March 17, 2011

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RBI Monetary Policy - March 2011

Event Update

Monetary Policy highlights: 17th March 2011

- *Global:* The global scenario presents a mixed picture. While growth in emerging market economies (EMEs) remains strong, that in the US and the Euro area is clearly gaining momentum. However, the sharp increase in oil prices as a result of the turmoil in the Middle East and North Africa is adding uncertainty to the pace of global recovery. Further, coming on top of already elevated food and other commodity prices, the spike in oil prices has endangered inflation concerns.

- It is as yet too early to assess the macroeconomic consequences of the natural disaster in Japan. As normalcy is restored, expenditure on reconstruction may provide a boost to the economy. However, substitution of thermal for nuclear energy in Japan may exert further pressure on petroleum prices.

- *Inflation:* After a slight moderation in January, headline WPI inflation reversed in February 2011 accompanied by a sharp increase in non-food manufactured products inflation. As expected, the food article prices have declined substantially since January 2011.

- The March 2011 WPI inflation is now estimated to be higher - around 8 per cent compared to previous projection of 7 per cent.

- *Fiscal deficit:* While the budgeted level of fiscal deficit for 2011-12 gives some comfort on the demand front, a potential increase in the subsidies on petroleum products and fertilizers as a result of high crude prices could put pressure on expenditure. It is critical, therefore, to focus on the quality of expenditure, keeping the aggregate under control without compromising on the delivery of services. Only by doing this can the fiscal situation contribute to demand-side inflation management.

- *Current Account:* Going by the recent robust export performance, CAD for 2010-11 is now estimated to come lower than earlier expected, at around 2.5 per cent of GDP.

- *Liquidity:* Going forward, the overall liquidity situation is expected to move close to the comfort level of the Reserve Bank (+/- 1 per cent of net demand and time liabilities of banks) although it is likely to come under some temporary pressure in the second half of March due to advance tax collections.

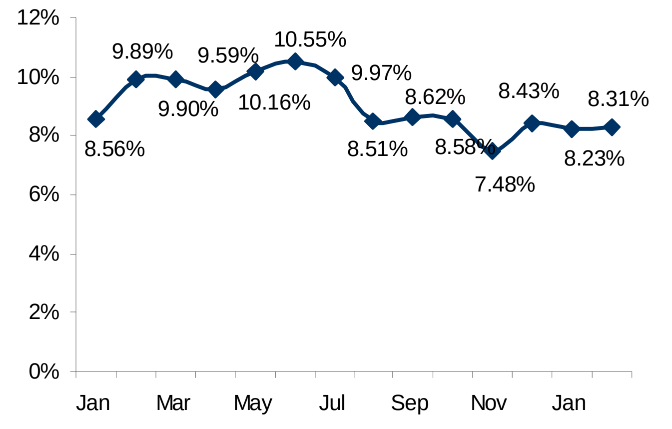
Expected Outcomes

The policy action in this Review is expected to

- Continue to rein in demand-side inflationary pressures while minimising risks to growth; and

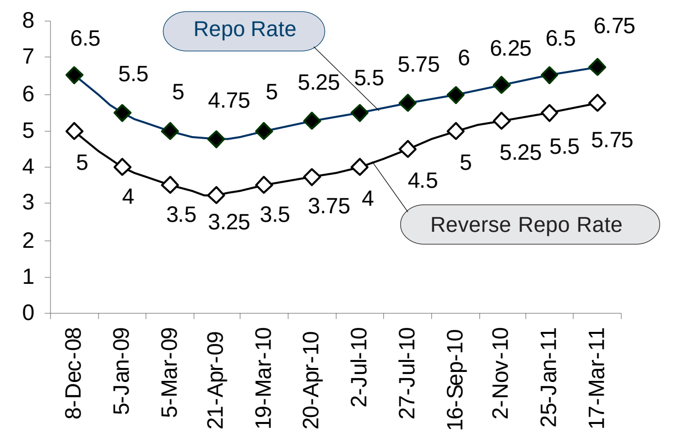
- Manage inflationary expectations and contain the spillover of food and commodity prices into more generalised inflation.

WPI Inflation - (2010-11)



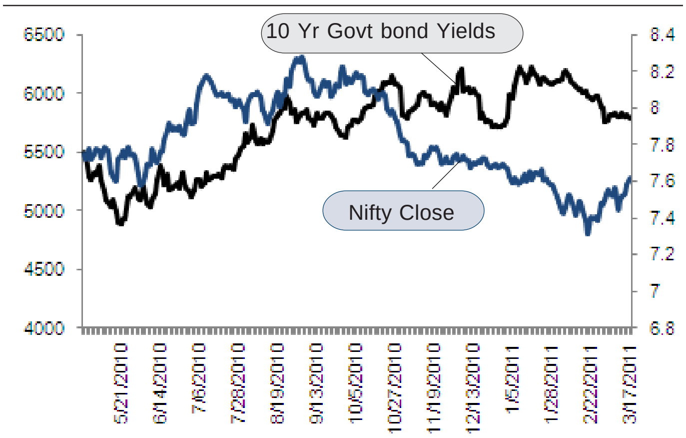
Source: LKP Research

Repo Rate and Reverse Repo rate



Source: LKP Research

10 yr Govt bond yields vs Nifty 50



Source: LKP Research

RBI policy action – 17th March 2011

Repo Rate

It has been decided to increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 6.5 per cent to 6.75 per cent with immediate effect.

Reverse Repo Rate

It has been decided to increase the reverse repo rate under the LAF by 25 basis points from 5.5 per cent to 5.75 per cent with immediate effect.

The view is that it is time lending rates catch up while deposit rates seem to have peaked.

CRR

The cash reserve ratio (CRR) of scheduled banks has been retained at 6.0 per cent of their net demand and time liabilities (NDTL).

RBI action over the last 12 months:

Date	Repo rate	Reverse Repo Rate
19-Mar-10	Hiked by 25 bps	Hiked by 25 bps
20-Apr-10	Hiked by 25 bps	Hiked by 25 bps
2-Jul-10	Hiked by 25 bps	Hiked by 25 bps
27-Jul-10	Hiked by 25 bps	Hiked by 50 bps
16-Sep-10	Hiked by 25 bps	Hiked by 50 bps
2-Nov-10	Hiked by 25 bps	Hiked by 25 bps
25-Jan-11	Hiked by 25 bps	Hiked by 25 bps
17-Mar-11	Hiked by 25 bps	Hiked by 25 bps

Other Actions

1. RBI hiked CRR on 29th Jan 2010 by 75 bps to 5.75%.
2. RBI hiked CRR on 20th April 2010 by 25 bps to 6.0%.
3. RBI snipped SLR rate by 100 bps to 24% on its policy on 17th Dec 2010, simultaneously announcing Open Market Operations (OMO) for an amount of ₹48,000 crore to the liquidity in the system.

Monetary Policy 2011-12

The Monetary Policy for 2011-12 will be announced on Tuesday, May 3, 2011.

Potential Market Impact:

- Risk to growth has come up as a concern in the current policy review
- The policy also does not mention inflation (8%) moderation in Q1FY12 as it did in previous policies
- Concerns on core demand led inflation have been accentuated
- Domestic fuel prices yet to be stepped up to global prices
- Deposit rates have run ahead of lending rates
- Credit growth still lags. Going forward credit growth will matter especially if rate hikes are expected in the slack period of H1FY12. The view is we can't have high growth of 9% and increase rates to curb inflation.

The rate announcements were in line with the expectations of the market participants.

We can't have high growth of 9% and increase rates to curb inflation

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