A STUDY OF IMPACT OF RBI POLICY RATES ON INFLATION

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INTRODUCTION

The Reserve Bank of India (RBI) is the Indian central bank. The RBI's most important goal is to maintain monetary stability - moderate and stable inflation in India. The RBI uses monetary policy to maintain price stability and an adequate flow of credit. Rates which the Indian central bank uses for this are the bank rate, repo rate, reverse repo rate and the cash reserve ratio.

The Reserve Bank of India (RBI) raised repo and reverse repo rates 13 times in previous year. RBI also deregulated savings bank deposit rate with immediate effect. This step was taken to arrest rising inflation in Asia's third largest economy. But this RBI's decision to hike short-term lending and borrowing rates could lead to higher interest rates and impact the growth momentum of the economy.

An Indian company has postponed expansion plans and review future profitability projections after the Reserve Bank of India raised key interest rates. The central bank also revised the GDP growth rate for FY11-12 to 7.6% from the earlier 8%, while the projection of WPI inflation has been kept unchanged at 7% for March 2012.

RESERVE BANK OF INDIA (RBI)

The Reserve Bank of India was inaugurated as on April 1 1935. Originally, the Reserve Bank was constituted as a shareholders' bank based on the model leading foreign central banks on that time. The bank's fully paid share capital was Rs. 5 Crores divided into shares of Rs. 100 each. Of this, Rs. 4, 97, 80,000 were subscribed by the private shareholders and Rs. 2,20,000 were subscribed by the Central Government. On January 1, 1949 the Reserve Bank of India started functioning as a state owed central banking institution.

As per Reserve Bank of India Bulletin RBI aims at the promotion of monetary integration of the economy, filling in the "Credit gaps". The preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as "to regulate the issue of banking notes and the keeping of reserve with review to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantages."

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Objectives of RBI:-

- ✓ To regulate the financial policy and develop banking facilities through the country.
- ✓ To remain free from political influence and be in successful operation for maintaining financial stability and credit.
- ✓ To act as the note issuing authority, bankers' bank and banker to government and to promote the growth of the economy within the framework of the general economic policy of the government, consistent with the need of maintenance of price stability.
- ✓ To assist the planned process of development of the Indian economy.

Other important tasks of the Reserve Bank of India are:

- to maintain the population's confidence in the system, to safeguard the interests of those who have entrusted their money and to supply cost-effective banking systems to the population;
- to manage foreign currency controls: facilitating exports, imports and international payment traffic and developing and maintaining the trade in foreign currencies in India;
- issuing money (the rupee) and adequately ensuring a high quality money supply;
- providing loans to commercial banks in order to maintain or grow the Gross National Product (GNP);
- acting as the government's banker;
- acting as the banks' banker.

RBI Repo rate or key short term lending rate

When reference is made to the Indian interest rate this often refers to the repo rate, also called the key short term lending rate. If banks are short of funds they can borrow rupees from the Reserve Bank of India (RBI) at the repo rate, the interest rate with a 1 day maturity. If the central bank of India wants to put more money into circulation, then the RBI will lower the repo rate. The reverse repo rate is the interest rate that banks receive if they deposit money with the central bank. This reverse repo rate is always lower than the repo rate. Increases or decreases in the repo and reverse repo rate have an effect on the interest rate on banking products such as loans, mortgages and savings.

REVERSE REPO RATE

Reverse repo rate is another method used by the RBI to control spiraling inflation. When the RBI thinks too much money is floating in the economic system, it increases the reverse repo

rate. This means that suddenly, the banks have a place to park their money which will fetch them a better rate of interest. Their money with RBI is completely safe. It is risk free.

Inflation:-

The inflation rate in India was last reported at 9.34 percent in November of 2011. From 1969 until 2010, the average inflation rate in India was 7.99 percent reaching an historical high of 34.68 percent in September of 1974 and a record low of -11.31 percent in May of 1976. Inflation rate refers to a general rise in prices measured against a standard level of purchasing power. The most well known measures of Inflation are the CPI which measures consumer prices, and the GDP deflator, which measures inflation in the whole of the domestic economy.

The current inflationary situation is way above the central bank's comfort zone of 5-6 percent. Higher inflation is not the only factor that is disturbing but it is also its stickiness that is frustrating. Headline inflation that is measured by the WPI (wholesale price index) has not come down to RBI's comfort level since December 2009 and has stayed above 8 per cent consistently from January 2010 onwards. The last time that inflation remained so high was from March 1994 to May 1995.

The current rise in inflation started from July 2009 (-0.62 per cent) from when it started to accelerate while the economy was still recovering from the significant global slowdown. From July 2009 it continued to show rising trends before reaching its recent peak of 14.86 percent in the month of April 2010 (see graph). Thereafter, moderating for some time, it again accelerated in the last three months. Inflation for the month ending March 2011 stood at 8.82 percent. There were arguments that as a higher base effect factors in, inflation will moderate from the first quarter of the 2011. In the month of October 2011 (See graph) again inflation reach to 10.06 percent on that time again RBI revised their rate. As a result of this now the inflation is declining.

Source

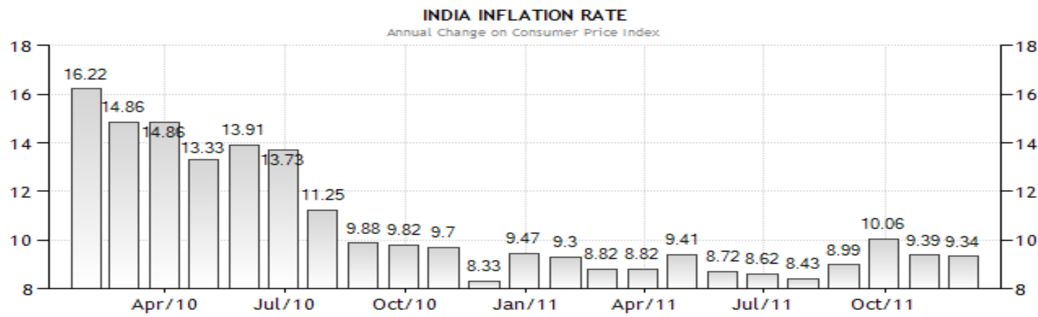
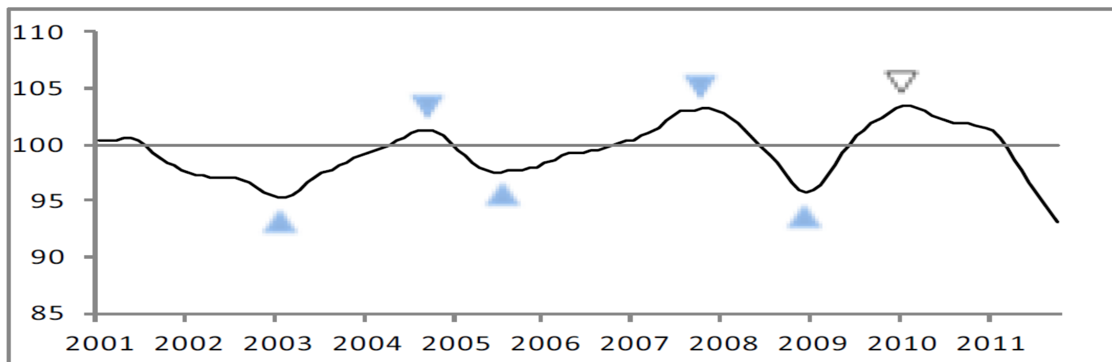


Figure 1 India Inflation Rate

Impact On Economy:-

One of the major functions for any central bank is to strike a balance between inflation and growth. Rise of any one can imbalance the other. Therefore the current high inflationary situation and consequently higher interest rates are definitely impacting the growth of the economy. The fact is well-captured in the observations based on Composite Leading Indicators (CLIs) developed by the OECD (Organisation for Economic Cooperation and Development) on the basis of parameters like IIP data, passenger car sales, call money rate, etc that provide early signals of turning points with regard to economic expansion and slowdown.



http://fin-insight.com/markets-this-week-2

Figure 2:- Composite Leading Indicators for India

From March 2010, CLI for India has started showing signs of falling (see graph) and for the month of March 2011 it was 99.59, down from 99.78 computed in the month of February. The way this figure is interpreted is that if CLI is decreasing and is below 100 it connotes a slowdown in the economic activity which is the case with India. CLI for India has been below 100 since January 2011 and is decreasing month on month. The fact that the economy is decelerating is further reiterated by the recent 'on the record' acceptance by the finance

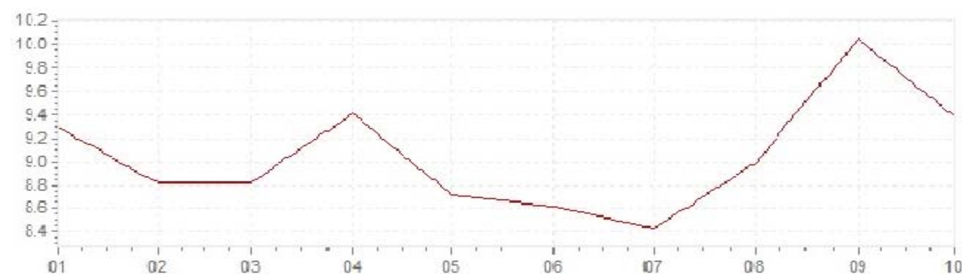
minister that the Indian economy will expand at a rate of 8 per cent for the year FY12, lower than what he had projected in his last budget speech of February 2011. Therefore, it is quite clear that rising inflation and interest rate is weighing heavy on the economic growth rate. But the worse news is that despite raising rates by thirteen times since December 2011, the interest rates have not peaked out. This will ultimately impact the business growth which is already struggling from higher commodity prices. Here is a check on the sectors and companies that are likely to face a higher level of pressure.

Supply And Demand

It is commonly believed that it is the supply side constraint and structural bottlenecks that lead to a high rate of inflation every time the economy picks up. The current situation seems to be no different. However, if we dissect the WPI data the reason for such a sharp increase can be attributed to both supply as well as demand side factors. Initially it was the supply side reaction due to the deficient monsoon of 2009 in most parts of the country, which led to lower agricultural production and higher prices. This fact is clearly reflected in the food inflation that has remained constantly in double digits from June 2009 to January 2011. Prior to that (between FY05-FY09), food inflation largely remained in single digits.

Apart from food inflation, fuel and power saw a significant rise in their prices due to a sudden and steep rise in the price of the crude oil due to the geo-political risks that came up. However, it is not only the supply side alone that is making the RBI’s effort less effective. We find that the demand side pressures are equally playing their own part to fuel inflation.

As inflation in manufactured products has refused to decline substantially, unlike food articles’ prices, it has become a bit of a puzzle as to how manufacturers are passing on increased input prices to customers, despite low demand. The overall macroeconomic scenario was not supporting demand. However, the demand would pick up in the next two quarters. This is predicated by many of the senior economist.



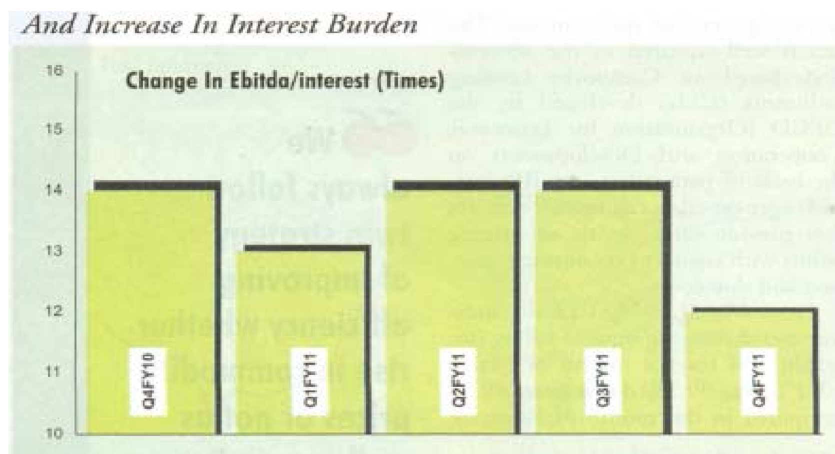
Source:- www.inflation.eu

Figure 3:-CPI (consumer price index) inflation India 2011 (yearly basis)

Impact on Sectors

Needless to say that interest rate-sensitive sectors and companies with a larger debt to equity ratio will be most affected by the rising interest cost. Some of the sectors due to the nature of being more capital intensive like construction, power, telecom, etc are likely to be hit most due to their high leverage. Apart from the increase in the interest burden it also seriously impacts any capex[1] plans by the companies. According to data compiled by CMIE (Center for Monitoring Indian Economy), India industry has a pipeline of projects worth Rs 22,00,000 crore lined up for 2010-13. Out of these, projects worth Rs 5,50,000 crore were expected to be commissioned in 2010-11, Rs 8,50,000 crore in 2011-12 and Rs 8,00,000 crore in 2012-13.

Moreover, according to reports, CMIE estimates that power, steel, road transport and allied services, telecommunications and petroleum are the sectors (in that order) wherein companies have announced mega investments for the next few years. The power sector alone is expected to commission projects worth Rs 4,40,000 crore by March 2013 to add generation capacity of 81,000 MW. Though these are long-term investment programmes and financial closures must have been achieved earlier, the interesting thing to point out is the implementation of the base rate. As banks now cannot lend below these rates any increase in the base rate will increase the interest burden for the companies and will directly hurt their financials.



Source:- Dala Street

If we analyze the interest cost of India industry. We find that it has already started showing signs of stress on the P&L accounts of the companies. For the 1,065 companies that have already

[1]Money spent to acquire or upgrade physical assets such as buildings and machinery. This tends to be a very large expense for companies with significant manufacturing facilities, and usually much less of an expense in the services sector. Also called capital spending or capital expense.

declared their Q4FY11 results (excluding finance companies), the finance cost has increased from 1.69 per cent of sales in Q4FY10 to 1.87 per cent of sales in Q4FY11. Some of the sectors that have been hit the hardest are construction, telecommunication, steel, etc that saw their interest cost as percentage of sales increasing anywhere between 2-10 bps. Some of the sectors that remained largely untouched are IT-enabled services that saw their interest burden declining. The above analysis shows that the rising interest rate has not yet dented India Industry financials as much.

Commodity Prices:-

After touching a low towards the dusk of 2008 and dawn of 2009, the commodity prices started to show signs of revival as various economies around the world provided stimulants to get out of the worst ever economic slowdown since the Great Depression. By the start of the year 2011, the prices were raging. The S&P GSCI[2], a bench-mark for investment in the commodity markets and as a measure of commodity performance comprising 24 commodities from all commodity sectors, is up by more than twice from where it was in February 2009. The reasons for such high commodity prices are not only growing economies, which demand more and more raw materials to fuel the growth, but several other factors too.

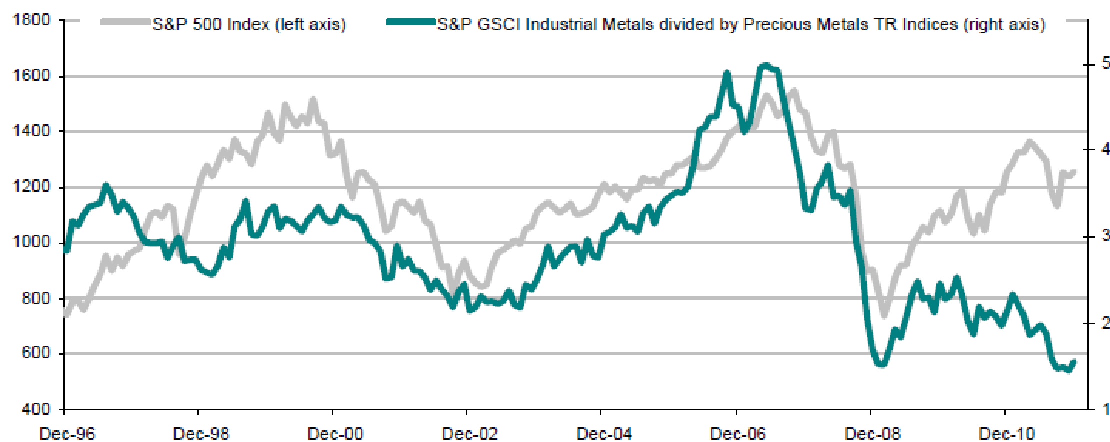


Figure 4: - S&P 500 and S & P GSCI Industrial Metals Index Divided by the S & P GSCI Precious Metal Index Ratio: Dec 1996- Dec 2011

Chief among these is the emergence of commodities as an asset class. Since early 2000, commodity futures have surfaced as a popular asset class for many financial institutions.

According to a CFTC[3] staff report (2008), the total value of various commodity index-related

[2] standard and poor's Goldman Sachs Commodity Index

instruments purchased by institutional investors had increased from an estimated USD 15 billion in 2003 to at least USD 200 billion in mid-2008. The reason for this increase was the lower or negative correlation that existed between commodity returns and stock market returns before 2000. But things changed with the dotcom bust and the collapse of the equity markets in the year 2000 with commodities starting to attract lot of funds as a hedge against stock market volatility.

However, after that the correlation changed between the stock market and commodities. What did not change was the monetization of the commodity market. It can be inferred from the rise in the flow of funds to the commodity market, which rose to USD 9.61 billion in the first quarter of CY11 compared to just USD 2.77 billion in the same time in 2010, according to EPFR Global.[4] What further helped increase the prices is the accommodative monetary policy provided by the Federal Reserve Bank resulting into QE2 (Quantitative Easing 2)[5]. This fundamentally changed the way commodity prices are currently deter-mined.

The law of demand and supply which used to be the prime factor for the price determination of commodities no longer holds true. It has become more of a portfolio re-balancing act between the different asset classes that is driving the prices. Commodities have beaten stocks, bonds and the dollar for five consecutive months till the end of April 2011. However, in 2011, there was some black swan events too like the floods in Australia, earthquake in Japan and political unrest in the Middle East and North Africa, which have somewhat influenced prices of some of the commodities.

Impact On India Industry

Whatever may be the reasons for the increase in the prices of commodities, it is always bad news for India Industry. The 1,065 companies that have announced their Q4FY11 results so far (excluding financials companies) have seen their raw material prices going up by 31 per cent compared to last year. And with regard to the percentage of topline, it has increased from 44 per cent of sales (Q4FY10) to 48 per cent of sales (Q4FY11). Some of the major sectors that saw a steep rise in their raw material cost include aluminum, steel, pharmaceuticals and

[3] Commodity Futures Trading Commission. The federal agency created by Congress in 1975 to regulate futures trading and protect participants against manipulation and fraud, through its administration of the Commodities Exchange Act.

[4] EPFR Global provides fund flows and asset allocation data to financial institutions around the world through its proprietary Web Interface.

[5] Quantitative easing was intended to stimulate an economy through a central bank's purchase of government bonds or other financial assets.

auto ancillary. Their raw material cost as a percentage of sales increased by 12 per cent, 9 per cent, 7 per cent and 5 per cent respectively.

When we see the overall impact of the rising interest rates and commodity prices on the bottom line of the companies, we believe it is yet to make any sizeable impact. The net profit margin is down marginally by seven basis points.

CONCLUSION:-

Despite RBI's desperate attempt to bring the monster of inflation under control, it showing good sign in controlling inflation. The average inflation of India in 2011: 9.08 %. Now Food inflation shrank by 2.9% in the week ended December 31 after shrinking by 3.36% in the preceding week as per the Commerce & Industry Ministry. Meanwhile, inflation in the Non-Food Articles space rose to 1.3% in the week under review from 0.85% in the previous week, the Government data showed.

Though international commodity prices have declined, rupee depreciation has blunted that effect on India. The RBI is very concerned about the impact of rupee depreciation on inflation. Still the inflation in manufactured products has refused to decline as per the current situation. According to GDP data, private final consumption growth fell to 16.09 per cent in the second quarter of 2011-12 year-on-year, from 16.31 per cent in the first quarter, which was also a low economic growth period.

The other factors that will keep the inflation at elevated levels are a hike in the fuel prices. The government has already hiked the petrol price and an increase in diesel prices many times in 2011. This will have a cascading effect and FMCG and consumer durable companies will find their distribution cost increasing. Now the government of India had stop the decision regarding petrol price hike this may help India to decrease the inflation effect in economy.

The sectors that are going to be hit the hardest are real estates, auto, cement and steel. Rising interest rates and commodity prices will slow down the demand for autos and it may even dampen the capex cycle, hurting the demand for steel and cement.

Banks might also face higher NPAs going forward and their credit growth may get keyed down. The least affected will be IT companies. The last time such a scenario (rising interest rate and commodity prices) was witnessed was in the year 2006-07.

RBI is continuously increasing interest rate which will probably hurt growth in the near term but is definitely a step which will help in setting straight the various anomalies that are currently inflicting the economy and in turn Indian industry at the macro level. All this will put the Indian economy back on the growth track helping it to grow at its true potential rate.

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