

## Annual Monetary Policy FY2011

**RBI hikes Repo, Reverse Repo and CRR by 25 bps; less than market expectation. Focus shifts to Inflation. Calibrated exit to continue.**

### Policy Rates as well as CRR hiked:

- The Reserve Bank of India raised the Cash Reserve Ratio, repo and reverse repo rates by 25bps (to 6%, 5.25% and 3.75% respectively) in line with our expectation.
- RBI announced measures to boost infrastructure sector. These include:
  - Allowing banks to invest in infrastructure bonds with a minimum residual maturity of 7 under the held to maturity (as opposed to mark to market) category.
  - Reducing provisioning requirements for infrastructure loans classified as sub-standard to 15% from 20%.

### Reasons for this action:

- With the recovery now firmly in place, there is need to move in a calibrated manner in the direction of normalising policy instruments.
- Inflation expectations remain at an elevated level. There is, therefore, a need to ensure that demand side inflation does not become entrenched.
- The RBI has to do a fine balancing act and ensure that while absorbing excess liquidity, the government borrowing programme is not hampered.

### Expected Outcomes

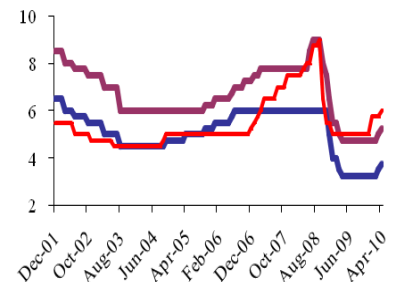
- Increase in CRR wil absorb about Rs. 12,500 cr of excess liquidity from the system.
- Inflationary expectations will be anchored while recovery process will be sustained.
- Policy instruments will be further aligned in a manner consistent with the evolving state of the economy.

### Bottomline:

- Both today's statement and yesterday's Macro report suggest that RBI's policy focus has shifted to inflation. The underlying price pressures are high and will keep inflation in high single digit. We cannot rule out an inter-meeting rate hike again in June.
- This rate hike will not immediately result in a rise in bank's lending rate.
- The rally in bond market after the policy announcement would be temporary as regular auctions, further rate hike, high inflation will negatively impact the sentiment.
- RBI will maintain adequate liquidity to manage large Govt borrowing program smoothly as credit picks up faster.
- Real interest rate continues to be negative and so expect RBI to continue to normalize rate in small steps.

### Economy Update

**Trend in Key Policy Rates**



## Monetary Policy Stance (Focus shifts to inflation)

- Anchor inflation expectations, while being prepared to respond appropriately, swiftly and effectively to further build-up of inflationary pressures.
- Actively manage liquidity to ensure that the growth in demand for credit by both the private and public sectors is satisfied in a non-disruptive way.
- Maintain an interest rate regime consistent with price, output and financial stability.

## Higher GDP and Credit Growth Forecast

Macro Indicators	Earlier projection FY 10	Actual FY 10	Projection for FY11
<b>GDP</b>	7.5%	7.5% (Estimated)	<b>8.0% with an upside bias</b>
<b>Inflation (end Mar)</b>	8.5% (March)	9.9% (March)	<b>5.5% (March)</b>
<b>Money Supply (M3)</b>	16.5%	16.8%	<b>17.0%</b>
<b>Aggregate Deposit</b>	17.0%	17.0%	<b>18.0%</b>
<b>Non-Food Credit Growth</b>	16.0%	17.0%	<b>20.0%</b>

## Global Monetary Policy Cycle Turning

### With a recovery underway, several central banks have already begun the process of monetary exit

- In Australia, the RBA has already raised rates for four times. With high oil prices supporting activity, the Norges Bank has already hiked and should do so again soon.
- In the US, the Fed has issued statement regarding keeping rates low for a longer period of time in view of incomplete recovery.
- The ECB is likely to drain liquidity, especially in 3Q and 4Q. Subdued growth, low inflation and recent sovereign debt crisis will keep rates low. Expected to raise rate only by 25bp in 2011.
- The BoJ will likely keep rates on hold until late-2011, given still-large economic slack and downward pressure on inflation.
- Apart from RBI's rate hike in March, Malaysia was the other country in Asia to raise the policy rate by 25bps. Thailand is also expected to raise rates soon.

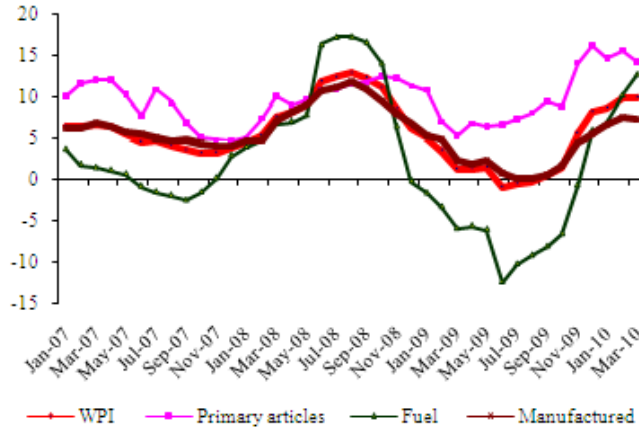
## Positive Market Reaction

- Bond market had a relief rally immediately after the announcement of the monetary policy. The 10-year benchmark yield moved down to 8.03% vs. 8.09% earlier. But going forward, higher inflation, better growth prospects, improved credit demand and higher government borrowings will keep pressure on bond yields.
- Equity market also reacted positively. It moved up after the policy statement. Announcement regarding infrastructure bonds in HTM category and reducing provisioning requirements for infrastructure loan are positive for Infra sector.
- A 25 bps rate move is viewed by the market as less than aggressive. So today's minimum rate hike is considered positive and definitely not a party pooper.

**Macro Backdrop**

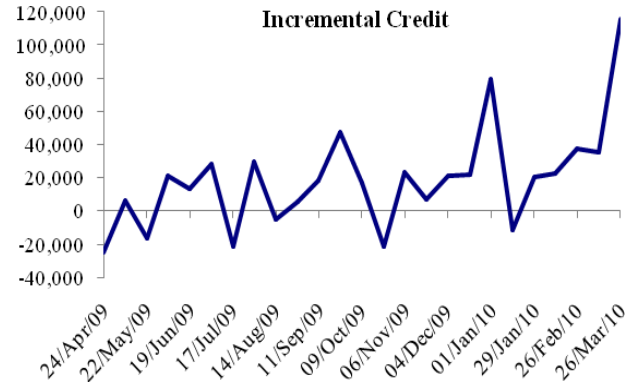
**Inflation on uptrend. Incremental credit showing signs of recovery**

**WPI Inflation was 9.9% in Mar, more than RBI's target of 8.5%.**



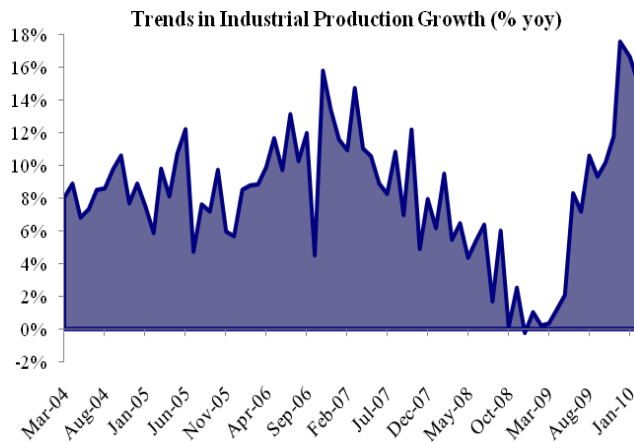
Though food prices were the key drivers of inflation until recently, there is slow build up of demand-side core inflationary pressures. Rising commodity prices, indirect tax hikes and return of pricing power in a few sectors (autos, cement, steel, processed food and rubber products) points to further pick-up in core inflation. WPI inflation seems to have peaked but will remain in higher single digit for some more time.

**Incremental credit in Rs Cr has improved. Credit growth was 17% yoy Mar'10 vs. the 12 year low of 9.7% in Oct'09.**



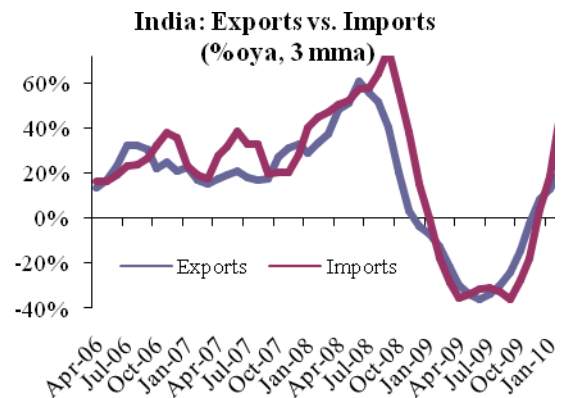
A massive increase in loan disbursement in the last fortnight of the fiscal year ending March 2010 helped banks not only to move past RBI's target of 16% annual growth but to improve to 17%. The incremental credit to deposit ratio in the last quarter in fiscal 2010 was 99%. For an economy that is expected to register a growth of 8.5%, credit growth should remain high.

**Industrial production had a V-shaped recovery, exports also went up for fourth straight month**



The recent IIP growth was partially helped by low base and policy stimulus. But obviously the positive momentum has gained traction. Currently growth is driven by construction, infrastructure and auto sectors. Growth is becoming more broad-based spreading from consumption-driven growth to a consumption and investment driven recovery.

**Indian exports increased by 35% yoy in Feb**



Exports for Feb went up for the fourth straight month to \$16.09 bn, a growth of 34.8%. However, imports grew at impressive 66% to \$25 bn underscoring the strong revival in the domestic economy.

**Timeline of Measures Taken by RBI since 16-Sept-08**

<b>Date</b>	<b>Measures</b>
16 <sup>th</sup> Sep'08	<ul style="list-style-type: none"> <li>• Raised interest rate ceilings on NRI deposits.</li> <li>• Provided additional liquidity by:               <ul style="list-style-type: none"> <li>(a) permitting banks to avail additional liquidity support under the LAF up to 1% of their net demand and time liabilities (a de-facto SLR cut) and</li> <li>(b) Extended the Secondary LAF (SLAF) to a daily basis.</li> </ul> </li> </ul>
6 <sup>th</sup> Oct'08	<ul style="list-style-type: none"> <li>• Reduced the Cash Reserve Ratio by 50bps to 8.5% - first cut since June 2003.</li> </ul>
10 <sup>th</sup> Oct-08	<ul style="list-style-type: none"> <li>• Reduces CRR by 100bps to 7.5%</li> </ul>
14 <sup>th</sup> Oct-08	<ul style="list-style-type: none"> <li>• Announces 14-day Term Repo Facility to meet liquidity requirements of Mutual Funds.</li> </ul>
15 <sup>th</sup> Oct-08	<ul style="list-style-type: none"> <li>• RBI cuts CRR by 100bps to 6.5%.</li> <li>• Allowed banks to borrow up to 0.5% of their NDTL to meet liquidity requirements of Mutual Funds.</li> <li>• Special Mkt Operations for Oil bonds instituted once again</li> <li>• Interest rates on NRI Deposits increased.</li> <li>• Rs250bn under the Agricultural Debt Waiver Scheme made available to banks immediately.</li> </ul>
20 <sup>th</sup> Oct'08	<ul style="list-style-type: none"> <li>• RBI cuts Repo Rate by 100bps to 8%.</li> </ul>
24 <sup>th</sup> Oct'08	<ul style="list-style-type: none"> <li>• During its policy meet on 24th Oct, RBI maintained status quo and kept rates unchanged at:               <ul style="list-style-type: none"> <li>- Repo Rate: 8%</li> <li>- Reverse Repo Rate: 6%</li> <li>- CRR: 6.5%</li> </ul> </li> </ul>
1 <sup>st</sup> Nov'08	<ul style="list-style-type: none"> <li>• Repo rate cut by 50bp to 7.5%.</li> <li>• CRR cut by 100bp to 5.5%.</li> <li>• SLR cut of 100bps to 24%.</li> <li>• A special refinance facility under which banks will be provided refinance up to 1% of bank's NDTL on 24 October 2008 at repo rate up to a max period of 90 days.</li> <li>• Banks can borrow upto an aggregate 1.5% of NDTL for financing NBFCs and mutual funds. With this move, effective SLR stands at 22.5%.</li> <li>• Buy back of MSS securities to fund fiscal slippage.</li> </ul>
7 <sup>th</sup> Nov'08	<ul style="list-style-type: none"> <li>• Reserve Bank of India to provide forex liquidity to Indian public and private sector banks having foreign branches or subsidiaries, through forex swaps of tenors upto three months.</li> </ul>
6 <sup>th</sup> Dec'08	<ul style="list-style-type: none"> <li>• RBI reduced policy rates:               <ul style="list-style-type: none"> <li>- The repo rate under the LAF is reduced by 100 bps from 7.5% to 6.5% bringing the total reduction to 250bps since October.</li> <li>- The reverse repo rate was reduced by 100 basis points from 6.0% to 5.0%. It is the first such cut in the current cycle.</li> </ul> </li> <li>• Measures for troubled sectors such as Real Estate, SME Segment, Exporters, and FCCBs.</li> </ul>
2 <sup>nd</sup> Jan'09	<ul style="list-style-type: none"> <li>• RBI cuts the Repo Rate and Reverse Repo rate by 100bps each to 5.5% and 4% respectively; and the CRR by 50bps to 5%.</li> </ul>
27 <sup>th</sup> Jan'09	<ul style="list-style-type: none"> <li>• No changes to rates in 3Q Policy Review, but timelines for refinance facilities extended to Sept'09.</li> </ul>
4 <sup>th</sup> Mar'09	<ul style="list-style-type: none"> <li>• RBI Reduces Repo, Reverse Repo Rates by 50bps each to 5% and 3.5% respectively.</li> </ul>
21 <sup>st</sup> Apr'09	<ul style="list-style-type: none"> <li>• RBI cut repo rate and reverse repo rate by 25 basis points to 4.75% and 3.25%. RBI left the cash reserve ratio (CRR) unchanged.</li> </ul>
28 <sup>th</sup> july'09	<ul style="list-style-type: none"> <li>• Left key rates unchanged</li> </ul>
27 <sup>th</sup> Oct'09	<ul style="list-style-type: none"> <li>• Key policy rates unchanged. SLR hiked back to 25%.</li> <li>• Unconventional measures withdrawn. Provisioning for banks increased.</li> </ul>
29 <sup>th</sup> Jan'10	<ul style="list-style-type: none"> <li>• CRR hiked by 75 bps in two stages from Feb 13, Policy rates kept unchanged.</li> </ul>
19 <sup>th</sup> Mar'10	<ul style="list-style-type: none"> <li>• Repo and Reverse Repo rates hiked by 25 bps in an inter-meeting move.</li> </ul>