstanding the persistently high inflation rate over the past two years, average inflation stood at around 5.5% in the 2000s, lower than the earlier trend rate of about 7.5%. Accordingly, the RBI indicated that conduct of monetary policy will continue to condition and contain perceptions of inflation in the range of 4.0-4.5%, in line with the Central Bank's medium-term objective of 3.0% inflation.

Guidance reiterates that future actions would lower policy rates

Given the risks to inflation, particularly on account of suppressed inflation in certain fuel items, the Central Bank concluded that it is premature to reduce policy rates at present, while maintaining the guidance that future actions would lower policy rates. Moreover, the RBI indicated that the timing and magnitude of future rate actions would depend on a number of factors, including policy actions to support investments that would ease supply constraints in food and infrastructure and clear signs of fiscal consolidation to create fiscal space for infrastructure spending.

The RBI exhorted the Government of India to revert to fiscal consolidation in a credible and sustainable manner in the upcoming Union Budget, in the absence of which it may be constrained from reducing the Repo rate despite the moderating investment and consumption growth.

The indicated stance of monetary policy was modified to 'respond to increasing downside risks to growth' in the Third Quarter Review, as compared to 'stimulate investment activity to support raising the trend growth' in the Second Quarter Review.

Third Quarter Review	Second Quarter Review
• Maintain an interest rate environment to contain inflation and anchor inflation expectations.	• Maintain an interest rate environment to contain inflation and anchor inflation expectations.
• Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.	• Stimulate investment activity to support raising the trend growth.
• Respond to increasing downside risks to growth.	• Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.

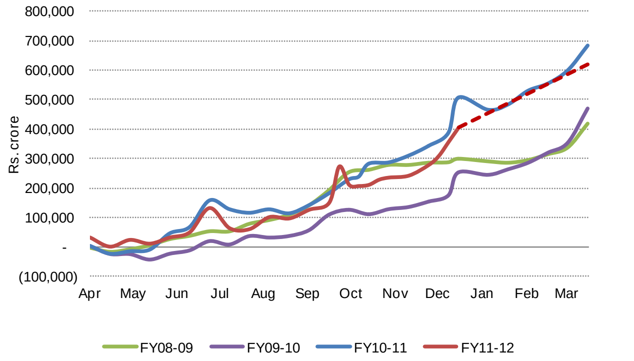
The Central Bank indicated the following expected outcomes of its monetary measures and guidance:

Third Quarter Review	Second Quarter Review
• Ease liquidity conditions.	• Continue to anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.
• Mitigate downside risks to growth.	• Reinforce the emerging trajectory of inflation, which is expected to begin to decline in December 2011.
• Continue to anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.	• Contribute to stimulating investment activity.

Credit growth estimate scaled down to 16%

RBI has scaled down its credit growth estimate for FY12 to 16% from 18% earlier, as a result of the slowdown in the private sector credit off-take in the current fiscal year. Systemic credit growth moderated to 15.8% (y-o-y) as on December 30, 2011, from 21% as on September 30, 2011 in a lagged response to the series of rate hikes effected by RBI since March 2010, slowing economic activity and increasing risk aversion by Banks.

Chart 6: Credit Growth (Financial year-to-date)



Source: RBI; ICRA Research

Systemic non-food credit stood at Rs. 42.81 lakh-crore as on December 30, 2011 registering YTD growth of 10.5% compared to 15.8% during the same period in FY11. Banking system credit needs to expand by Rs. 2.13 lakh-crore in Q4FY12 to reach the projected 16% growth for the year.

While interest rates continue to remain high, credit off-take in Q4 of every fiscal in the past has been higher than the first three quarters put together (Rs. 1.77 lakh crore in FY11 and Rs. 2.17 lakh-crore in FY10) and ICRA expects systemic credit growth to reach RBI's projection in the current fiscal, even without any support in the form of reduction in interest rates. Nonetheless, the absolute credit growth for the full year is likely to fall short of the Rs. 6.82 lakh-crore growth recorded in FY11.

Overall Comment

The RBI cut the CRR by 50 bps to 5.5% of NDTL to address the systemic liquidity deficit that remains above its stated comfort levels and support the flow of credit to various sectors of the economy given the heightened concerns on growth indicators. In a welcome development, the Central Bank highlighted a shift in the monetary stance towards growth concerns. The RBI also urged the Government of India to hasten the introduction of policy measures to improve the investment climate and revert to fiscal prudence in order to contain inflationary pressures in the economy. Given the RBI's concerns that rupee depreciation and adjustment in prices of fuel items on account of suppressed inflation may stoke inflationary pressures, we expect the Central Bank to refrain from announcing further open market purchases of Government securities in the near term, keep the repo rate unchanged in Q4 2011-12, and embark on monetary easing in April 2012.

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