Mid-Quarter Monetary Policy Review

RBI raises policy interest rates on inflation concerns

March 17, 2011

The Reserve Bank of India (RBI) is facing a tough challenge at present, as high inflation amidst slowing industrial growth has made policymaking a complex task. In its third mid-quarter monetary policy review of 2010-11 held today, the RBI once again hiked the key policy rates by 25 bps each. The repo and reverse repo rates now stand at 6.75 per cent and 5.75 per cent, respectively. Contrary to expectations, inflation has continued to remain high. Importantly, core (non-food manufacturing) inflation surged in February 2011, indicating the build-up of demand-side pressures in the economy. Moreover, the upside risks to inflation have intensified in the wake of rising crude oil prices.

Volatility in call rates reduces with improved liquidity

Several recent measures by the RBI have helped ease liquidity pressure. After experiencing bouts of severe liquidity deficit in December 2010, the money market got some respite in the first 2 months of 2011 due to OMO auction purchases as well as higher government spending. Going forward, the RBI expects the overall liquidity situation to move close to its comfort level (+1/-1 per cent of net demand and time liabilities of banks), with a temporary deficit in the second-half of March 2011 due to advance tax collections

Core inflation crosses the 6 per cent mark

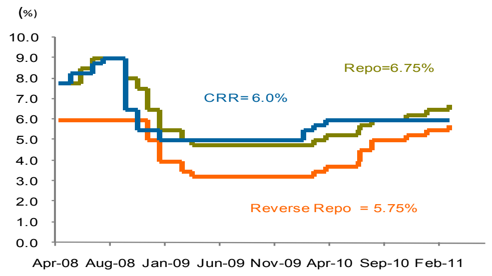
Headline inflation continues to remain high; the latest reading for February 2011 came in at higher-than-expected 8.3 per cent due to significant rise in core (non-food manufacturing) inflation. In addition, inflation for December was revised upwards to 9.4 per cent from the previously reported 8.4 per cent. This takes the average inflation for the year so far to a high of 9.2 per cent as compared to a subdued 3.0 per cent during the same period last year.

As expected, food (primary and manufacturing) inflation has now started to taper off, as new *rabi* crop has entered the market. However, core inflation continues to stay well above its medium-term trend and surged to 6.1 per cent in February 2011, clearly signaling the second-round impact of rising input costs. This is of particular concern to the central bank, as it wants to manage inflationary expectations and contain the spillover of food and commodity prices into more generalized inflation. We expect average WPI inflation at around 9 per cent in 2010-11 and at 5.8-6.0 per cent in 2011-12, though the recent escalation in crude oil prices, due to tensions in the Middle east and North Africa region, have increased the upside risks to inflation. The RBI has revised the WPI inflation projection for March 2011 upwards to around 8 per cent from earlier 7 per cent.

GDP growth to moderate marginally to 8.3 per cent in 2011-12

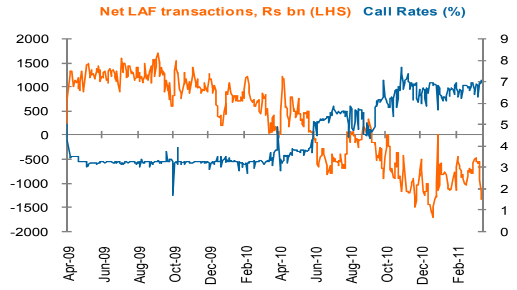
The recent moderation in industrial output can be attributed to the high base effect of last year, as the index continues to show an uptick on a month-on-month seasonally-adjusted basis. On an annual basis, industrial growth fell to a low of 2.5 per cent in December 2010, before recovering to 3.7 per cent in the next month. Capital goods growth remained volatile; it turned negative in December-January 2010-11 after having registered a double-digit growth in the preceding 2 months, suggesting the slowing down of investment momentum. Investment growth as reflected by the gross fixed capital investment growth too moderated in the third quarter of 2010-11. Going forward, we expect GDP growth to slow down to 8.3 per cent in 2011-12 from the CSO's advance estimates of 8.6 per cent for the current fiscal. Industrial growth will slow due to rising interest rates, while services sector growth is expected to remain robust. Agriculture growth, despite a normal monsoon, would decline due to a higher base.

Chart 1: RBI maintains anti-inflationary stance



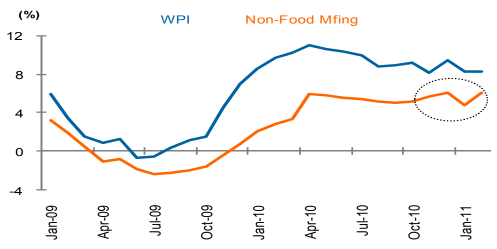
Source: RBI

Chart 2: Liquidity improves in the economy



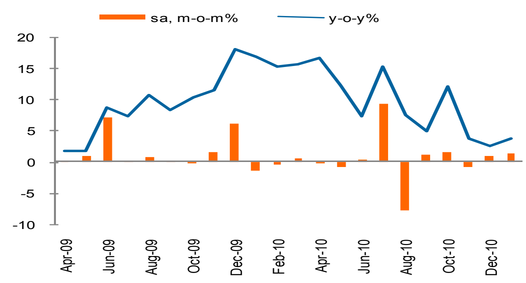
Source: RBI and CCIL

Chart 3: Sharp pick-up in core inflation



Source: Ministry of Industry

Chart 4: Volatility in industrial output continues



Source: CSO and CRISIL estimate

Deposit growth expected to be at 19-20 per cent in 2011-12

Given the tightening liquidity scenario and rising demand for credit, several banks hiked deposit rates by 100-200 bps during October 2010 to January 2011. As a result, the deposit growth rate picked up from 14.3 per cent as on September 24, 2010 to 16.5 per cent as on February 25, 2011.

In 2011-12, CRISIL Research expects a further 25-50 bps hike in deposit rates across maturities, as deposit growth continues to lag credit growth. Further, with the increase in deposit rates, and real interest rates turning positive, the deposit growth rate is expected to be in the range of 19-20 per cent by 2011-12.

Credit growth expected to moderate to 18-19 per cent in 2011-12

Aggregate y-o-y bank credit growth accelerated to 23.3 per cent as on February 25, 2011 from 19.1 per cent as on September 24, 2010. This was primarily on account of robust credit flow to industries like basic metal and metal products, engineering and retail, apart from infrastructure, thus making the credit growth more broad-based.

CRISIL Research expects the pace of credit growth to moderate to 18-19 per cent in 2011-12 on account of a decline in the growth of capital investments across sectors such as telecom, airport infrastructure, cement and petrochemicals. Also, the prevailing high interest rates are likely to impact the credit growth of the industry as well as the retail segment.

Net interest margins likely to come under pressure

In the current scenario, with the repo rate being the effective policy rate, the increase of 25 bps is expected to result in a further increase in the cost of funds for banks. As banks would not be able to hike lending rates in line with the increase in cost of funds, CRISIL Research expects net interest margins to decline by 15-20 bps in 2011-12.

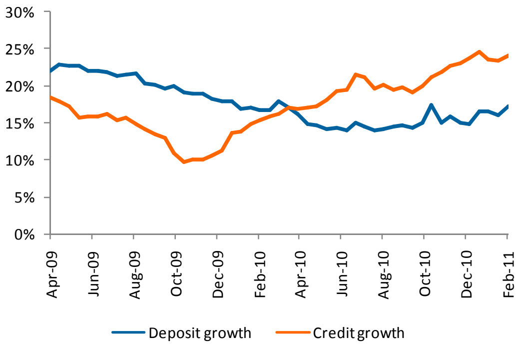
Incremental credit-deposit ratio to be 70-72 per cent in 2011-12

Strong credit offtake and relatively slower growth in deposits had led to the incremental credit-deposit ratio increasing to 100.1 per cent on February 25, 2011 from 93.5 per cent on September 24, 2010. CRISIL Research expects the incremental credit-deposit ratio to reach 70-72 per cent by the end of 2011-12, primarily due to an expected moderation in credit growth and a strong deposit growth rate.

Table 1: CRISIL Macroeconomic forecast for 2011-12

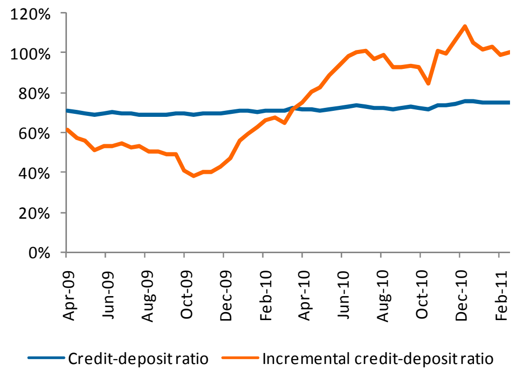
	Parameter	Forecast
Growth (%)	Agriculture	**2.7**
	Industry	**7.9**
	Services	**9.9**
	Total GDP	**8.3**
Inflation (%)	WPI average	**5.8-6.0**
Interest rate (%)	10-year G-sec (year-end)	**7.9-8.2**
Exchange rate	Re/US$ (year-end)	**43.0-44.0**
Fiscal deficit	Fiscal deficit (as a % of GDP)	**5.0**

Chart 5: Growth in credit and deposits



Source: RBI and CRISIL Research

Chart 6: CD and incremental CD ratios



CD: Credit-deposit
Source: RBI and CRISIL Research

Table 2: Sector-wise bank credit growth

(Growth, y-o-y %)	Industry	Services	Personal loans	Textiles	Iron & iron products	Infrastructure
1QFY09	26.9	31.3	15.9	20.9	24.4	41.7
2QFY09	30.6	35.3	17.4	23.1	33.7	35.8
3QFY09	30.2	27.6	14.6	18.4	24.7	38.5
4QFY09	25.8	19.2	8.5	12.5	37.0	35.1
1QFY10	21.2	20.5	5.5	8.3	29.9	35.1
2QFY10	17.9	11.0	2.3	9.3	23.2	44.7
3QFY10	15.7	11.5	-0.4	9.2	21.3	43.2
4QFY10	20.1	15.0	4.7	12.7	23.9	42.3
1QFY11	25.8	14.1	6.5	18.6	26.2	44.3
2QFY11	29.2	21.0	8.9	16.7	26.5	55.0
3QFY11	27.4	25.0	13.4	17.0	28.2	43.1

FY: Financial year

Source: RBI and CRISIL Research

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