



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

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### Key Highlights

- Benchmark Repo Rate unchanged at 8.50%; Reverse Repo and Marginal Standing Facility (MSF) stand unchanged at 7.50% and 9.50%, respectively.
- Bank Rate, Cash Reserve Ratio and Statutory Liquidity Ratio unchanged at 6%, 6% and 24%, respectively, of net demand and time liabilities (NDTL)
- Baseline projection for headline WPI inflation for March 2012 maintained at 7%, reflecting the moderation in food inflation and expected moderation in aggregate demand. However, inflationary impact of the depreciation of the Indian rupee remains a concern. Formal numerical assessment of inflation projection to be made in the Third Quarter Review of Monetary Policy.
- Downside risks to baseline projection of 7.6% for GDP growth for FY12 increase significantly; formal numerical assessment of growth projection to be made in the Third Quarter Review of Monetary Policy.
- Systemic liquidity tightens in past two months; despite high Repo utilisation under LAF, MSF remains unutilised.
- Guidance provided that further rate hikes may not be warranted given moderating growth momentum and that subsequent policy actions are likely to reverse the stance of monetary policy. However, inflation and inflationary expectations remain above the Reserve Bank of India's (RBI's) comfort zone even as the weakening of the Indian rupee remains a concern.

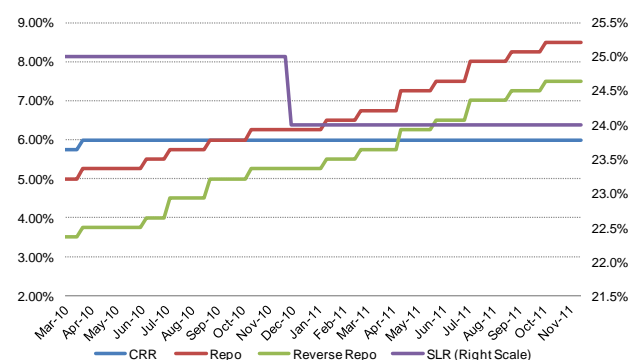
## RBI holds on to repo rate as indicated in its previous guidance

In line with RBI's earlier guidance and ICRA's expectations, the RBI has kept the benchmark Repo rate unchanged at 8.50%. Despite the moderating domestic growth and worsening outlook for global growth, the Central Bank persisted with a tight monetary stance as inflation and inflationary expectations remain higher than the RBI's comfort level.

Banks continue to hold their base lending rates at elevated levels, which in conjunction with the moderating investment and consumption growth has impacted the pace of growth of credit off-take in the recent months. Non-food credit growth in year-on-year (y-o-y) terms slowed to 17.5% on December 2, 2011 from 21.2% on September 30, 2011, lower than RBI's indicative projection of 18%. The lagged effect of the past monetary tightening may percolate further into the system and result in an additional easing of credit growth.

While inflation and inflationary expectations remain above the RBI's comfort zone, the moderating economic growth prompted the RBI to issue a guidance that further rate hikes may not be warranted and that subsequent monetary policy actions are likely to ease the policy rate. In ICRA's view, while the interest rate cycle has peaked, the RBI is unlikely to loosen monetary policy in the immediate term.

Chart 1: Movement in Key Rates



Source: RBI

## Baseline projection for headline inflation for March 2012 retained at 7%; nevertheless impact of rupee depreciation remains a concern

The RBI indicated that at present inflation and inflationary expectations exceed its comfort zone. Headline inflation related to the wholesale price index (WPI) declined from 9.73% in October 2011 to 9.11% in November 2011, led by a decline in food inflation. However, the inflation related to non-food manufactured products rose from 7.63% in October 2011 to nearly 8% in November 2011. Moreover, the index levels of nine of the 11 sub-groups of non-food manufactured products rose on a month-on-month basis in November 2011, which partly indicates the impact of the sharp depreciation of the Indian rupee since late September 2011. In addition, the inflation rate for September 2011 was revised upwards from 9.72% to 10.00%, the highest pace since July 2011. ICRA expects the WPI inflation for October 2011 to be revised upwards to an extent, particularly led by an anticipated revision in the index level for minerals.

Table 1: Trends in WPI inflation

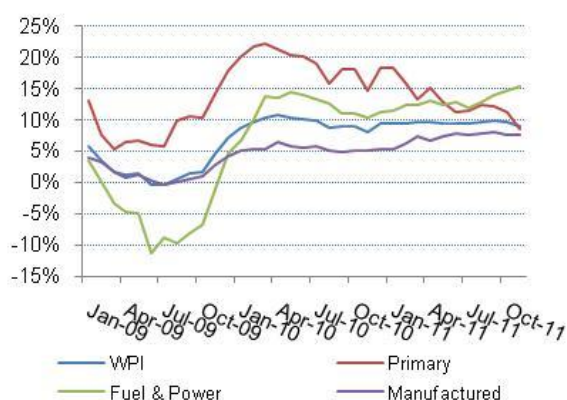
	Weight	Sept 2011		Oct 2011	Nov 2011
		Initial	Revised	Initial	Initial
<b>WPI</b>	<b>100.00</b>	<b>9.7%</b>	<b>10.0%</b>	<b>9.7%</b>	<b>9.1%</b>
<b>Primary Products</b>	<b>20.12</b>	<b>11.8%</b>	<b>12.2%</b>	<b>11.4%</b>	<b>8.5%</b>
- Food	14.34	9.2%	9.6%	11.1%	8.5%
- Non Food	4.26	14.8%	14.6%	7.7%	3.2%
- Minerals	1.52	24.8%	26.1%	20.4%	18.0%
<b>Fuel &amp; Power</b>	<b>14.91</b>	<b>14.1%</b>	<b>14.0%</b>	<b>14.8%</b>	<b>15.5%</b>
<b>Manufactured Products</b>	<b>64.97</b>	<b>7.7%</b>	<b>8.0%</b>	<b>7.7%</b>	<b>7.7%</b>
- Food	9.97	8.0%	8.0%	7.8%	6.8%
- Non Food	55.00	7.6%	7.9%	7.6%	8.0%

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

The Central Bank indicated that inflationary pressures are likely to ease given the recent trend in food inflation and the anticipated moderation in demand side pressures following the slowing economic growth. ICRA expects food inflation to dampen from 8.5% in November 2011 to around 2.5%-3.5% in December 2011, reflecting a cooling of food prices subsequent to the favourable harvest as well as the base effect. This is expected to offset the impact of the recent rupee depreciation, and result in a moderation in headline inflation to around 8% in December 2011, from 9.1% in November 2011.

Moreover, the RBI highlighted that momentum indicators such as the seasonally adjusted month-on-month inflation rate are displaying signs of moderation. Nevertheless, concerns remain on account of the high crude oil prices and depreciation of the rupee. While maintaining the baseline projection for headline WPI inflation for March 2012 at 7%, the RBI indicated that a formal numerical assessment of inflation projection would be made in the Third Quarter Review of Monetary Policy.

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



**Chart 32: Food Inflation (y-o-y, Weekly)**



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

### **Downside risks to baseline projection of 7.6% for GDP growth for FY12 increase significantly**

The Central Bank expressed concern regarding the deceleration of economic growth, reflecting the uncertain global conditions, impact of past monetary tightening and domestic policy uncertainties, and particularly the deceleration in investment. The pace of growth of gross domestic product (GDP) at factor cost (constant prices) moderated to 6.9% in Q2FY12, from 8.4% in Q2FY11 and 7.7% in Q1FY12, led by a decline in the pace of industrial growth. Gross fixed capital formation (GFCF) underwent a de-growth of 0.6% in Q2FY12, as compared to an expansion of 10.3% in Q2FY11 and 7.9% in Q1FY12. The Index of Industrial Production (IIP) recorded a de-growth of 5.1% in October 2011 with all the use-based industries recording a contraction in that month. ICRA highlights that some data sources such as automobile production and merchandise exports suggest an improved industrial growth scenario in November 2011 as compared to October 2011. Additionally, the RBI indicated that the Purchasing Managers' Index (PMI) for the services sector improved in November 2011 from the contraction seen previously. Satisfactory progress of sowing under the major *rabi* crops is likely to result in favourable agricultural output.

Given the global and domestic macroeconomic scenario and the slowing growth momentum of the Indian economy, the RBI indicated downside risks to its growth projection of 7.6% for FY12. The Central Bank communicated that a formal numerical assessment of growth projection would be made in the Third Quarter Review of Monetary Policy.

## Systemic liquidity tightens on account of higher government borrowing; RBI to resort to OMOs

Following an enhancement in Government of India's (GoI's) market borrowing programme for H2FY12 by nearly Rs. 53,000 crore, systemic liquidity has tightened since November 2011. The average borrowings under the Liquidity Adjustment Facility (LAF) increased to around Rs. 89,000 crore since November 2011, which is considerably higher than the RBI's stated comfort zone of +/-1% of NDTL. While the borrowings under the LAF rose to more than Rs. 1.1 lakh crore on 15<sup>th</sup> December 2011, this was related to the temporary stress created by the advance tax payments. Nevertheless, the Marginal Standing Facility (MSF) available to the Banks at 1% higher than Repo rate has remained unutilized since mid-July 2011. Moreover, the inter-bank call rates hovered close to the Repo rate in the recent months implying that Banks were able to meet their liquidity requirements largely through the LAF window, given that they hold excess SLR of nearly Rs. 300,000 crore (average SLR level of 29%). In addition, the RBI purchased securities of over Rs. 24,300 crore through open market operations (OMOs) since late-November 2011 in order to infuse liquidity.

Although credit growth has moderated in the recent months, ICRA expects GoI's market borrowing programme to be revised upwards as the fiscal deficit is likely to exceed the budgeted level,<sup>1</sup> which may strain systemic liquidity. ICRA expects the RBI to announce further open market purchases of G-sec of around Rs. 30,000-40,000 crore in H2FY12 to infuse liquidity and bring LAF utilisation within the stated comfort zone and ensure availability of funds for economic growth.

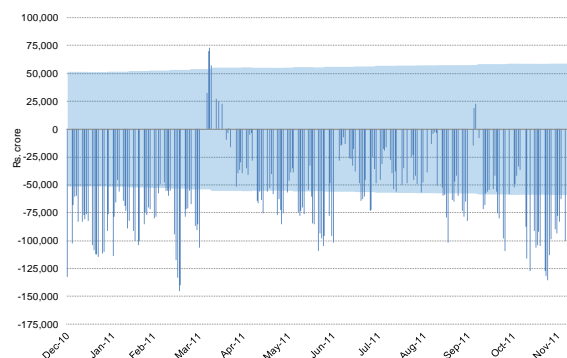
### Overall Comment

As anticipated, the RBI kept the policy rate and the CRR unchanged in its mid-quarter policy review as inflationary pressures are yet to diminish particularly in the case of non-food manufactured products. However, the guidance provided today was distinctly less hawkish, highlighting that further rate hikes may not be warranted and that subsequent monetary policy actions are likely to ease the policy rate. Nevertheless, the RBI has not provided a timeline for the same.

While the pace of growth of the Indian economy has clearly moderated in the recent months, a number of temporary factors contributed towards the substantial 5.1% contraction in manufacturing output indicated by the Index of Industrial Production in October 2011, including the impact of the Telangana agitation and strikes in key coal mining areas. Moreover, several factors contributing towards the contraction in mining output over the past months would not benefit from a looser monetary policy.

Notwithstanding the measures taken by the Central Bank to arrest the depreciation of the rupee, it is unclear at what level the currency would stabilise in the near term. Therefore, we expect the RBI to remain cautious regarding the possibility that a weaker rupee may result in a flaring up of inflationary pressures. Accordingly, the RBI is likely to keep the policy rate unchanged in Q4 2011-12, and embark on monetary easing in Q1 2012-13, once inflation moderates below 7%.

**Chart 4: Daily LAF outstanding**



*Note: Negative amounts indicate injection of liquidity by RBI*

*Note: Shaded portion indicates 1% of NDTL*

Source: RBI

<sup>1</sup> Please refer "[ICRA Comment: Outlook for the Indian Economy worsens](#)" published in November 2011



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