



ICRA Comments on RBI's First Quarter Review of Monetary Policy Statement for 2011-12

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Highlights of the RBI's Policy Statement – Jul 2011

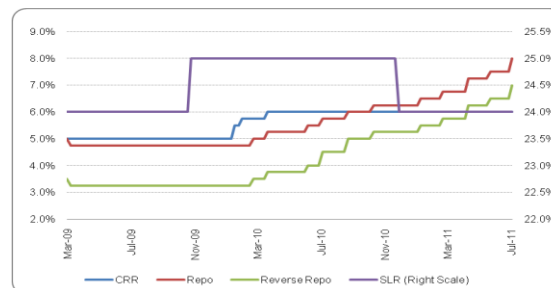
- Benchmark Repo Rate increased by 50 basis points (bps) from 7.50% to 8.00% with immediate effect; Reverse Repo and Marginal Standing Facility revised to 7.00% and 9.00%, respectively
- Bank Rate remains unchanged at 6%; Cash Reserve Ratio (CRR) remains unchanged at 6% of Net Demand and Time Liabilities (NDTL)
- Inflationary pressures remain dominant concern for monetary policy; baseline projection for WPI inflation for March 2012 revised to 7% from 6% with an upward bias
- Baseline projection of real GDP growth for 2011-12 retained at 8% based on the assumption of a normal monsoon and crude oil prices averaging US\$110 per barrel; policy stance revised to 'manage the risk of growth falling significantly below trend'
- Indicative projection of M3 growth and non-food bank credit growth for FY12 revised to 15.5% (from 16%) and 18% (from 19%), respectively

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Policy rates increased by 50 bps to tackle stubborn inflation levels

During the First Quarter Review of Monetary policy the Reserve Bank of India (RBI) hiked the Repo Rate by 50 bps to 8%, with immediate effect. With the current hike, the RBI has increased Repo Rate by 325 bps since March 2010. For the second time in this financial year, the RBI raised the benchmark Repo rates by 50 bps. The stronger than expected monetary action has been justified by the Central Bank as a measure to maintain the credibility of its commitment to control inflationary pressures and consequently anchor medium-term inflation expectations, and to emphasize the absence of complementary demand and supply sides policy responses.

Chart 1: Movement in Key Rates



Source: RBI

Inflation remains a key concern for monetary policy; baseline projection for March 2012 revised upwards

With actual inflation close to 10%, exceeding the RBI's expectations for the quarter under review, and evidence of broad-based inflationary pressures, inflation remained the dominant concern of monetary policy. The RBI revised its baseline projection for WPI inflation for March 2012 to 7% from 6% with an upward bias and highlighted that inflation is expected to remain elevated for a few more months before moderating towards the latter part of the year. In light of the prevailing inflationary pressures, the RBI reiterated its monetary policy stance to maintain an interest rate environment that moderates inflation and anchors inflation expectations. The higher-than-anticipated rate hike was accompanied by a hawkish guidance, linking a change in the policy stance to a visible sustainable downturn in inflationary pressures.

Inflationary pressures would continue to pose concerns in the coming months, led by suppressed inflation related to incomplete adjustment of administered fuel prices and inadequate revision of electricity prices following the hike in coal prices earlier in 2012. The RBI highlighted that while the spatial distribution of the monsoon would hold the key for food items such as coarse grains, pulses, oilseeds and cotton, a favourable monsoon would not ease inflation related to non-vegetarian protein items; ICRA expects primary food inflation to remain around 8-9% until November 2011. In the event of a reversal in the recent trend of easing commodity prices, particularly crude oil prices, pass through of the same to prices of non food manufactured products may add to inflationary pressures in the coming months. Overall, ICRA expects WPI inflation to remain above 9% in H1FY12 and may surpass 10% in some months. Accordingly, another rate hike in the short term cannot be ruled out.

Given the adverse impact of elevated inflation on the investment demand and overall economic growth in the medium term, we think that the Government needs to take steps to dampen aggregate demand through fiscal tightening and tackle the supply side constraints on a priority basis.

Baseline projection of GDP growth for FY12 retained at 8%

The RBI highlighted that the revised and rebased Index of Industrial Production (IIP) shows that industrial growth did not ease in H2FY11, as previously expected, although industrial growth has displayed signs of moderation since April 2011. The Central Bank retained its baseline projection of 8% GDP growth in FY12, highlighting that this entails a moderation relative to the growth performance in FY11, which partly reflects the ongoing monetary tightening. Notably, the RBI modified its policy stance to 'manage the risk of growth falling significantly below trend' from to 'foster an environment of price stability that is conducive to sustaining growth in the medium-term coupled with financial stability'.

The continued transmission of monetary tightening to higher interest rates is likely to dampen the pace of growth of investment and private consumption demand in FY12, although buoyant exports may support manufacturing growth to an extent in the coming months. The growth outlook for mining & quarrying would be influenced by various policy decisions taken by the Government. Given the high base effect, the agricultural sector would display moderate growth in FY12 even in the event of a favourable spatial distribution of rainfall,

thereby providing a limited boost to economic growth. The services sector is expected to continue to support economic growth in the ongoing fiscal year. Overall, ICRA expects economic growth to moderate to 7.8-8% in FY12 from the 8.5% growth recorded in FY11.

Deficit Systemic liquidity to ensure continued transmission of policy actions

The systemic liquidity remained in deficit (although the average deficit remained within the RBI's comfort zone of +/- 1% of NDTL) throughout Q1FY12, except for a brief period in April 2011 when it was in surplus. In the Policy Review, the RBI modified its stance regarding liquidity management to 'manage liquidity to ensure that monetary transmission remains effective, without exerting undue stress on the financial system' from its previously articulated stance to ensure that liquidity remains broadly in balance.

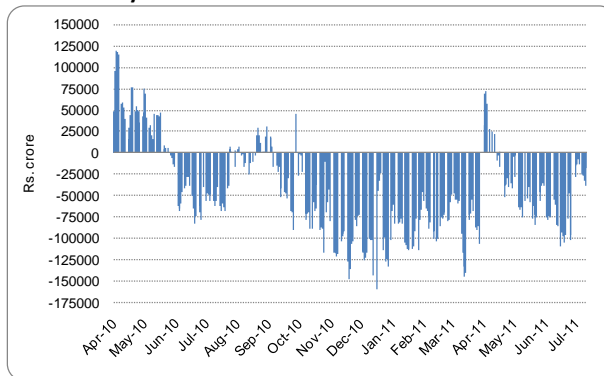
With improved monetary transmission in the recent months, the current rate hike is likely to further impact the lending and deposit rates in FY12.

Given the RBI's stance to anchor inflationary expectations and an unlikely reversal in inflationary pressures at least over the next few months, we expect the systemic liquidity profile to remain in deficit mode. At the same time, while we do not yet revise our FY12 estimates of a 17-18% credit growth and 16-17% deposit growth, we acknowledge that it would be a challenge to meet credit growth estimates given the expected hike in lending rates by the banks.

Overall Comment

With the level and persistence of inflation remaining the dominant concern for monetary policy, the RBI hiked the repo rate by 50 bps despite emerging signs of a moderation in growth in the current fiscal. The stronger-than-anticipated policy action was accompanied by a hawkish guidance, linking a change in the policy stance to a visible sustainable downturn in inflationary pressures. ICRA expects WPI inflation to remain above 9% in H1FY12 and may surpass 10% in some months; accordingly, another rate hike in the short term cannot be ruled out.

Chart 2: Daily LAF



Note: Negative amounts indicate injection of liquidity by RBI

Source: RBI



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