

Title: Baby Steps Behind the Curve

Region: INDIA

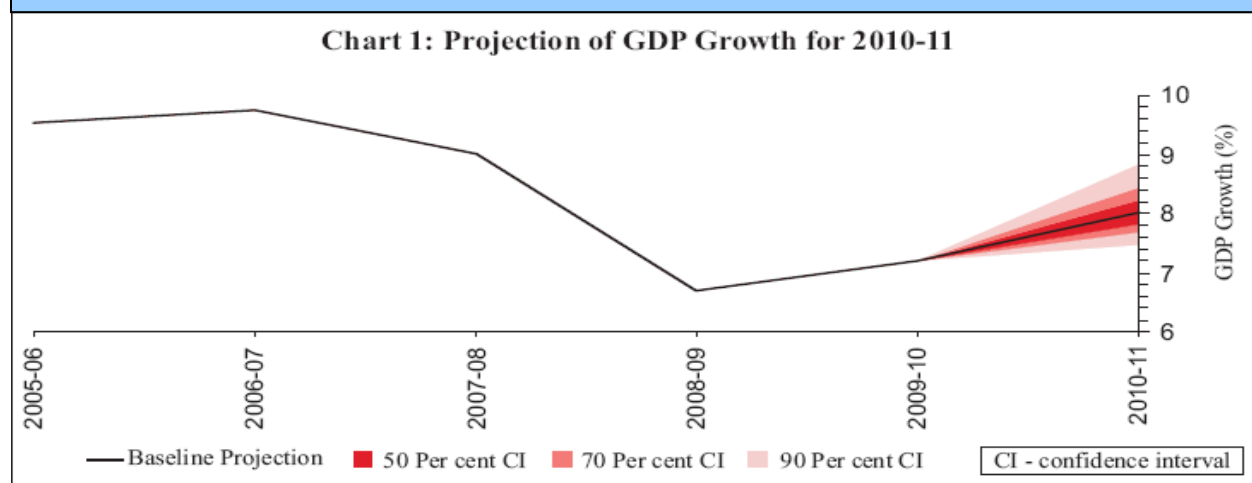
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The Central Bank of India, RBI, unveiled its Annual Monetary Policy Statement for the year 2010-11. The primary thrust of the policy seems to be the well known “Tackling Spiraling Inflation and Controlling the Inflationary expectations” yet maintaining the growth impulses. But from the weaker action taken, growth seems to be ahead of inflation. The monetary policy delivered token hikes in repo, reverse repo and CRR of 25 bps each, taking further its gradual and measured approach in the exit strategy.

What though was surprising was the existence of number of “dilemmas and dichotomies” for RBI. Such as, the policy document was reasonably hawkish on economic growth prospects (8% GDP growth rate with upside), but the action taken (25 bps hikes) was a little dovish. One more of the dilemmas was the RBIs expression of its anguish on managing (withdrawal of) the liquidity yet providing sufficient of it to fund the higher nominal economic growth (13.5%) and the smoother clearance of the large government borrowing program (+36% higher yoy) of 2010-11. Another one of the dilemmas was an uncertain global scenario but a fast improving and consolidating domestic growth scenario. And the final trilemma of the famous “impossible trinity” of capital inflows, flexible exchange rate and independent monetary policy.

Chart I: RBIs Real GDP Growth projection for 2010-11



Source: RBI, Annual Monetary Policy 2010-11

So what do we read from the Monetary Policy?

- RBI is confident of the economic recovery (good for stock markets) being on track and more entrenched since last policy, though has not called it as a “full fledged recovery” as the private consumption still lagged. May be it will wait for signs of more durability of the recovery. The real GDP growth estimates being pegged at 8%, with an upside bias.
- The usual worry on the spiraling inflation especially non food (7.2%) or core inflation and the rising inflationary expectations continues, especially in the households. The transition of supply driven (food) inflation to generalized

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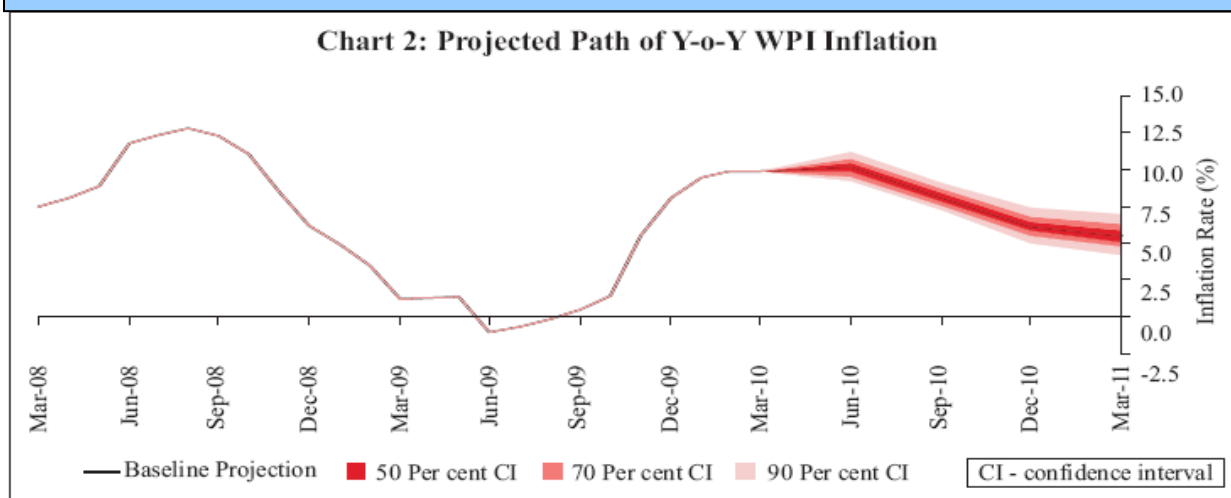
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demand driven one is a cause of concern for RBI and it will act quickly (raise rates) in future to bury the escalating price levels. RBI has targeted inflation at 5.5%. The problem is a surge in global commodity prices, buoyant domestic demand pressures or a weaker monsoon will ensure that the actual inflation deviates from the targets on higher side. By raising the rates by just 25 bps, RBI has taken a big gamble on inflation not overshooting. RBI and the Government officials are confident though of the inflation rolling over. In fact RBI has designed TV advertisements to control inflationary expectations. Better supply management is something which RBI and Government are banking on to lower inflation instead of raising rates rapidly. They will face the credibility test here.

Chart II: Projected Inflation (WPI): RBIs big Gamble



Source: RBI, Annual Monetary Policy 2010-11

- The money supply, deposit and bank credit growth rate targets were set at 17%,18% and 20% resp (Table I). Except for bank credit, the other targets seems to be in line with nominal GDP growth rate and income elasticity of money demand. There are chances of the bank credit growth rate being more than 20% on back of the expected rising investment and capex cycle. Loans to Industry are already up by 20% yoy (26th Feb 2010) with iron/steel and infra sector loans higher by 24% and 42% resp. The state owned banks credit growth rate is already higher at 19.2% yoy, who have a 75% share in the total bank credit. And only around 48% of the funding of commercial sector now comes from bank sources.
- As RBI has now taken the baby steps (smaller rate hikes) in the normalization process, the window for inter meeting hikes remains wide open, keeping the bond markets on the “Slippery Slope of Uncertainty”. This will box in the government bond yields as of now.
- The challenge for RBI is now to manage the large Government program in a non disruptive manner and so at the lowest possible cost to the Government. It will need support from non bank buyers such as provident funds and insurance companies. The program is largely front loaded. This is in direct conflict with its

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commencement of “Liquidity Normalization” by RBI and its efforts to maintain the overnight rates in the middle and not at the lower end of the LAF corridor. RBI will try and maintain the banking liquidity marginally surplus closer to the neutral levels required to fund the targeted nominal GDP growth rate, at an assumed Income elasticity of Money Demand. And the neutral liquidity will be inter alia a function on Capital flows & RBIs intervention in USD-INR markets, Government Spends, Reserve Requirements, and Money Multipliers etc. At the first signs of overheating RBI will ensure that the liquidity turns into a deficit and overnight rates closer to the higher end or beyond the LAF corridor.

Table I: Macro Economic Variables and RBI Targets

	RBI Targets (2010-11)	Current	Remarks and Bias
Real GDP Growth Rate yoy	8%	7.2%	Upside Bias (RBI)
Inflation WPI yoy	5.5%	9.8%	May overshoot
Money supply Growth yoy	17%	16.7%	Fair and in line
Bank Credit Growth Rate yoy	20%	16.7%	May overshoot
Bank Deposit Growth yoy	18%	17%	Fair and in line

Source: RBI WSS, Annual Monetary Policy 2010-11

- Another noticeable aspect of the last few monetary policies of RBI is the frequent references to Asset Price Inflation, especially real estate and stocks. In current policy document RBI talked about the positive link of rising real estate prices and the stock markets. A recent paper released by Dr Patra of RBI, asset prices found its place as input into the monetary policy decision. RBI should be normally worried on asset prices when they are accompanied by strong bank credit growth, which is the case now. RBI is cautious on an asset prices bust that can jeopardize financial stability or the real economic growth. Stronger and pre-emptive regulations are the options available to RBI in such cases.
- One more reason that RBI must have gone slower on the rate hikes is the fear of a flood of capital inflows disproportionate to GDP, on higher interest rate differentials, higher growth expectations and an appreciating INR. The INR in real terms (six currency REER) has already appreciated by 15% in 2010, which is another reason as to why RBI might have gone slower on rate hikes.

There has been a good amount of debate in markets and in press that RBI has been “Behind the curve” viz whether it has raised the rates by a smaller margin than justified by economic variables. I am in this camp. And there are simple reasons (refer to the next page) for it for more action this time, though I may not have forward looking data that RBI might have access to. If the economy is growing too fast as compared to its trend, interest rates need to rise to avoid many of the adverse consequences such as runaway inflation.

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- RBI has admitted in the policy documents that subject to some caveats, the economic growth now is becoming more entrenched and broad based. And the demand side pressures are getting accentuated. Is RBI going to wait till the economy overheats?
- The structural or core inflation is already on the higher side. If supply side does not improve, commodity prices rise and monsoon disappoints, inflation risk would escalate. The household inflationary expectations are already higher. Higher inflation needs higher rates.
- If the Taylor Rule (used by central banks world over) used in setting the nominal policy rates is of any consequence in Indian context, the policy rates are at least lower by 200 bps. Though one caveat here, India is not an inflation targeting central bank like many others in developed markets.
- Many of the coincident and forward looking indicators are pointing towards a rapid economic growth rate approaching the trend levels. Some of the indicators are: Rising IIP index, Higher trade and current account deficit, rising exports and non oil non gold imports, stretched capacity utilizations (steel 89%, fertilizers 96%, cement 83%), narrowing output gaps, improving bank credits, return of pricing power to corporate (good for stock markets), PMIs above 50 in recent times, good hiring, shortage of skilled labor leading to wage spirals, higher business and consumer confidence (from surveys) leading to sustained capital expenditures etc.

If RBI continues to stay behind the curve (though it says it's not), the real interest rates will continue to be negative on the policy, short and long rates, unless inflation collapses. Indian negative real interest rates are one of the lowest in the world now. And sustained negative real interest rates are de stabilizing for an economy since it distorts the saving and investment balances in the country, fuels higher demand for tradable goods, widens the trade and current account deficits, enhances inflation, creates asset bubbles by increasing risk appetite, results in real appreciation of the domestic currency etc. The risk reward ratio of staying behind the curve is heavily tilted towards risks.

I am sure RBI is vigilant towards the same and to put it in "cricket terms" is all padded up to take swift action as and when required. So the window for further rate hikes remains wide open as and when RBI sees more data on growth being broad based and more entrenched. And it won't wait till next policy meeting in July 2010.

RBI needs to be very careful and nimble in judging the economic growth level and timing the exit of accommodative monetary policy. So the baby has to take longer strides later if the heat of growth and inflation catches up.

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