Economics

India: Upside inflation risks remain despite CRR hike

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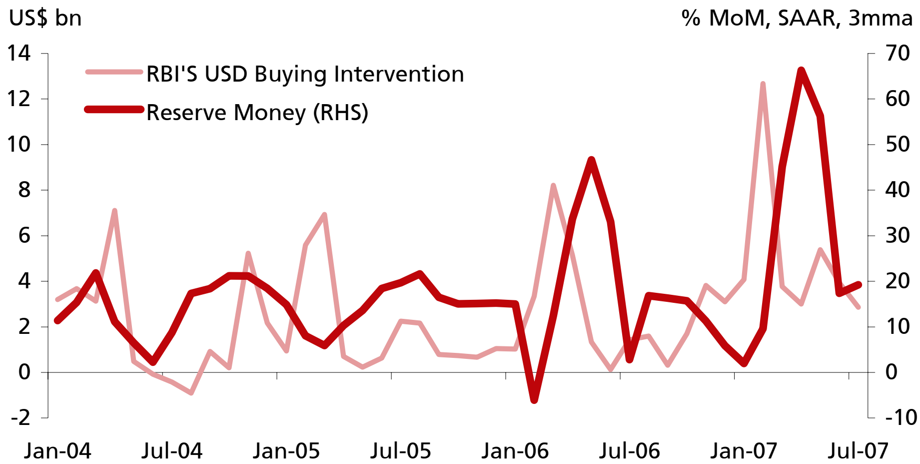
The central bank rightly noted the sharp rise in reserve and broad money in July "warrants" a response

Summary

- At its monetary policy meeting on Jul 31, the Reserve Bank of India (RBI) raised the cash reserve ratio (CRR) by 50bps to 7.00%. The higher rate comes into effect from Aug 4. All other rates, namely, the repo rate, the reverse repo rate and the bank rate were left unchanged at 7.75%, 6.00% and 6.00% respectively. The RBI also withdrew the INR30bn ceiling on daily reverse repo auctions with effect from Monday, Aug 6, while retaining the discretion to re-impose a ceiling as appropriate.

The RBI's moves were not expected by the market but they should not come as a surprise either. The central bank rightly noted that the sharp rise in reserve and broad money in July "warranted" a response. Reserve money growth as on Jul 20 stood at 29% YoY. Unlike previous occasions, the authority did not implement the CRR hike in two steps of 25bps each. However, as we set out below, even the 50bps CRR hike doesn't mitigate rising inflation risks for 4Q07.

IN: Rise in Unsterilised Intervention



Key statements

- The key summary statements from the RBI's policy statement and accompanying macro economic review are:

(1) Domestic economic activity has continued to expand at a strong pace and there are indications that the impulses of growth are getting broad-based.

(2) Pre-emptive monetary measures and fiscal and supply side measures have helped in containing inflation.

(3) It is necessary to note that while there is an abatement of inflation in the recent period, upward pressures persist.

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At the same time, the authority noted 'volatility in equity and currency markets with worldwide ramifications have imparted an additional dimension of uncertainty to the evolution of the international economic environment. These developments are necessitating the RBI to intensify policy monitoring with a policy preference for insulating domestic real activities from these shocks. This suggests that the RBI is likely to continue building FX reserves in line with the 'liquidity at risk'.

Sterilisation still lags behind intervention

- We agree with the authority's assessment on growth and with the CRR hike but we believe they are still underestimating inflation risks. The FX intervention in recent months is still at odds with their monetary policy stance. Foreign reserves stood at USD222bn as on Jul 20, having risen by USD8.5bn month-to-date. Adjusting for FX valuation effects (the data is marked-to-market on a weekly basis), we estimate that the RBI intervention in July was USD6-7bn.

Even after the latest CRR hike, we estimate the unsterilised intervention from May-Jul at circa US$9bn.

As each 25bps hike in the CRR removes only circa USD1.8-2.0bn from the system, the RBI would have to continually keep up the CRR hikes and sterilisation bond issuances to keep reserve money growth under control. In fact, due to seasonal vagaries in money demand and hence in reserve money, we think the RBI has to sterilise more for every dollar of intervention in the months Jun-Sep than it does typically. As such even after the latest CRR hike, we estimate the unsterilised intervention from May-Jul at circa USD9.0bn (***please see table***).

Table: Estimates of Intervention and Sterillisation Operations (US$ bn)

	Injection of Liquidity	Withdrawal of liquidity			Net injection of liquidity
	via FX Intervention	via MSS	via CRR	Total	
			(direct impact)		
Feb-Apr 07	20.0	8.5	7.0	15.5	4.0
May-Jul 07	15.0	2	4	6	9.0

RBI would have to hike the CRR by another 75-100bps in Aug and issue US$2-4bn in MSS bonds (assuming additional intervention in Aug is nil) to offset the US$9bn of liquidity that it has injected via intervention.

- To bring down reserve money growth, the RBI would have to sterilise this amount, but not without difficulty. For example, within the next one month, if we assume fresh intervention is nil (for the sake of simplicity), the RBI would have to hike the CRR by another 75-100bps and issue another USD2-4bn in Market Stabilisation Scheme (MSS) bonds to offset the USD9bn of liquidity that it has injected via previous months' FX intervention. We, however, think the authority would not go to this extent and it would definitely not slash FX intervention. Therefore, inflation risks remain going into 4Q07 (in sequential MoM terms, not in headline YoY terms).

- At present, the outstanding MSS issuances stand at INR900bn vs a ceiling of INR1.1tn. This gives the RBI room to absorb circa USD6bn from the system before it hits the wall (again, something it would not want to do as it gives the wrong signals to the market). Therefore, the ceiling would also have to be raised in next couple of months despite the costs involved in sterilisation and the risks this pose to the Fiscal Responsibility and Budget Management (FRBM) Act targets. The FRBM Act requires that the revenue deficit (excluding capital expenditure and receipts) be eliminated by 2008-09. The government has the room to hike the MSS at present due to buoyant tax revenue but still has to exercise caution.

- However, doing all this is not sufficient to keep inflation well behaved in 4Q07. We expect WPI inflation growth to rise above 7% MoM (saar) in Oct-Dec 07. The RBI however wants to keep the annual average WPI inflation below 5%. While the RBI looks at the headline YoY rate, it would be a matter of time before the sequential growth in inflation reflects in the annual comparison. In order to meet the targeted inflation, the RBI would have to cut intervention by half in the coming months and really increase sterilisation efforts. Indeed, they really need to bring down reserve money growth rate towards 20% y/y – a level that seems contrary to their desire to control the USD/INR (for more details, please see article "India: Reassessing potential growth, inflation risks" Jul 30, 2007).

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