Economics

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Monetary Policy and implications: January (FY14)

In a surprising policy move today, RBI announced an increase in key policy interest (repo) rate in its Third Quarter Monetary Policy Review thereby continuing with the pursuance of the objective of targeting inflation and anchoring inflationary expectations to further build an environment conducive to growth in the long run. The market had been expecting status quo on the policy front. By increasing rates this time, Dr Raghuram Rajan has increased rates by 50 bps after taking over as Governor.

Highlights below –

- Repo rate under liquidity adjustment facility (LAF) raised by 25 bps, from 7.75% to 8%
    - Accordingly, reverse repo rate stands adjusted at 7%
- Marginal Standing Facility (MSF) rate stands 100 basis point above the repo rate at 9%
    - Bank rate now stands at 9%
- Cash Reserve ratio (CRR) unchanged at 4% of NDTL

Rationale for Policy Stance

- ***Inflation continues to remain the focal point governing the RBI strategy:*** With the anticipated decline in vegetable and food prices, the inflation figures measured by the Consumer Price Index (CPI) and Wholesale Price Index (WIP) declined significantly in December. However, prices of services remain elevated. Similarly, there was a rise in Non food manufactured products inflation in December. The RBI believes that rising prices of services and intermediates in conjunction with growing bank credit, pick up in capacity utilisation and the decline in inventories of raw materials and finished goods in relation to sales suggest that aggregate demand pressures have emanated which can pressurize inflation upwards. Addressing these concerns in a timely manner is vital to stabilise and anchor inflationary expectations. This further reiterates RBI's clear focus on inflation.
- ***Dr Urjit Patel Committee Report:*** The rate hike is consistent with the "glide path" for disinflation recommended by the expert committee on monetary policy framework which suggests CPI inflation target of below 8% by January 2015 and below 6% by January 2016.
- ***Emerging economies still fragile:*** Although the global economy is improving with growth in the USA picking up (as also evidenced by the commencement of the tapering of the Fed's Quantitative easing programme), growth remains subdued in Euro area and Japan. Among the Asian economies, fear looms large regarding a slowdown in China. Hence, uncertainty clouds the prospects of some emerging market economies. In light of the above, emerging countries' financial markets are at a high potential risk.
- ***Liquidity measures undertaken time and again to ensure sufficient credit flow:*** Liquidity conditions remained tight after the first week of January as Government deposits increased at the RBI. Hence, RBI intervened by conducting 7 days term repos worth Rs 100 billion and 28 days term repos worth Rs 300 billion in addition to the cumulative flow of Rs 1.4 trillion through 7-days, 14-day repos and

export credit refinance together. To provide further liquidity, the RBI conducted open market operations of Rs 95billion on January 22. RBI has actively managed liquidity in the system so that there is adequate credit flow to the supply side of the economy. Evidently more than liquidity, it is inflation that continues to remains RBI's prime concern.

- Ongoing growth momentum is expected to slow down in Q3 and Q4 of FY14 owing to the economy being in an industrial recession. While industrial output has contracted for two consecutive months ***substantial fiscal tightening*** is expected in Q3 and Q4 FY14.
- Foreign reserves have risen since September and oil marketing companies have been buying Foreign exchange from the markets to settle their swaps when due with the RBI. However, given the volatility in global economy, it is vital for both fiscal and monetary authorities to continue efforts at ***macroeconomic stabilisation***.

RBI's Economic Outlook

- **Real GDP in the range of 5-6% in FY15:** Expecting policy actions of the RBI to succeed with lower desired inflation would help to increase GDP growth from 4.8-4.9% in FY14 to a range of 5-6% in FY15. External investments may further boost the real GDP growth forecast for FY15.
- **CAD estimated at 2.5% of GDP in FY14:** Rising merchandise exports and declining non-oil imports have fostered overall trade figures reducing the trade deficit in FY14 (April-December) by 25% from its level in the corresponding period in FY13. RBI estimates the CAD to ease to 2.5% of GDP (or lower) in FY14 compared with 4.8% of GDP in FY13 which should be adequately financed through the external portfolio investments inflows, rising FDIs and increasing external commercial borrowings. *Our estimate for CAD based on developments in the external sector so far till December would be between 2.5-2.75% of GDP.*
- **CPI targeted at below** 8% by January 2015. It concedes that there are risks which could push inflation figures upwards.

CARE's view

- Given the upside pressures on inflation it will be difficult to contain CPI inflation at 8% by March 2014. Hence, *CARE expects a status quo in repo rate in the next policy review on 1st April 2014. This is a change from the earlier held view that there would be a drop in interest rates based on the assumption that inflation would ease. As RBI has indicated that they do have a target CPI inflation rate in mind, which is unlikely to be realized by March end, lowering of interest rates will not be possible.*
- Growth prospects for FY15 would be constrained by interest rates remaining sticky at the current level. Further, with Elections in May 2014, investors would wait and watch for a clear direction to be given in terms of policy and economic outlook. Therefore, there would be a delay of 3-4 months before investment is committed. In the light of this, our projection for growth for FY15 would be 5.5-6%.

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