

RBI hikes key rates

The Reserve Bank of India in its Annual Monetary Policy Review for financial year 2011-12, raised the repo and reverse repo rates by 50 basis points each. The repo and reverse repo rates now stand at 7.25% and 6.25%, respectively. The repo rate is the rate at which banks borrow money from the RBI and the reverse repo rate is the rate at which the RBI borrows money from banks. Meanwhile, the CRR was left unchanged at 6%.

As per the Central Bank the outlook and monetary strategy for the financial year 2011-12 was determined by the following three points:

- First, global commodity prices, which have surged in recent months are, at best likely to remain firm, and may well increase further over the course of the year. This suggests that higher inflation will persist, and may indeed get worse.
- Second, headline and core inflation have significantly overshot even the most pessimistic projections over the past few months. This raises concerns about inflation expectations becoming unhinged.
- The third factor, one countering the forces mentioned above, is the likely moderation in demand, which should help reduce pricing power and the extent of pass-through of commodity prices. This contra-trend cannot be ignored in the policy calculation. However, a significant factor influencing aggregate demand during the year will be the fiscal situation. The budget estimates offered reassurance of a fiscal rollback. However, the critical assumption, that petroleum and fertiliser subsidies would be capped, is bound to be seriously tested at prevailing crude oil prices. Even though an adjustment of domestic retail prices may add to the inflation rate in the short run, the Reserve Bank believes that this needs to be done as soon as possible. Otherwise, the fiscal deficit will widen and will counter the moderating trend in aggregate demand.

Against this backdrop, the stance of monetary policy of the Reserve Bank will be as follows:

- First, to maintain an interest rate environment that moderates inflation and anchors inflation expectations.
- Second, to foster an environment of price stability that is conducive to sustaining growth in the medium-term, coupled with financial stability.
- Third, to manage liquidity to ensure that it remains broadly in balance, with neither a large surplus diluting monetary transmission nor a large deficit choking off fund flows.

As regards outcomes, the above monetary policy actions are expected to:

- First, contain inflation by reining in demand side pressures, and anchor inflation expectations; and
- Second, the actions are expected to sustain growth in the medium-term by containing inflation.

Following the announcements, Shriram Ramanathan, Portfolio Manager - Fixed Income, Fidelity International, said, "The RBI's move to hike rates by a higher-than-expected 50 basis points is a welcome move. It recognises the worrying upward trend in core inflation, inflationary expectations and the consequent risks to sustainable medium-term growth. Hence, the RBI appears to have clearly accepted a trade-off of slightly lower growth in the near-term, while going in for more aggressive tightening to rein in inflation. While the near-term impact on bond markets is likely to be negative, Fidelity sees this as a medium-term positive move as it enhances the RBI's ability to control inflation."

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