EXPECTATIONS:

'THIRD QUARTER REVIEW OF MONETARY POLICY STATEMENT 2011-12'

The RBI is scheduled to announce its Q3 review of monetary policy on 24th January 2012. We expect RBI to keep key policy rates unchanged.

Our expectations

So far in the current financial year, the major driving factor for the RBI's monetary policy had been the growth-inflation trade-off. However, in recent times the persistent deficit in liquidity conditions and the volatility in the exchange rate have also called for the Central Bank's attention.

In this context, we expect the following from tomorrow's policy review:

- **Repo rate to remain unchanged at 8.50%**
- **Inflation projections to be maintained at 7.00%**
- **CRR and SLR to be retained at 6.00% and 24.00% respectively**
- **Continuance of buy back of bonds (through OMO auctions) to boost liquidity**

Overview of monetary conditions

Table 1: Monetary Aggregates

Financial year so far (%)	Apr-Dec 2010	Apr-Dec 2011
Money supply	11.1	10.8
Deposits	11.0	11.9
Credit	16.0	10.7
Investment	4.6	12.8
Credit-deposit ratio	75.7	74.9
Incremental credit-deposit ratio	108.3	85.9

Source: RBI

At the beginning of 2011-12, RBI projected bank non-food credit to grow at 18% and aggregate deposits to grow by 16% during the fiscal. The monetary indicators show that credit growth has been lower in Apr-Dec 2011 compared to the corresponding period last fiscal. A closer look at the sectoral deployment shows that deployment to medium industries has fallen from 15.5% last fiscal to 6.8% in the current financial year. Similarly, lending to services has moderated from 10.4% to 4.2% with computer software (-3.1%) and tourism, hotels & restaurants (9.1%) industry being most affected. Further, vehicle loans have declined to 9.5% while housing loans have slowed but at a moderate rate to 7.6% from 8.8% last fiscal. It is further observed that banks have moved away from speculative high risk sectors as is indicated by the fall in deployment to commercial real estate from 14.5% to 4.3% in 2011-12.

In the light of the current developments in the economy, bank credit is expected to fall short of the RBI projections while aggregate deposits and money supply are in line with expectations and are likely to meet their targets. SLR investments on the other hand, have risen sharply from 4.6% in Apr-Dec 2010 to 12.8% for the same period this fiscal.

Overview of government borrowings

Table 2: Details of Government Borrowings

Rs. crore	2011-12
Budget Estimate	4,17,128
Additional Borrowings	92,800 (appro.)
Borrowings Completed	4,25,000 (83%)
On an Average (%)	
5 yr Gsec Yield	8.42
10 yr Gsec Yield	8.41

Source: RBI

The government in the Union Budget estimated the Gross Fiscal Deficit (GFD) to be 4.6% of the GDP. However, it is unlikely for the government to meet this target on account of revenue lost from direct tax and reduction in custom & excise duty. Further, government expenditure has increased through higher borrowings. The government has already announced additional borrowing of Rs 77,872 cr taking the net borrowing to Rs 4,95,000 crore.

Based on these factors fiscal deficit target for 2011-12 is likely to slip to 5.5%.

Driving factors behind policy

Growth-Inflation trade-off:

Headline inflation, illustrated by the Wholesale Price Index (WPI), has been hovering around 9.00% since late 2009. The unrelenting price rise was initially driven by supply side constraints, which gradually generalized across the board. The RBI has been following the anti-inflationary stance since early 2010. In 2011-12 itself, the RBI increased repo rate, which is the rate at which the banks borrow from the RBI, 5 times (by 175 bps).

With growth slipping to 6.90% in Q2 from 7.70% in Q1 2011-12, mainly on account of the sluggish growth illustrated by the industrial sector that registered a growth rate of 3.50% in Apr-Oct 2011-12, RBI paused raising interest rates in its December 2011 review.

In the last few weeks, there has been a sharp decline in the prices of primary articles taking the WPI index for December to as low as 7.50% compared with 9.10% for November. The present trend of negative food inflation is likely to assist WPI to move towards 7.00% target of the RBI earlier than expected and be in range of 6.5-7% by March end.

Industrial activities, on the other hand, are expected to remain subdued in the current fiscal. Overall projections for IIP have been brought down to around 5.00% from 7.10% estimated in July. Further, on the whole GDP growth is expected to be in the around 7.00% for 2011-12 mainly driven by consumption demand rather than investment demand.

The RBI is not expected to lower repo rate till inflation, especially core inflation, declines to sustainable low level.

Liquidity-Exchange Rate trade-off:

Liquidity condition, especially in the banking system, have been tight since November with the banks borrowing on an average Rs. 1,10,214 crore daily from the RBI through the LAF facility. Banks have also resorted to Marginal Standing Facility (7 times) and borrowed approximately Rs. 20,000 crore at the rate of 9.50%.

Meanwhile, rupee has been weakening against the Dollar since August and has depreciated by around 14.00% so far. Rupee has been strengthening during the last few days and stood at Rs. 50.33 per Dollar on 20th January 2012 mainly driven by policy actions taken by the Government to boost capital flows into the domestic economy, namely, deregulation of NRE deposits and so on.

A cut in the Cash Reserves Ratio (CRR), which is the minimum reserves that each bank must park with the RBI as a certain percentage of their demand and time liabilities, has been considered as a possibility in order to immediately induce liquidity in the system. However, CRR is a critical monetary tool and the RBI would not wish to give contrary signals to the market till inflation slows to the desired levels.

Therefore, the RBI would continue to induce liquidity through more OMO auctions and would retain CRR at 6%.

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