

Another rate hike – May not be the last one

Overview: The 25 basis points (bps) hike in the repo rate, announced today by the Reserve Bank of India (RBI), should be seen in the light of persistently high inflation. As of August 2011, headline inflation, as measured by the Wholesale Price Index, remained above 9 per cent for the ninth consecutive month and is rapidly inching towards the double-digit mark.

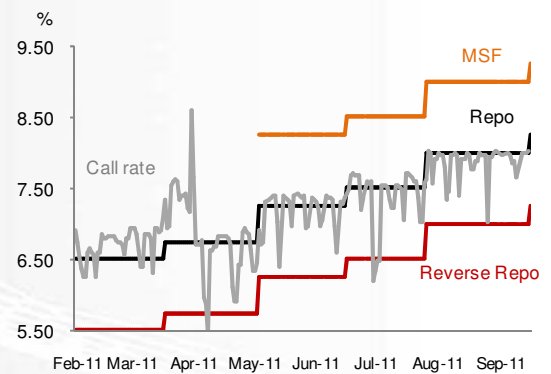
Any hike in interest rates first reduces demand before curbing inflation. And this happens with a lag. While there are clear signs of a slowdown in domestic demand, the second leg of policy rate transmission is yet to occur, as core inflation shows no signs of abating. Non-food manufacturing inflation (core inflation) is stubbornly high at 7.7 per cent, reflecting demand-side pressures.

Inflation will moderate in the second half of 2011-12 as slowing demand will lower core inflation. It will however, continue to persist above the RBI's comfort zone. The recent depreciation of rupee will push up the imported component of inflation. In addition, high food inflation despite good monsoons and artificially suppressed fuel prices due to the incomplete pass through of global crude oil price will offset some of the gains from falling core inflation. While we might be heading towards the end of the rate hike cycle, today's hike may not be the last one.

Higher inflation makes way for another policy rate hike

- The RBI, on September 16, 2011, raised the repo rate by 25 bps to 8.25 per cent. This is the twelfth increase in policy rates since March 2010.
- Although headline inflation and core inflation currently remain high at 9.8 per cent and 7.7 per cent respectively in August 2011, the cumulative impact of past rate hikes on output growth and subsequently on inflation will increasingly come forth through the rest of 2011-12.
- While export growth remained high at 54.9 per cent in the first four months of 2011-12, it is unlikely to sustain in the coming months, given the worsening global macroeconomic outlook.

Chart 1: Another rate hike to combat inflation

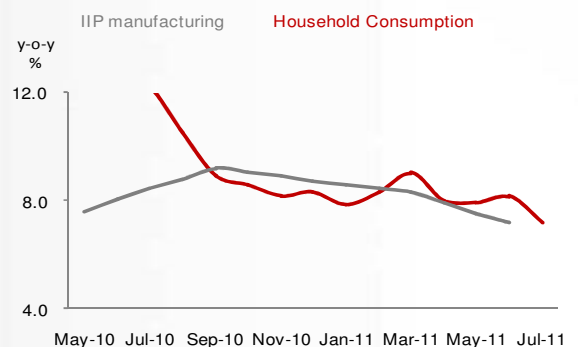


Source: RBI

Monetary policy transmission is gathering pace

- Increases in interest rates raises the cost of bank credit which dampens demand for goods and services. With a moderation in demand growth, pressure on prices comes down.
- About 60% of total demand in the economy comes from household consumption. Household consumption growth declined to 6.3 per cent in April-June 2011 from 9.5 per cent a year earlier.
- Investment growth, especially the housing and construction segments have also seen lower growth with a commensurate decline in credit growth. Credit growth to other industrial sectors has also sharply slowed over the past year, as reflected in IIP manufacturing growth.

Chart 2: Impact on output and consumption is evident



Note: Data pertains to 6 month moving average. Household consumption for interim months is estimated

Source: Ministry of Statistics, Central Statistical Organisation

Table 1: Inflation pressures refuse to abate

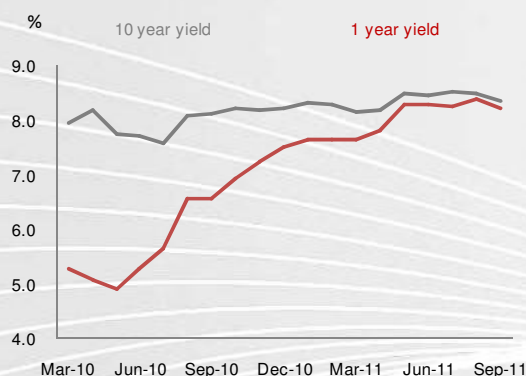
	2008-09	2009-10	2010-11	April to August '11
WPI-ALL	8.1	3.6	9.6	9.6
Total Food	9.1	15.2	15.8	8.5
Core	5.7	-0.3	6.3	7.4
Fuel group	11.7	-1.7	12.3	12.6

Source: Ministry of Commerce and Industry, CRISIL Research

Inflation to persist above RBI's comfort zone

- Food inflation will remain stubbornly high despite a normal monsoon, due to higher minimum support prices and a persistent gap between demand and supply of food articles.
- With petrol prices being raised again in September, and with global fuel prices yet to pass-through fully into the domestic market, inflation woes will increase. Moreover a depreciating rupee will push up cost of imports.
- The impact of the RBI's past rate hikes is yet to result in lower inflation. Even if month-on-month pressure on core inflation begins to subside hereon, overall inflation could reach only about RBI's projection of 7.0 per cent by March 2012 - still above the comfort zone of 5.0 to 5.5 per cent.

Chart 3: Short-term rates have risen faster



Source: RBI, CRISIL Research

Monetary tightening and higher short-term government borrowing have narrowed spreads

- During April to August 2011, the Centre borrowed mostly at the shorter end of the yield curve by issuing more cash management bills to meet temporary liquidity mismatches.
- At the longer-end, since the government borrowing programme has been as per schedule (raising Rs 2,400 billion so far this fiscal, yields remained fairly unchanged. At the shorter-end however, higher issuance of cash management bills (of Rs 720 billion) in addition to the stipulated treasury bills pushed up short-term yields.
- On account of monetary tightening and higher government borrowing, 1 year government bond yields have risen higher than the 10-year bond yield, which has narrowed spreads.

Table 2: Sector-wise bank credit growth

(Growth y-o-y %)	Industry	Services	Personal loans	Textiles	Iron & iron products	Infra structure
1QFY09	26.9	31.3	15.9	20.9	24.4	41.7
2QFY09	30.6	35.3	17.4	23.1	33.7	35.8
3QFY09	30.2	27.6	14.6	18.4	24.7	38.5
4QFY09	25.8	19.2	8.5	12.5	37.0	35.1
1QFY10	21.2	20.5	5.5	8.3	29.9	35.1
2QFY10	17.9	11.0	2.3	9.3	23.2	44.7
3QFY10	15.7	11.5	-0.4	9.2	21.3	43.2
4QFY10	20.1	15.0	4.7	12.7	23.9	42.3
1QFY11	25.8	14.1	6.5	18.6	26.2	44.3
2QFY11	29.2	21.0	8.9	16.7	26.5	55.0
3QFY11	27.4	25.0	13.4	17.0	28.2	43.1
4QFY11	23.6	23.9	17.0	19.2	28.0	38.6
1QFY12	22.0	20.9	17.3	20.3	21.0	30.2

Note: Financial year

Source: RBI

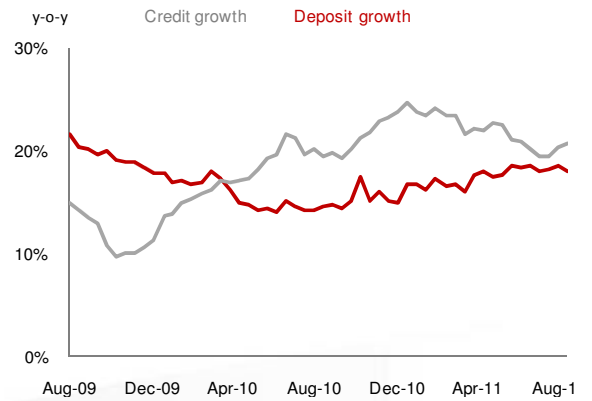
Credit growth to moderate to 18 per cent by March 2012

- Aggregate y-o-y bank credit growth moderated to 20.7 per cent as on August 26, 2011 from 21.6 per cent on March 25, 2011, due to slowdown in economic growth and rising interest rates.
- There has also been a marked slowdown across sectors such as infrastructure, especially telecommunication, and petrochemicals.
- CRISIL Research expects credit growth to moderate further to about 18 per cent by March 2012 due to a slowdown in investment growth.
- With the additional 25 bps hike in repo rate, banks' cost of funds will rise further. However, sluggish credit demand and the limited ability of banks to pass on the increase in cost of funds would pull down their net interest margins by 15-20 bps in 2011-12.

Deposit growth to be robust at 18 per cent by March 2012

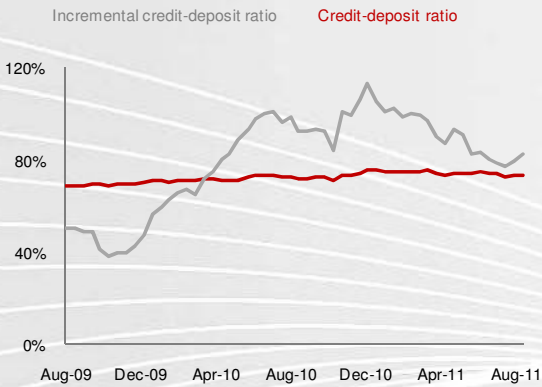
- The cumulative rise in deposit rates in the first quarter of 2011-12, moderation in economic activity and a correction in capital markets, accelerated deposit growth to 18.0 per cent as on August 26, 2011 from 16.0 per cent as on March 25, 2011.
- With an easing liquidity situation and slowdown in credit off-take, CRISIL Research does not expect deposit rates to rise further over the next two quarters.
- Among other funding avenues, Certificate of Deposit (CD) issuances too have been subdued in the first half of 2011-12 as liquidity levels stay comfortable.
- As the real rate of return turns more attractive, deposit growth is expected to remain at about 18 per cent for 2011-12.

Chart: 4: Growth in credit and deposits



Source: RBI

Chart 5: CD and Incremental CD ratios

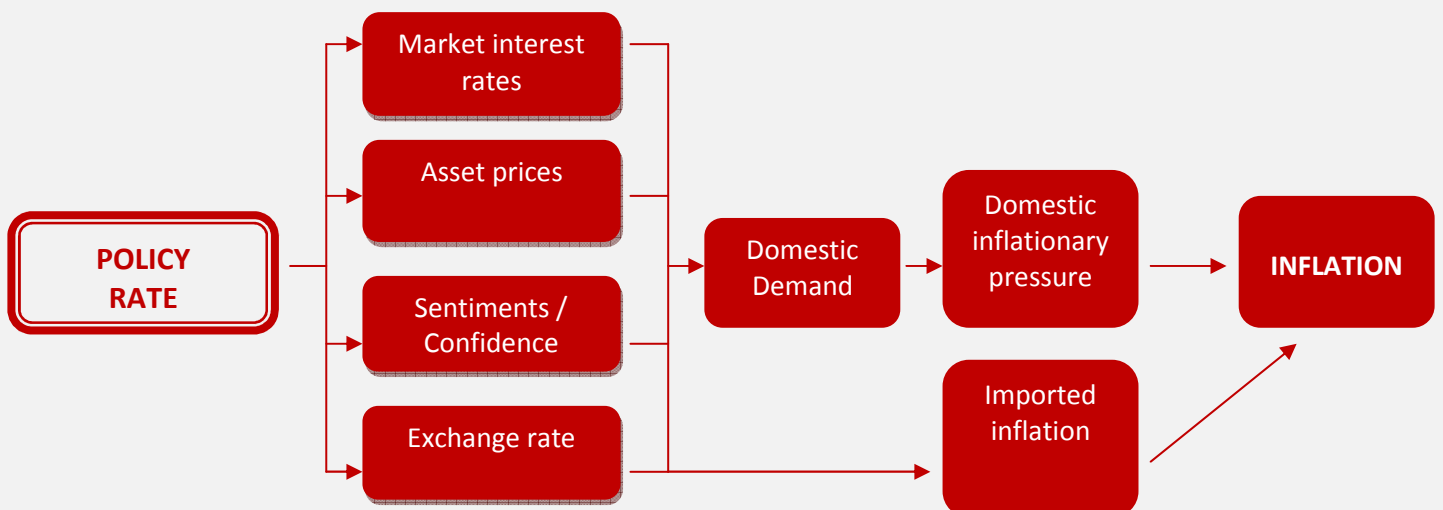


Source: RBI

Incremental credit-deposit ratio to further fall to 75-80 per cent by March 2012

- With a moderation in credit off-take due to higher interest rates, and a relatively higher growth in deposits, the incremental credit-deposit ratio declined to 82.7 per cent on August 26, 2011 from 97.2 per cent on March 25, 2011.
- As this scenario is likely to continue, CRISIL Research expects the ratio to stabilise at 75-80 per cent by the end of 2011-12.

Box 1: Interest rates to Inflation – Understanding the transmission mechanism



Source: Bank of England

Macroeconomic Outlook 2011-12

	Parameter	2011-12
Growth (%)	Agriculture	2.7
	Industry	7.3
	Services	9.4
	Total GDP	7.7-8.0
Inflation	WPI Average	8.0-8.5
Interest Rate	10-year G-sec (Year-end)	8.1-8.3
Exchange Rate	Re/US\$ (Year-end)	43.0-44.0
Fiscal deficit	Fiscal Deficit (as a % of GDP)	5.0

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Last updated: 31 March, 2011

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