

January 23, 2012

# Economic Weekly



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## Policy Eve: Rate Cut Only A Matter Of When

**R**ESERVE Bank of India's monetary meet on Tuesday (January 24) is a crucial. RBI's assessment of inflation and growth dynamics will form the basis of its future decisions. In its December mid-quarter policy, the central bank had hinted at reversal of monetary tightening, but the question is will it act in the policy due tomorrow? Another question is will inflation remain low going forward? This question arises as food inflation is bound to firm up from last week of January when base effect wears off.

Food inflation being structural, it will be crucial to know what RBI thinks is appropriate remedy for future breakouts from inflationary pressures. Also, core inflation appears to have reached a plateau, more because of base effect, and is at the mercy of many external factors including exchange rate, crude oil and commodity prices. In addition, industrial growth has been volatile as it turned positive in November after a contraction in October.

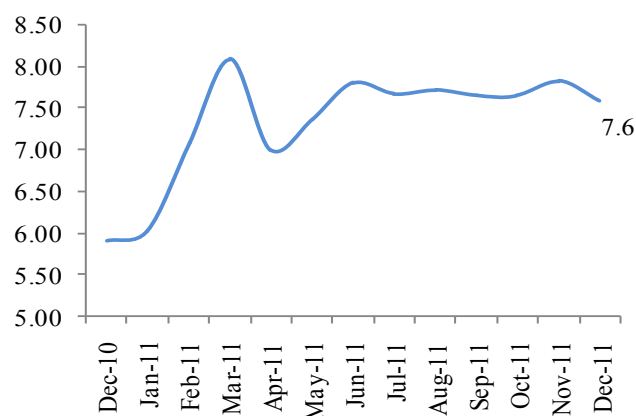
RBI's monetary and macro economic developments document that is released a day before the policy meet may provide some hints to RBI's action on Tuesday. Off late, RBI has faced criticism for being behind the curve and it seems to be a little behind this time too as other central banks, such as China and Brazil, have been assisting growth.

- ◆ **Non-Food Manufactured Inflation:** Non-food manufactured inflation, that forms the basis of RBI's core inflation reading, is yet to see any downtrend in prices. Although core inflation eased on a year-on-year basis to 7.6% in December from 7.8% in November, largely due to high base last year, on a month-on-month basis, core inflation rose 0.6%. Weakening of rupee, elevated prices of crude oil and commodity are some of the factors that led to core inflation remaining firm. This has also prevented producers from cutting prices despite poor demand. Core inflation has risen sharply in last three months compared with earlier months when Indian rupee was stable at ₹44-45 versus the dollar.

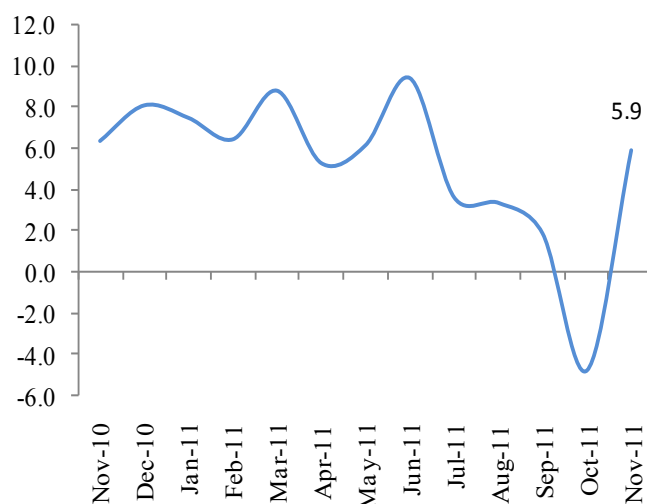
- ◆ **RBI's FX Intervention:** To contain core inflation from factors, such as currency depreciation, it became imperative for RBI to swiftly act. In [Economic Weekly dated January 16](#), we carried details of RBI's intervention. RBI's intervention stabilised rupee and it has gained 7.3% from the all-time low of ₹54.30 against dollar on December 15. All this holistically are attempts to contain inflationary expectations. If indeed rupee trends back to sub-₹50 levels, which also seems likely, it will help restore confidence in RBI's ability to contain inflationary pressures owing to external account.

- ◆ **Growth Dynamics:** Although industrial growth was positive in November, it is unlikely to continue sustainably until intermediate and capital goods show a turnaround. Also, the poor momentum continues as April-Nov industrial growth stood sharply lower at 3.9% compared with 8.4% a year ago. Also, lower IIP growth in October-December (because of a contraction in October) is also going to keep gross domestic product growth at sub-7% levels, on a year-on-year basis.

**Core Inflation % YoY**

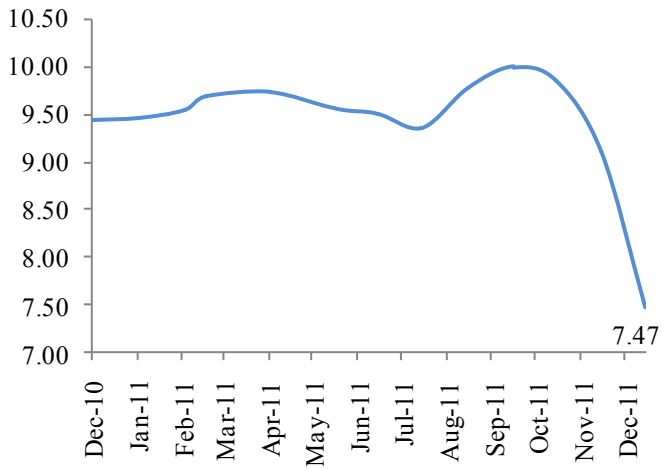


**IIP, % YoY**

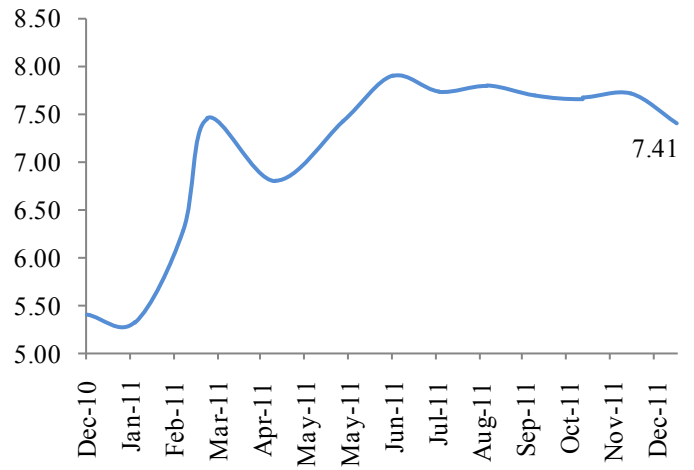


**Only A Matter OF Timing:** Rate cuts by the RBI are now due and it's only a matter of timing when it actually starts easing the interest rate curve. RBI is likely to ease and act when it feels inflationary pressures from external account and others can be managed on a sustained basis. Also, RBI could wait until rupee depreciation is further checked so that core inflation eases on a sustainable basis. We also feel RBI might give priority to Open Market Operations rather than slash Cash Reserve Ratio. However, we feel that the best time for RBI to act is now and it should start easing interest rates as it will take at least two quarters for the impact to feed through the system. Also, while RBI cannot resolve the structural problems behind persistent inflation, it needs to start cutting rates now lest it be accused of acting late, like it was blamed for delaying the onset of interest rate hikes.

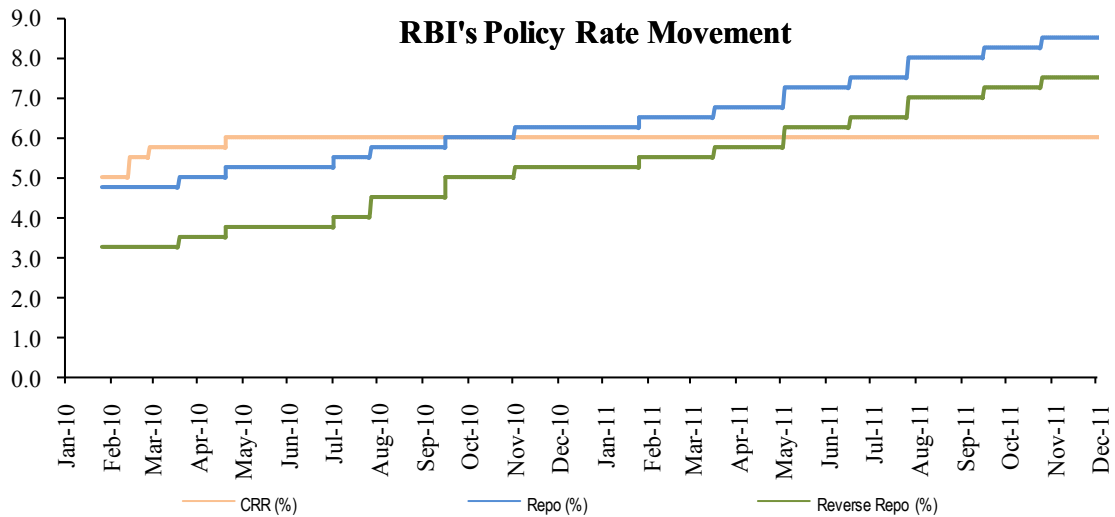
**WPI Inflation, % YoY**



**Manufactured Products Inflation, % YoY**



**Monetary Cycle**

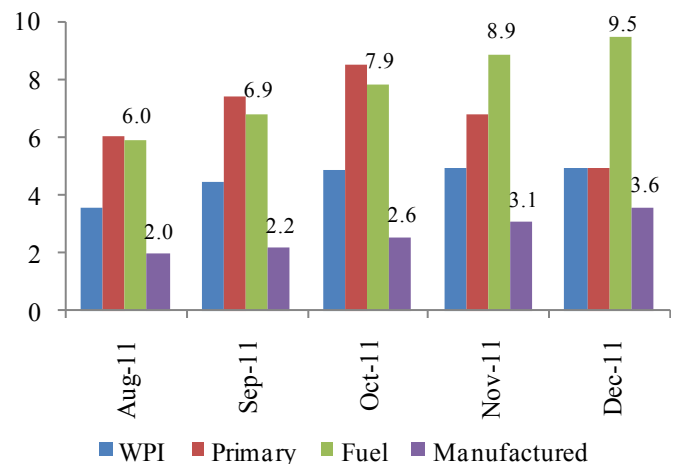


## Inflation Build-up In FY12

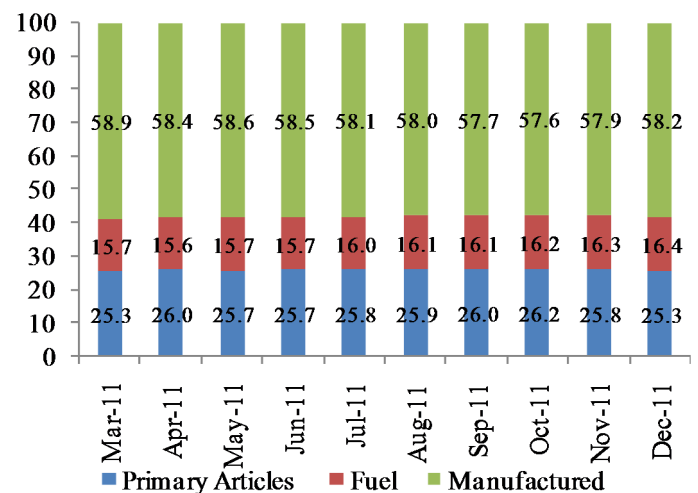
**W**HOLESALE Price Index inflation in December slowed to 7.47% from 9.11% in November. Although inflation has decelerated on a year-on-year basis, it is interesting to analyse pressure points of the inflationary cycle this year. WPI index has risen 4.9% between March-end and December 2011. Over the past three months, WPI index has been largely stable due to primary articles index declining, as food prices eased from previous highs. Fuel index has shown sharpest gain this financial year.

- ◆ **Inflation Drivers This Financial Year:** Fuel has been the biggest driver of inflation this fiscal year. Fuel index rose 9.5% this financial year until December from end of March 2011. Fuel index has increased particularly after sharp depreciation of the rupee since August. Primary articles index has risen 4.9% this financial year, which is lower from 6.9% in November compared with March 2011. Primary articles index has eased in December, which has also caused overall WPI index to remain stable despite pressure from fuel and manufactured index. Manufacture products gained 3.6% until December this financial year. Manufactured products has shown a consistent rise over the months.
- ◆ **Fuel Prices:** Fuel prices are a big pressure point for inflation as it has two-fold effect on the economy; one, direct and, second, indirect through a pass-through effect. India, being a net importer of crude oil, has faced pressure from this commodity due to elevated prices and depreciation of rupee. Fuel contributes around 16.4% to inflation as of December.
- ◆ **Manufactured Goods:** Manufactured products index has continued to rise despite an economic slowdown due to sustained pressure from commodity prices and currency depreciation. It is essential that the rise in manufactured inflation is arrested before RBI can ease the rates cycle. Manufactured products accounts for 58.2% of inflation as of December.
- ◆ **Primary Articles Inflation:** Despite decline of primary articles inflation to 3.1% on a year-on-year basis in December, it still contributes 25.3% to overall inflation despite a 20% weight in the overall WPI. Primary articles have been a major driver of inflation this year. Decline in primary articles inflation has been largely due to high base effect this year.

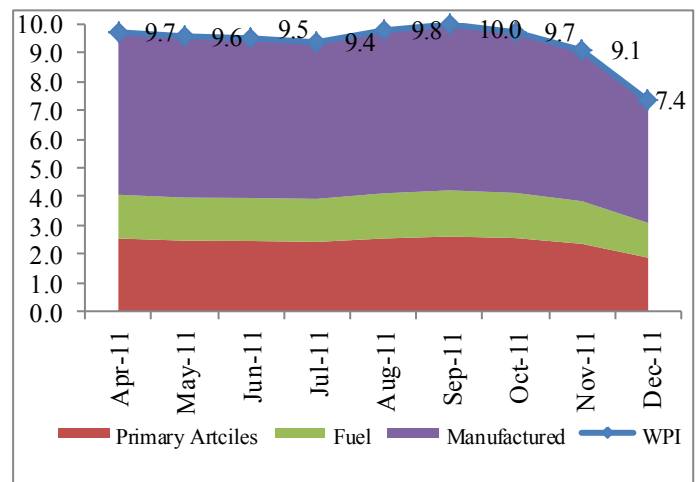
### % Increase in WPI Index Since March 2011



### WPI Major Constituents Trends, % Share



### WPI Inflation, Constituents in %, YoY



## Liquidity Situation Worsens

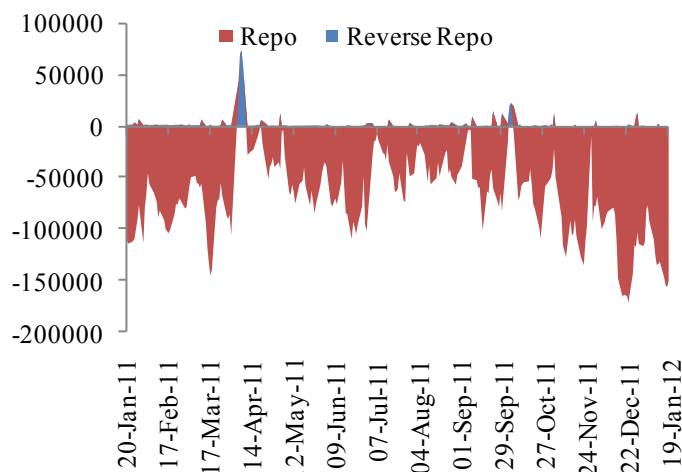
**L**IQUIDITY in the system has remained in sharp deficit in the past few months, particularly since October. It's over one- and-a-half years now that RBI has maintained liquidity in deficit mode to maintain its anti-inflationary stance, but liquidity deficit has increased even beyond RBI's comfort zone of +/- 1% of Net Demand and Time Liabilities (NDTL). Money market rates have edged up due to a liquidity squeeze in the past few months. Additional borrowings by government will make it even more difficult for private companies to borrow from the market.

- ◆ **Net Repo Volumes:** Net average repo volumes stood around ₹150,000 crore this month. This will roughly be 2.5% of Net Demand and Time Liabilities of the banking system. This is despite the fact that RBI maintained that it is keen to maintain liquidity at +/- 1% of NDTL of the banking system. With liquidity deficit over RBI's comfort zone, the clamour for CRR cut has increased. However, given RBI's anti-inflationary stance and its statements to maintain liquidity through OMOs, if and when necessary, a CRR cut might be difficult at the moment. However, any CRR cut will be hugely beneficial to the banking system which is burdened with a large liquidity deficit. OMOs have increased in last two months. In November, net injection through OMOs stood around ₹9,500 crore, while in December it increased to nearly ₹34,000 crore with aggravating liquidity deficit situation. RBI's net sales have been in negative zone since January 2011 indicating net injection of liquidity in the system.

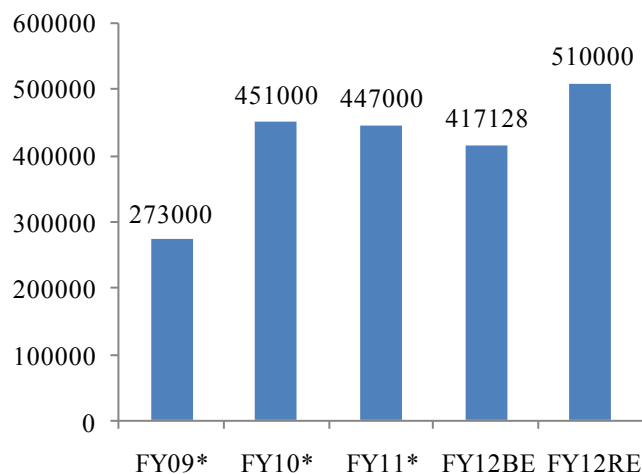
- ◆ **Crowding Out:** Hike in government borrowing by ₹50,000 crore can crowd out private investments. This situation will become serious in the fourth quarter when tax mop-up becomes critical for government and will result in further liquidity squeeze. In addition to its original borrowing programme, government has borrowed ₹90,000 crore. This, coupled with the tight liquidity situation, is going to make it difficult for private players to borrow from market.

- ◆ **Money Markets:** Liquidity deficit has resulted in higher money markets rates. Call rates touched a high of 9.68% in December. Call rates were in 6-7% range in January 2011. Tight liquidity situation forces participants to borrow from money markets on an overnight basis. Call rates have risen consistently since January 2011. Call rates may rise further towards March when advance tax outflows drain the banking system.

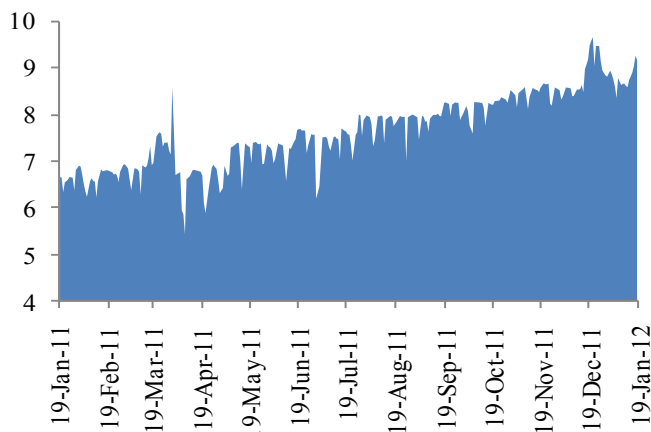
**Repo and Reverse Repo, ₹ Crore**



**Borrowing Programme, ₹ Crore (\*Indicates Actuals)**



**Weighted Average Call Rates, %**



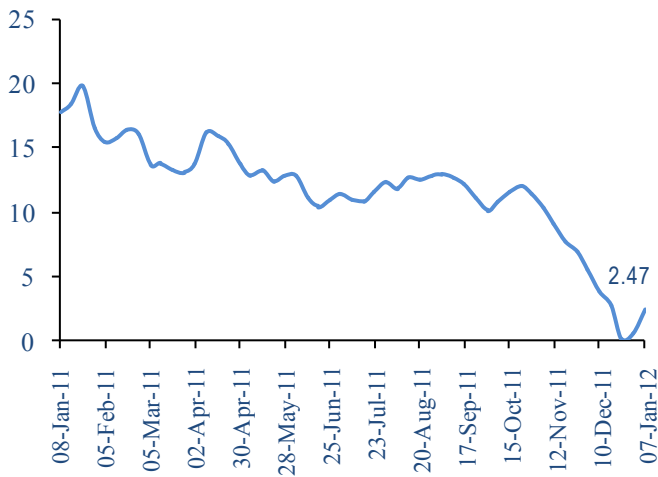
## WPI Primary Articles Inflation

**P** R I M A R Y articles inflation in the week ended January 7 stood at 2.47% on a year-on-year basis compared with 0.51% in the previous week. Weekly primary articles inflation rose because of rise in prices of food and non-food articles. Food inflation remained negative for the third week in a row at negative 0.42% compared with negative 2.90% a week ago.

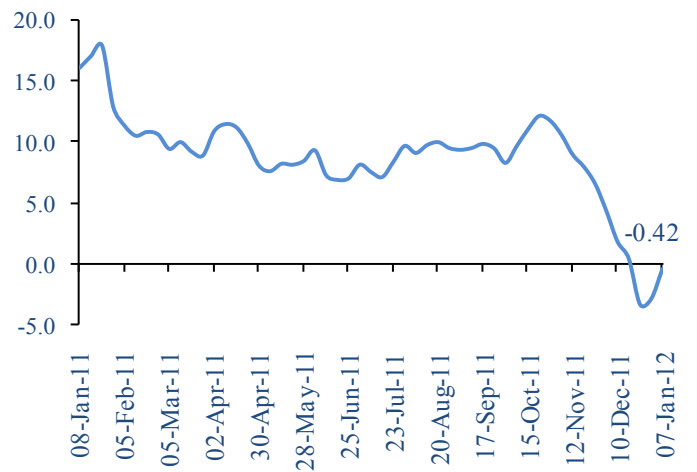
With high base to wear off in coming weeks, especially from January 29, food inflation is likely to turn positive albeit at low single digits.

Non-food articles inflation stood at 1.84% compared with 1.29% a week ago due to rise in prices of non-food articles 0.88%.

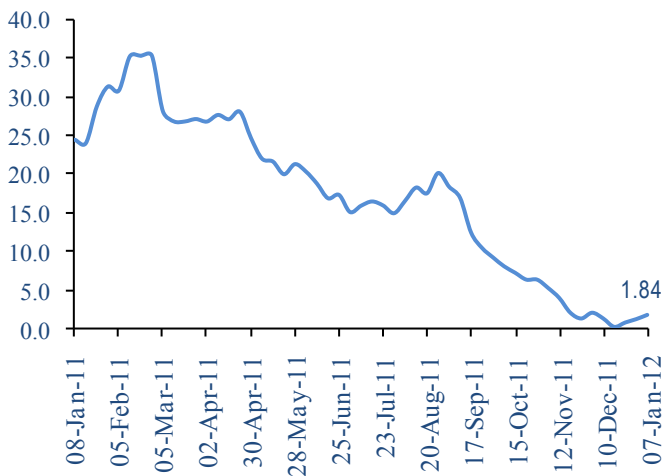
**Primary Articles Inflation, % YoY**



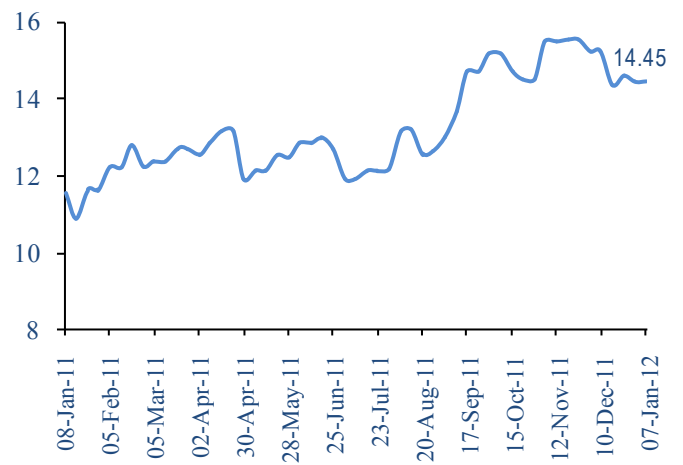
**Food Inflation, % YoY**



**Non-Food Inflation, % YoY**



**Fuel Inflation, % YoY**

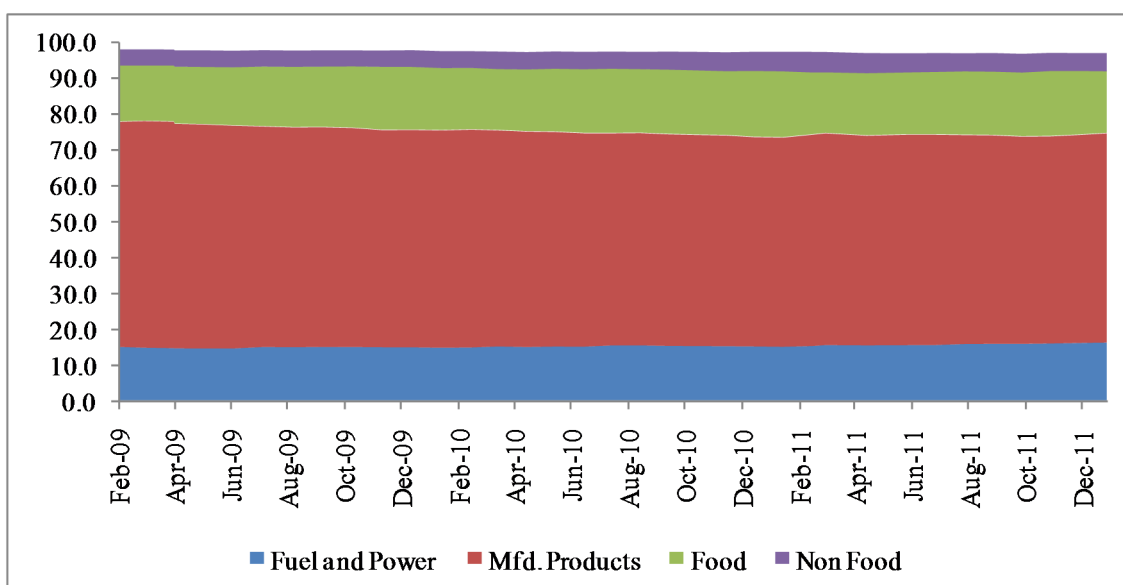


## Weekly Trends In Primary Articles Inflation

- ◆ Food inflation stood at a negative 0.42% on a year-on-year basis in the week ended January 7 compared with negative 2.90% in the previous week. Food inflation was off previous week's low due to food prices rising 0.05% from the week before. Food prices rose due to higher prices of jowar, maize, poultry chicken and fish marine, among others.
- ◆ Non-food articles inflation stood at 1.84% compared with 1.29% a week ago due to rise in prices of non-food articles 0.88% over the week. Non-food articles index rose due to higher prices of oilseeds.
- ◆ Minerals inflation stood unchanged at 24.06% on a year-on-year basis compared with 23.52% in the last week.
- ◆ Fuel inflation stood at unchanged at 14.45% on a year-on-year basis in the week ended January 7 as there was no change in prices.

WPI Sub groups	Index	% YoY	% YoY	% WoW	% WoW
	07-Jan-12	07-Jan-12	31-Dec-11	07-Jan-12	31-Dec-11
Primary articles	199.1	2.47	0.51	0.25	0.51
Food Articles	190.9	-0.42	-2.90	0.05	0.42
Non Food Articles	182.6	1.84	1.29	0.88	1.29
Minerals	322.8	24.06	23.52	0.44	0.00
Fuel	172.7	14.45	14.45	0.00	0.00

## WPI Inflation Trends as % Share of Constituents



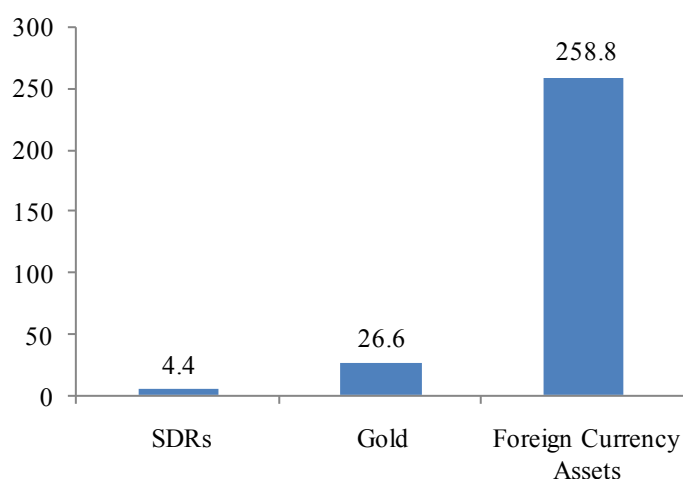
## Forex Reserves Fall Further

**F**OREIGN exchange reserves declined further by \$1 billion to \$292.5 billion in the week ended January 14, largely due to a fall in foreign currency assets. Total foreign exchange reserves comprise foreign currency assets, special drawing rights and central bank's position in gold, all of which are measured in US dollars. Forex reserves have been on a declining trend for the past few months as imports have been buoyant while exports have come down sharply.

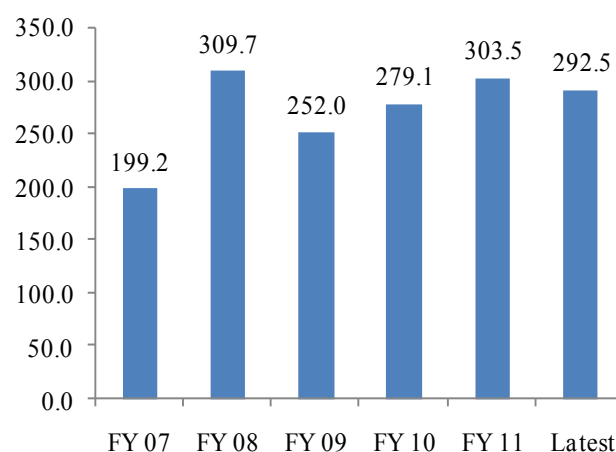
- ◆ During the week ended January 14, foreign currency assets declined \$1 billion to \$258.8 billion. Revaluation changes and RBI's intervention in forex markets could have led to decline in foreign currency assets.
- ◆ Reserve position with International Monetary Fund, special drawing rights, position in gold remained largely unchanged during the week.

\$ billion	Forex Reserves	SDRs	Reserve Position In IMF	Gold	Foreign Currency Assets
24-Dec-11	300.9	4.4	2.7	28.0	265.7
31-Dec-11	296.3	4.4	2.4	26.6	262.9
07-Jan-12	293.5	4.4	2.7	26.6	259.8
14-Jan-12	292.5	4.4	2.7	26.6	258.8

**Forex Reserves Components (in \$ billion)**



**Forex Reserves Annual Trends (in \$ billion)**



## **Speech By RBI Executive Director**

RBI Executive Director B. Mahapatra delivered a speech on 'The Global Financial Crisis' on January 21

### **The Global Financial Crisis: New Awakening**

Backdrop of the speech is unprecedented economic turbulence that the world went through since 2008. Mr Mahapatra described prominent protests that marked 2011 such as Arab Spring, Occupy Wall Street and Spanish Indignados.

The speech also focused on issues such as corporate governance, compensation practices and ethics.

#### **Link to the report:**

[http://rbi.org.in/scripts/BS\\_SpeechesView.aspx?Id=657](http://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=657)

## Growth Signs In The USA

**P**OOR economic news from the Euro zone overshadowed news about improvement in US economic growth. The US economy is improving as can be seen by fall in unemployment ratio. Improvement in automobile sales and new home sales also indicate that US economy could be reviving. Third quarter GDP growth is expected to rise and set the tone for revival. The US has so far faced pressures because of poor labour and housing markets. However, improvement in labour markets raises hopes that housing markets might revive in 2012.

- ◆ **Third Quarter:** US third quarter GDP growth is expected to have improved to 3% from 1.8% in the second quarter. Economists hope to see turnaround on host of factors such as improved consumer confidence, employment generation and auto sales.
- ◆ **Unemployment Dipped:** Unemployment ratio fell to 8.5% in December after almost two years of 9% jobless rate. Employers added 853,000 jobs in the second half of 2011 compared with 782,000 in the first half of the year. New home sales data is pointing to some improvement.
- ◆ **Auto Sales:** Improvement in auto sales is likely to continue



into the fourth quarter also. Auto sales data, which is a lead indicator, showed a strong improvement in the last three months of 2011. Car and trucks sold stood at 13.4 million units in a seasonal annualised basis compared with 12.4 million in previous quarter. Auto sales have been highest since second quarter in 2008. Improvement in consumption can lead the way for an overall turnaround in the US economy.



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