



## Review of the First Quarter Monetary Policy Statement 2010-11

### *Key Highlights:*

- Repo rate hiked by 25 bps from 5.5% to 5.75%
- Reverse Repo rate hiked by 50 bps from 4% to 4.5%
- CRR kept unchanged at 6%
- SLR kept unchanged at 25%
- Bank rate kept unchanged at 6%
- GDP growth projection for FY 2010-11 revised upwards to 8.5% from 8% (with an upward bias) as announced in the April policy
- FY 2010-11 March end WPI inflation projected at 6% (revised upwards from 5.5% earlier)

Amidst growing concerns over high domestic inflation, the First Quarter Review of the Monetary Policy statement FY 2010-11 exhibits the clear shift of balance to decisively contain inflation and anchor escalating inflationary expectations. The Review reiterates the need for the domestic monetary policy to curb inflationary pressures whilst the global recovery still appears uncertain. The Policy Statement remains hawkish when compared to market expectations that mostly expected a 25 bps hike in the two key rates. The RBI treads ahead in the 'exit' process started in the October 2009 policy by explicitly raising the key interest rates, viz. the Repo rate by 25 bps and the Reverse Repo rate by 50 bps.

### *Backdrop of the Policy Review:*

#### *- Inflation key concern*

The RBI Governor unveiled the First Quarter Review of Monetary Policy statement 2010-11 amidst recognition of the difference in the economic challenges faced by the advanced and emerging economies in the current scenario. Highlighting the significant macro-economic changes since the April policy, the increased uncertainty over global growth and the recovery in the domestic growth based on private consumption and investment demand, the policy asserts high inflation to be its dominant concern and hence continues the process of withdrawal of monetary stimulus measures announced post the Lehman crisis.

#### *- Inflation projection for March end FY 2010-11 revised upwards to 6%*

### *Domestic outlook:*

The policy explicitly highlights the upside risks to domestic inflation, already at disconcerting levels. The Review cautions against factors exacerbating the same going ahead; viz. shift of supply side pressures to a more generalized inflation, that is pick up in demand side pressures, fast emerging capacity constraints,



upward revisions in the WPI numbers announced already, second round effects coming through (tracking the deregulation of petrol prices and hike in prices of diesel, LPG and kerosene), revision of minimum support prices (MSPs), structural bottlenecks in certain commodities, return of pricing power to producers and uncertainty over the rainfall in the remaining two months (which could probably lead to further price pressures in food articles). Accordingly, the baseline projection for WPI inflation for end March 2010 is revised upwards to 6% from an initial projection of 5.5% in the April policy. The policy also mentions that an adequate monsoon, decline in the global energy and commodity prices as well as reduction in domestic prices of competitive imported goods (tracking idle global capacity) would lead to a softer inflation rate. The policy endeavors to contain perception of inflation in the range of 4-4.5% bearing in mind the medium-term objective of 3% inflation.

***- GDP growth forecast  
revised upwards to 8.5% for  
FY 2010-11***

The Central Bank recognises the firm and broad-based consolidation in domestic growth, reverting to pre-crisis growth trajectory. The policy highlights the improved sentiment on the domestic front in terms of an improved monsoon this season which could lead to a pick up in rural demand, revival of strong domestic demand, replenishment of inventories, robust indirect tax collections, robust IIP growth seen since June 2009, pick up in credit off-take, sustained increase in the import and export growth, buoyancy in the services sector, improved corporate profitability and translation of investment intentions into action across sectors. The policy also highlights downside risks to the buoyant economic growth, viz. uncertain global growth scenario, potential slowdown in capital flows, widening of current account deficit (leading to dampened investment). The RBI adopts a cautious stance against the adverse impact of global uncertainty on domestic manufacturing and services sectors tracking the global linkages via trade, financial and confidence channels. The policy is optimistic on the industrial growth and the services sector as well as on improvement in domestic demand. Tracking the progress of monsoon, the policy revises the projections for GDP growth for FY 2010-11 to 8.5% from 8% (with an upward bias) pegged in the April policy.

***- Repo rate hiked by 25bps,  
Reverse Repo by 50 bps to  
5.75% & 4.5% respectively***

The policy lays emphasis on price stability without disrupting the recovery process. The Central Bank recognises that for an emerging economy like India, lower policy rates can complicate the inflation outlook and impair inflationary expectations. Taking into consideration that the domestic economy lags in the process of normalisation of monetary measures taken since the crisis and the fact that real rates are not consistent with the strong

growth momentum, the Central Bank deemed appropriate to raise the Repo rate by 25 bps and the Reverse Repo rate by 50 bps.

The RBI recognises the transformations seen in the money market in the last quarter. From a liquidity surplus mode for 18 months to a deficit mode since the last two months, the markets have witnessed sudden liquidity crunch and extreme volatility in the money market rates. In light of the same, the effective money market rate moved from the Reverse Repo rate (usually operational during surplus liquidity) to the Repo rate (operational rate during a deficit) The tightening of monetary conditions by 150 bps (width of the LAF corridor) prompted the Central Bank to curb this volatility by lowering the LAF corridor (now 125 bps). The RBI did so by unevenly hiking the Repo (25 bps) and Reverse Repo (50 bps) rate. The RBI also mentioned that systemic liquidity would improve however remain in a deficit zone for now. The RBI therefore left the CRR unchanged at 6%. The Central Bank sees a bi-directional move in the liquidity going ahead and hence has taken measures to reduce future volatility by narrowing the corridor.

*- Non-food credit growth projected at 20%*

*- M<sub>3</sub> growth projection set at 17%*

The policy notes the moderation in M3 growth, the slowdown in bank deposits growth as well as the pick up seen in credit off-take. In expectations of monetary aggregates evolving along the projected trajectory in the April policy even with higher growth projection, the RBI retained its M3 growth projection for FY 2010-11 at 17% and non-food credit at 20%. A peculiar point in this policy review is the absence of a projection for the deposit growth.

### ***Monetary Policy Stance:***

The policy stance is explicitly based on the high inflation as a dominant concern and thus a decisive shift to contain inflation and anchoring inflationary expectations. With positive outlook on growth, the RBI adopts a cautious stance against the steeply high inflation rate. With this stance, the Central Bank intends to rein in demand pressures, sustain the growth momentum and reduce volatility of short term rates.

The Review thus explicitly highlights the policy stance as follows:

1. Contain inflation and anchor inflationary expectations, while being prepared to respond to any further build-up of inflationary pressures.
2. Maintain an interest rate regime consistent with price, output and financial stability.
3. Actively manage liquidity to ensure that it remains broadly in balance so that excess liquidity does not dilute the effectiveness of policy rate actions.

The stance is on similar lines to that mentioned in the April policy, the specific change being, while the April policy mentioned the need to curb inflationary expectations, the July policy aims at taming the existing high inflation as well as anchor future inflationary expectations. In a bid to respond effectively with changing macro-economic environment the RBI has increased the frequency of the Monetary Policy Review. The stance mentions liquidity management to primarily aid the effective transmission of policy rate hikes.

*Other measures:*

The RBI highlighted the need for flexibility in monetary actions in rapidly evolving macro-economic situation. The RBI has thus announced the undertaking of mid-quarter reviews roughly at the interval of about one and half months after each quarterly review. The mid-quarter reviews will be in June, September, December and March in the form a press release. Tracking changing liquidity dynamics, the RBI proposed to set up a Working Group to review the operating procedure of monetary policy of RBI, including the LAF.

*The way ahead:*

The policy reflects a hawkish stance, aiming to tame inflation while at the same time allowing the recovery to be sustained. The economy has witnessed aggressive tightening since March 2010 (Repo - 100 bps, Reverse Repo rate - 125 bps and CRR - 100 bps). Foreseeing liquidity tightness for some time now, the policy highlights the explicit shift to the Repo rate as the operational rate. The RBI will formally scan and release it's assessment of the economy every six weeks as a mid-quarter review. We expect the RBI to adopt a gradual tightening approach depending upon the outcome of these assessments. Considering the uncertain outlook towards global growth and in wake of expectations of softening in the headline inflation and IIP numbers (due to base effect) the RBI may adopt a wait and watch policy in the September mid-quarter review.

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