



ICRA's Comments on the RBI's Mid-Quarter Monetary Policy Review, September 2011

Contact

Karthik Srinivasan
karthiks@icraindia.com
+91-22-30470028

Vibha Batra
vibha@icraindia.com
+91-124-4545302

Aditi Nayar
aditin@icraindia.com
+91-124-4545385

Avinash P
avinashp@icraindia.com
+91-44-45964311

Key Highlights

- Benchmark Repo Rate hiked by 25 basis points (bps) to 8.25%
- Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) kept unchanged at 6% and 24%, respectively, of net demand and time liabilities (NDTL) of Scheduled Commercial Banks (SCBs)
- Bank Rate kept unchanged at 6%
- Containing inflation and anchoring inflationary expectations remain the key focus of monetary policy with inflation remaining high, generalised and substantially in excess of the Central Bank's comfort zone
- Downside risks to growth projection for 2011-12 made by the RBI in July 2011, led by moderating domestic demand and impact of weakening global growth momentum and rising uncertainty
- Liquidity remains in deficit in line with the stance of monetary policy
- The monetary stance of the Reserve Bank of India (RBI) likely to be influenced by signs of downward movement in inflation trajectory and repercussions of global events

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Repo Rate hiked by 25 bps to reinforce past policy tightening and anchor inflationary expectations

The RBI increased the Repo Rate by 25 bps to 8.25%, with immediate effect, in line with ICRA's expectations. As anticipated, the Central Bank maintained its anti-inflationary policy stance and focussed on containing domestic inflationary expectations given that inflation remains elevated, generalised and has persistently exceeded the RBI's comfort zone.

The current rate hike was undertaken by the RBI in spite of the expected adverse effect on the momentum of domestic economic growth, from the lagged impact of substantial policy tightening over the past 18 months as well as an anticipated decline in growth of Indian exports following heightened uncertainty over the global growth outlook.

Since March 2010, the Repo Rate has been raised by a cumulative 350 bps, despite which the non food credit growth for the Banking system remains robust at 20.1% in August 2011, higher than the RBI's indicative projection of 18% for FY12. Systemic liquidity remains in deficit, in line with the RBI's stance. Since the last policy review in July 2011, the extent of the liquidity infusion under the RBI's Liquidity Adjustment Facility (LAF) has largely remained within the RBI's comfort zone of +/-1% of NDTL, except on certain days in September 2011 due to pressures related to the advance tax payments.

Inflationary pressures persist; weakening consumer demand may ease pressures in the coming months

Headline inflation related to the wholesale price index (WPI) rose to 9.78% in August 2011 from 9.22% in July 2011, with an acceleration in inflation related to several major categories within the WPI index, highlighting the presence of generalised inflationary pressures in the economy. Additionally, an increase in the index levels for seven of the 11 groups within non-food manufactured products in month-on-month terms in August 2011 emphasizes that inflationary pressures remain fairly widespread.

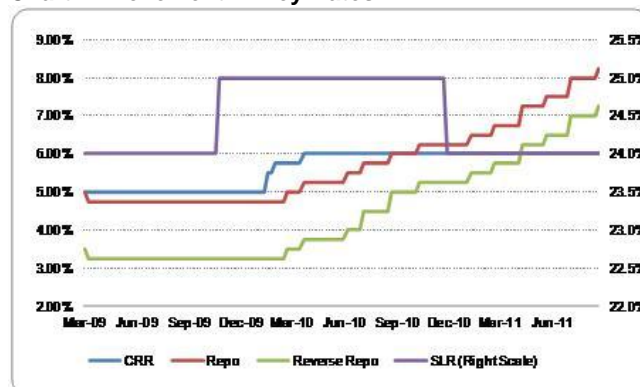
Table 1: Trends in WPI inflation in July and August 2011

	Weight	Jul-11	Aug-11	Change
WPI	100.00	9.22%	9.78%	0.56%
Primary Products	20.12	11.30%	12.58%	1.27%
- Food	14.34	8.19%	9.62%	1.43%
- Non Food	4.26	15.51%	17.75%	2.24%
- Minerals	1.52	25.03%	23.43%	-1.60%
Fuel & Power	14.91	12.04%	12.84%	0.79%
Manufactured Products	64.97	7.49%	7.79%	0.30%
- Food	9.97	7.55%	8.05%	0.49%
- Non Food	55.00	7.53%	7.77%	0.24%

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

The RBI noted the persistence of high food inflation despite a normal monsoon, highlighting the rigidity imparted by structural mismatches in supply and demand of some food items. Notably, the rise in food inflation in August 2011 was primarily led by higher inflation related to vegetables, fruits and non-vegetarian protein products. Although the annual inflation rate for pulses remains negative, the price index has displayed a considerable increase since June 2011. With the area sown under pulses

Chart 1: Movement in Key Rates



Source: RBI

currently lower than the same reported at the end of August 2010, the domestic demand-supply imbalance may widen in the current year, resulting in a continued rise in wholesale prices of pulses in the coming months and a higher dependence on imports. Additionally, the recent depreciation of the rupee reflecting rising risk aversion in response to the heightened global uncertainties, are expected to make imported goods more expensive in the near term. However, this trend may reverse following higher capital inflows in response to the widening differentials in interest rates (as a result of the significant monetary tightening pursued by the RBI relative to other Central Banks) and substantial disparity in economic growth rates (notwithstanding the anticipated moderation in economic growth in India) relative to the Advanced Economies.

The RBI highlighted that the pass-through of higher input prices into domestic fuel and electricity prices remains incomplete. The Central Bank pegged the direct impact of the recent upward revision of Rs. 3.14 per litre in petrol prices at 7 bps; ICRA notes that the indirect impact of higher petrol prices on inflation would be limited as compared to a similar rise in prices of diesel or coal. However, the RBI indicated that the moderation in crude oil prices has been modest so far in light of the weakening global economic outlook, and suggested that stabilising energy prices may ease inflationary pressures in the coming months.

Moreover, the Central Bank also suggested that a weakening consumer demand, partly in response to the lagged effect of the substantial policy tightening that it has undertaken, is expected to contribute towards a moderation of headline inflation in the coming months.

Chart 2: WPI Inflation (y-o-y, Monthly)

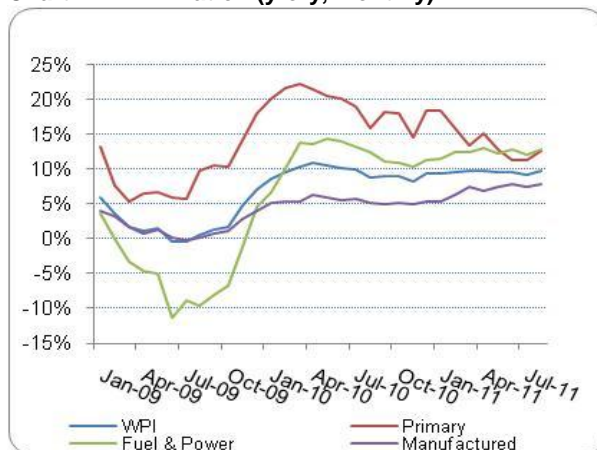
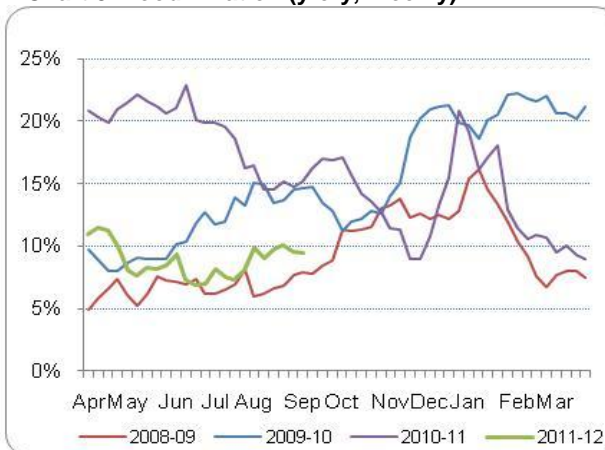


Chart 3: Food Inflation (y-o-y, Weekly)



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

Downside Risks to RBI's Projection of 8.0% real GDP growth for 2011-12

The RBI indicated the presence of downside risks to its projection of real GDP growth of 8.0% for 2011-12 (as indicated in the First Quarter Review of Monetary Policy) on account of moderating domestic demand in response to the tight monetary policy being conducted by the Central Bank, and the likely decline in growth of Indian exports following the weakening economic growth outlook for the Advanced Economies.

Broadly, various indicators suggest that notwithstanding a moderation, there has not been a sharp slowdown in the domestic growth momentum. Data released by the Central Statistics Office (CSO) indicates that the pace of growth moderated in Q1FY12 relative to Q1FY11 for both real economic growth at factor cost (to 7.7% from 8.8%) and private final consumption expenditure (to 6.3% from 9.5%). Nevertheless, the rise in prices of several groups of non-food manufactured products suggests that producers retain the ability to pass through rising input costs, suggesting that demand conditions have not weakened sharply. Additionally, although overall growth of the Index of Industrial Production (IIP) was a low 3.3% in July 2011, the RBI highlights that excluding the volatile capital goods index, the IIP expanded by 6.7% in July 2011. Growth of gross direct tax collections of Government of India (Gol) remains healthy at around 26% for April-August 2011 as compared to the same period in 2010, although net direct tax collections underwent a contraction in the same period, led by a faster release of refunds. A healthy magnitude of monsoon rainfall so far is expected to result in improved output for many crops (excluding pulses) as per the First Advance Estimates released by Gol. Overall, ICRA

expects continued transmission of monetary tightening to result in a further weakening of consumer demand and economic growth to moderate to 7.5-7.7% in 2011-12, from 8.5% in 2010-11.

Overall Comment

As anticipated, the RBI increased the Repo Rate by 25 basis points to counter any further hardening of inflationary expectations in light of the acceleration in headline inflation in August 2011, despite the moderating domestic economic growth and heightened uncertainty about the global economic outlook.

The guidance provided by the Central Bank indicates that its policy stance would be influenced by signs of downward movement in the inflation trajectory and the implication of global events. Various indicators suggest that inflationary pressures persist, including the rise in inflation related to non-food manufactured products, the recent revision in petrol prices and the persistence of high food inflation despite a normal monsoon. However, a weakening domestic consumer demand and the likelihood that global energy prices may correct reflecting the sluggish growth outlook, are expected to contribute towards a moderation of headline inflation. Overall, ICRA expects WPI inflation to decline in the coming months relative to the level recorded in August 2011 and the RBI to maintain the repo rate at the current level in the near term, which would be consistent with its anti-inflationary stance.



ICRA Limited

An Associate of Moody's Investors Service

CORPORATE OFFICE

Building No. 8, 2nd Floor, Tower A, DLF Cyber City, Phase II, Gurgaon—122002
Tel.: +(91 124) 4545 300; Fax: +(91 124) 4545 350

REGISTERED OFFICE

Kailash Building, 11th Floor; 26, Kasturba Gandhi Marg; New Delhi—110001
Tel.: +(91 11) 2335 7940-50; Fax: +(91 11) 2335 7014, 2335 5293
Email: info@icraindia.com Website: www.icra.in

Branches: **Mumbai**: Tel.: +(91 22) 24331046/53/62/74/86/87, Fax: +(91 22) 2433 1390 o **Chennai**: Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 o **Kolkata**: Tel + (91 33) 2287 0450, 2240 6617/8839, 2280 0008, Fax + (91 33) 2287 0728 o **Bangalore**: Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 o **Ahmedabad**: Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 o **Hyderabad**: Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 o **Pune**: Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 2553 9231

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