Don't Strike The Iron When It Is Hot
(RBI should not Increase Rates Further)

As time approaches for the Reserve Bank of India to announce its annual monetary policy for the year 2011-12, money markets have gone into a tizzy. Bond yields have gone up by around 20 points across maturities and across the rating spectrum. The ten-year benchmark government bond which was lapped up by an optimistic trading community at 7.80% in the first week of April, soon slipped to 7.90% and later to 8.07%. Top rated bank bonds also lost ground as yield on the 10-year (at call) State Bank of India bond increased from 9.19% to 9.37%. Other corporate bonds are faring much worse as they are finding few buyers even at levels ranging from 9.55% (AAA) to 13.00% (junk variety).

So what has brought about this sudden panic? After all, the Reserve Bank has been gradually increasing key policy rates for over thirteen months now. The expected hike on May the third should hardly be a cause for major concern.

The Probable Panic Triggers

Very briefly, the following are some of the factors that would have influenced the market makers:

1. The banking system had become flush with funds in April first week following Government's March-end spending – a normal phenomenon every year. Banks were lending overnight surpluses exceeding Rs 600 billion to RBI in reverse repos. Now, just three weeks later, banks have to borrow Rs 500 billion from RBI in repos every day. This is quite unusual for this time of the year as the Government's borrowing for the year has not even begun in full earnest.

2. Inflation fears have been further stoked by Deputy Governor Dr. Subir Gokarn's address to a leading Chambers of Commerce on April 05,2011. http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=558#Slide8 The central bank's top internal economist decried all attempts to treat high inflation as a new norm and has warned of a spiraling price rise. The use of the word "spiraling" has spooked traders as it denotes the seriousness that the central bank is awarding to the situation.

3. While, the market has taken in its stride all of RBI' s tightening actions spread evenly over last one year , such calmness was possible because many of the early steps were perceived as only a rollback of the easy money policy which was enacted in 2008-09 following the global liquidity crisis. Now the future actions are being seen as just the beginning of a new tightening cycle.

4. It is feared that once the overnight rates cross 7.50%, we may witness chaos in the bond markets. While the Government bond yields may be affected only marginally because of compulsory regulated buying, other top rated bonds may see a total lack of buying interest from banks/mutual funds/insurance companies leading to competition in

pricing between issuers. This would really spike the yields and put them on the path to the high levels of 2008 when AAA bonds got placed at 11.00% to 11.25%.

5. Lastly, it is the fear that RBI's hammer strike may be heavier than the traditional one quarter of one percent that may be causing so much distress amongst bond investors. This fear is leading to the unloading of trading positions not unlike the proverbial small animals jumping off a sinking ship.

Should RBI stoke such fires?

What has the central bank achieved by giving rise to such panic in the money markets? Consider its actions in the past few months :

1. The central bank withdrew liquidity from the banking system by increasing cash reserve ratio (which carries no interest) from 5.00% to 6.00% last year. Therefore, it has forced banks into borrowing their own money back from RBI by paying a high rate of interest and making the banks non-compliant of basic asset liability management principles.

2. It has raised overnight rates by around 2.50% in a series of eight baby steps spread over twelve months.

3. During the same twelve months, annual inflation on a YoY basis has come down from 10.23% in March 2010 to 8.98% in March 2011. Food inflation has come down from 22.16% to 12.96%; Fuel and Power inflation is steady at 12.92% from 13.81% a year ago while Manufactured Goods inflation has gone up from 5.19% to 6.21%. Since the latter has a wieghtage of 65% in the total index, it has managed to pull up the entire inflation from an expected 8% to an actual 8.98%.

4. Dr. Gokarn has lamented that higher inflation is making the workers and the producers raise their wage and price demands leading to a vicious cycle that may well spiral out of control.

Some Counterpoints

While not doubting Dr. Gokarn's sincerity of purpose in the fight against inflationary pressures, one would like to take a close look at the interpretation of the data presented in his treatise. http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=558#Slide8

1. The Deputy Governor has had GDP and inflation data plotted in an effort to prove that whenever high growth has been accompanied by high inflation it has been followed by long spells of low growth low inflation. What has not been mentioned is that the in both the given instances, it was the severe tightening measures that may have led to fall in the growth rate. Further, the attempt to justify this reasoning by giving examples of China for its high growth low inflation model cannot be accepted as none of us knows the imperatives of the pricing of wages or products in that country.

2. With regard to food inflation, the data given by Dr. Gokarn appears to support a hands off approach for monetary regulators (and not the hammering that has actually been handed out).
   A detailed study of product specific price data given on the official website *http://eaindustry.nic.in* throws up some interesting facts.

   a. In a number of important commodities current prices are either the same (or lower) than in 2004-05 (base year) or the same have gone up by only 2%-3% per annum. Remember, there could have been a sudden high spike during this period but the supply response by producers has ensured a fall at a later date. These commodities include potatoes, green peas, tomatoes, cauliflower, coconut, grapes, ginger. Items like vanaspati and groundut oil in processed food items also reflect a similar picture.

   b. Then there are a number of commodities where prices went up sharply in the 2005-07, but the same are relatively stable (or even lower) since then. This would foremost include the overall cereal and pulses index which has remained unchanged for over 24 months now. Further, individual commodities include oilseeds, rice, gram, tea and coffee reflecting unchanged prices over 30 months or so.

   c. We have items where price hikes came in the year 2009-10 but the inevitable supply responses have ensured a fall in prices, a fall which could continue till prices come to more reasonable levels. Some of these items are arhar, moong ,masur and urad (all pulses), onion, brinjal, and mutton.

   d. Finally, we have food items like milk, fish, eggs (animal products) and fruits where the supply response is likely to take longer because of obvious practical considerations. These items are also constitute the category favoured by consumers migrating from low income to middle income groups and, hence, the fast growing demand is outstripping the supply response. Such items would take longer to stabilize.

This attempt to analyze food inflation data has been made only to underline that monetary responses have very little role to play in fighting such price rises. True , the effects on wages and overall inflation has to be considered but we must also remember that people have choices amongst the same category of foods (say fruits, vegetables, pulses, oils) and, therefore, higher prices of a particular commodity leads to shift in eating preferences and lower demand for such products until the supply catches up and brings down prices.

3. A further study of price data over the past six years (beginning base year 2004-05) reveals that overall the prices have been increasing at the rate of 6.8% per annum. This annual YoY increase has been led by Primary articles (11% p.a.) having an Index weight of 20% and Fuels/Power (8% p.a.) having Index weight of 15%. The Manufacturing sector, with the balance weight of 65%, has been relatively calm with an annual increase of 4.9%. Even in the manufacturing sector, one of major drivers of inflation have been Food products and Metal alloy products which together have an Index weight of around 21%. Thus, fuel, food and food products have been the major drivers of inflation in the recent past.

4. Prices of manufactures products remained almost unchanged between June 2008 to November 2009. This was despite a 16% hike in prices of the sub-category manufactured food products (as a direct fallout of rise in primary food prices). This would imply that the rest of the manufactured category actually saw a fall in prices during these 18 months. Remember this was the global crisis period. This period also witnessed wage cuts in many industries. Now that the crisis has passed, it is just normal for employees to regain lost ground by demanding higher wages and for producers to fix higher prices to retain profit margins. This exhilaration is unlikely to continue much longer and the prices are likely to start stabilizing soon enough.

5. The aforesaid conclusions can also be drawn from Dr. Gokarn's presentation where he has given details of drivers of inflation in Slide 5. The data shows that Manufactured Non-Food category accounted for zero percent of inflation in 2009-10 and the entire blame fell on Food, Fuel and Food Products. A certain amount of backlash from industry is quite on expected lines and not really unreasonable. The coming months should now see greater stability in Manufactured Goods prices.

Conclusion- Do Not strike the Hot Iron

After this long and rather arduous exercise, we can conclude as under:

- Food prices of a number of items have been falling over the past few months and once the base effect of last year wears off, we are likely to see the food inflation coming down to 5% or less within the next four to five weeks. The country has had a record production of food grains.
- This will also have a stabilizing effect on food products which form part of the Manufacturing Goods Index.
- Prices of crude oil appear to be coming out of the free fall mode.
- The Index of Industrial Production shows clear signs of a sharp slowdown particularly since November 2010 when RBI's tightening measures started showing their effect. The IIP is likely to reflect a growth of 8% in 2010-11 as against 11% last year. Clearly the rising interest rates have spooked producers besides sending consumers into the savings mode.
- Rising interest rates are actually leading to an increase in cost of production and, hence are contributing to inflation.
- There are signals that commodity prices world-wide may start falling in the near future which would augur well for India's domestic prices.

Looking at this scenario, it would appear that India's economy is still hot enough to remain on the fast growth trajectory for quite some time. However, it is also in a brittle situation on account of the very high prevailing interest rates (ranging from 13.50% to 16.00% p.a. for most classes of entrepreneurs). Reserve Bank of India appears to be in no mood to pay heed to the warning signals being emitted by the bond markets as well as by the IIP numbers. Increasing the interest rates every 45 days in the last one year, has created a climate of uncertainty as well as inevitability- both of cannot be good for fresh investments.

The Reserve Bank should consider holding back further rate increases for at least next three months and closely study price behavior lest it has to backpedal later (as it had to do quite embarrassingly in late 2008). Let it not strike the iron when it is hot- lest it break.

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http://econintersect.com/wordpress/?p=8391

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