RBI Monetary Policy Review: The tightening gathers momentum!.. Sharad Kotak

In the third quarter review of monetary policy for the year 2009-10 released on 29th January 2010, where consensus expectation was a 0.50% increase in Cash Reserve Ratio (CRR), RBI surprised the markets a tad by hiking the CRR by 0.75%. However it left the reverse repo and repo rates unchanged at 3.25% and 4.75% respectively in line with consensus expectations. The hike in CRR implies that banks would have to place an additional Rs. 36,000 crores with the central bank. These steps give momentum to RBI's tightening of monetary policy and both the policy document and post-policy comments by the Governor emphasized the point. In tune with its signals the central bank also reiterated its intention to:

Anchor inflation expectations and keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments as warranted.

Actively manage liquidity to ensure that credit demands of productive sectors are adequately met consistent with price stability.

Maintain an interest rate environment consistent with price stability and financial stability, and in support of the growth process.

Key takeaways from the policy

RBI increased its GDP growth estimate for financial year ending March 31, 2010 to 7.5% from an earlier estimate of 6.0%. This is on the back of revival in export growth due to improvement in global economy, improved business optimism, better financing conditions and continued recovery in industrial production and services sector activity.

On inflation, RBI has upped its estimate to 8.5% by end-March 2011 in the wake of little seasonal moderation in food prices, movement in prices of the non-administered omponent of the fuel group and some signs of demand side pressures. However RBI expects inflation to moderate from July 2010 on the assumption of a normal monoon, stable global oil prices and recent monetary measures undertaken.

RBI also stressed that the opportunity to use imports to contain food prices is quite limited due to the elevated level of global commodity prices.

The central bank has reduced the non-food credit growth projection for 2009-10 to 16% from 18% on the back of increased availability of funds to corporate sector from domestic non-bank and external sources. Consistent with this, aggregate deposits of scheduled commercial banks are projected to grow by 17%. Based on projected credit growth and the remaining very marginal market borrowing of the government, the projected broad money (M3) growth in 2009-10 has been reduced to 16.5%. RBI notes that fiscal deficit remains a big risk to short-term economic management and to medium-term economic prospects. It exhorts government to start fiscal consolidation and ideally do two things "first, indicate a roadmap for fiscal consolidation; and second, spell out the broad contours of tax policies and expenditure compression that will define this roadmap".

Outlook

After spending months preparing markets for the exit from its accommodative stance, RBI chose to hold back on hiking rates and limited itself to absorbing liquidity. Having said that, there were some clues as to what will guide future policy decisions and markets:

The central bank reiterated that "a consolidating recovery should encourage us to clearly and explicitly shift our stance from 'managing the crisis' to 'managing the recovery'" however at the same time it felt "amidst concerns about rising inflation, we must remember that the recovery is yet to fully take hold" thus reflecting a fear that "Strong anti-inflationary measures, while addressing one problem, may precipitate another by undermining the recovery, particularly by deterring private investment and consumer spending". This indicates that central bank possibly does not want to send any signal that may slow down the growth engine at this stage.

At the same time RBI recognizes that while current inflation pressures stem from the supply side, the recovery "increases the risk of these pressures spilling over into a wider inflation process". This implies that if the recovery process sustains and demand-driven inflation pressures build-up, the RBI will not hesitate to hike policy rates.

In summary, further monetary tightening is a matter of time. The Governor pointed out in one of his post-policy interviews that RBI considered raising the rates as a possible policy action but refrained from doing so as it wanted to encourage creation of capacity in the economy to fight any potential demand led price pressures in future. RBI notes that "our main policy instruments are all currently at levels that are consistent with a crisis situation than with a fast-recovering economy" thus recognizing a need to move away from the current accommodative monetary stance. RBI further says that "the reversal of monetary accommodation cannot be effective unless there is a roll back of government borrowing" thus putting the onus on government to reduce fiscal deficit in order to make way for better credit growth and help RBI in the tightening process.

For bond market, the steep yield curve and limited auctions of government bonds till March 2010 are positive factors. However stacked against this, are rising inflation, potentially a huge borrowing program for next financial year and possibly no support from RBI in the form of Open Market Operation (OMO) purchases. As a result yields may gradually drift higher from current levels as market braces itself for fresh borrowing programme and as inflation remains high with a possibility of an inter meeting move from RBI. The key risk to our view is a surprise in the form of a lower fiscal deficit (our estimate: 5.5% of GDP for 2010-2011) projection in the budget and a lower than expected borrowing for 2010-2011.