

1Q Review of Monetary Policy FY2011

RBI hikes Repo by 25 bps and Reverse Repo by 50 bps. Maintains a hawkish tone on inflation. Calibrated exit to continue. Announces Mid-quarter reviews.

Policy Rates hiked, CRR left untouched:

- The Reserve Bank of India raised the Repo rate by 25 bps to 5.75%
- Reverse Repo rates by 50bps to 4.50%.
- CRR was left untouched at 6.00%.

Reasons for this action:

- **Growth:** Domestic drivers of growth are robust. Risk to growth is global scenario through trade and particularly through Capital Inflows.
- **Inflation:** RBI is very worried about inflation. Non-food WPI inflation increased to 10.6% in June'10 from near zero in Nov'09, contributing 70% to inflation suggesting that inflation is very much generalised. Factors impacting inflations going forward are: good monsoon, crude price, idle global capacity and domestic demand.
- **Liquidity:** *RBI states that transmission of monetary policy through rate actions works most effectively when liquidity is tight. The present tight liquidity has caused overnight call money interest rates to move towards the upper bound of the LAF corridor, with effective tightening of 150 bps. The repo rate has emerged as the operating policy rate. This has brought the system closer to a point at which policy rate actions are likely to have greater traction. Liquidity pressures will ease, but the system is likely to remain in deficit mode for now. The guiding principles of LAF corridor are:*
 - *It should be broad enough not to prompt market participants to place their surplus funds with RBI.*
 - *It should not be so broad that it gives scope for greater interest rate volatility to distort the policy signal.*

Expected Outcomes

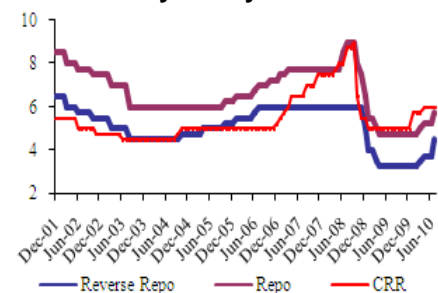
- Moderate inflation by reining in demand pressures.
- Maintain financial conditions conducive to sustaining growth.
- Generate liquidity conditions consistent with more effective transmission of policy actions.
- Reduce the volatility of short-term rates in a narrower LAF corridor.

Bottomline:

- **Both today's statement and yesterday's Macro report suggest that RBI's policy focus has shifted to inflation**
- **RBI will maintain a balanced liquidity conditions (not excess) for better transmission of policy actions.**
- **RBI feels that real policy rates are still not consistent with strong growth. So, expect RBI to continue to normalize rate in small steps.**

Economy Update

Trend in Key Policy Rates



Monetary Policy Stance (More hawkish on inflation)

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

Higher GDP and Inflation Growth Forecast

Macro Indicators	Earlier projection FY 11	Actual at present	Projection for FY11
GDP	8.0% with an upside bias	7.4% (FY10)	8.5%
Inflation (end Mar)	5.5% (March)	10.55% (June)	6.0%
Money Supply (M3)	17.0%	15.3%	17.0%
Aggregate Deposit	18.0%	15.0%	-
Non-Food Credit Growth	20.0%	21.6%	20.0%

Global Monetary Policy rate on hold for major economies

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

- Global rates are expected to remain on hold for some more time.
- Fed, ECB, BoE and BoJ are all likely to keep rates on hold to the end of this year.
- Even Central Bank of China is now expected to keep rate on hold.

Asian Policy Rate and Movement

Country	Policy Rate	As on 27th July	Last move	
			Date	Amount
China	1-Year Deposit Rate	2.25	Dec-08	-27
India	Repo Rate	5.75	Jul-10	25
Indonesia	SBI 28-days	6.5	Aug-09	-25
Korea	BOK Policy Rate	2.25	Jul-10	25
Malaysia	Overnight Policy Rate	2.75	Jul-10	25
Philippines	O/N Policy Rate	4	Jul-09	-25
Taiwan	Re-discount Rate	1.375	Jun-10	12.5
Thailand	Overnight Repo Rate	1.5	Jul-10	25

- However, growth recovery and higher inflation has resulted in divergence in some Asian policy rates. Following the inter-policy hike in India in July, Taiwan surprised the market by a 12.5bps hike followed by 25 bps earlier-than-expected hike by Korea, Thailand and Malaysia.

Positive Market Reaction

- Bond market reacted positively to the policy rate hike. It had already priced in this move and remained flat. However, for a couple of minutes just after the policy announcement, the yield on 10 yr benchmark moved down to 7.64% before it moved back again.
- Equity market also reacted positively. It moved up after the policy statement.
- A 25 bps Repo rate move is viewed by the market as less than aggressive. In this tight liquidity conditions, Repo rate is already the effective operating rate and so a Reverse Repo rate hike by 50 bps (higher than market expectation) did not spook the market.

Macro Backdrop

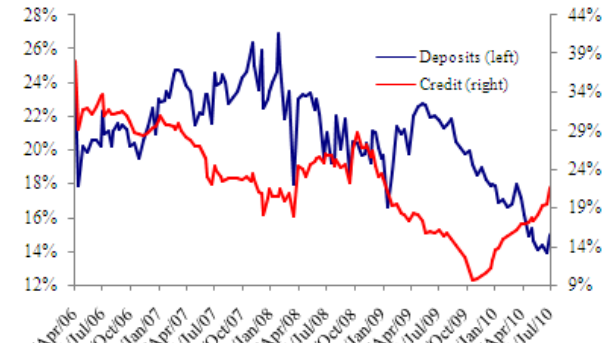
IIP stabilizing but underlying activities remain buoyant; Incremental credit recovering smartly

IIP in May at 11.5% from 16.4 in April



Industrial production is averaging 14% in this fiscal YTD. Going forward, as favourable base disappears, IIP moves to more sustainable single digit growth.

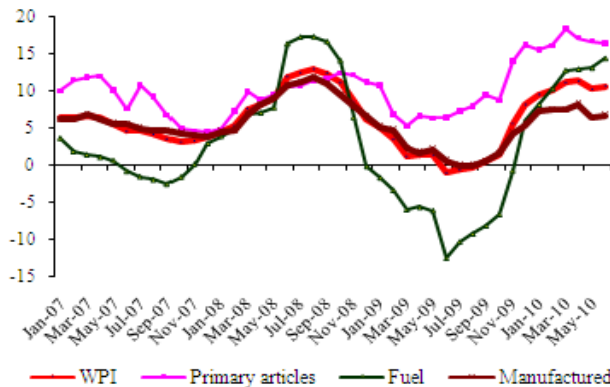
Credit growth was 21.6% yoy as on 2nd July'10



Credit has posted a growth of 21.6%yoy helped by 3G auction outflow. The incremental credit to deposit ratio is above 100%. The uptick in credit off-take bodes well for growth story.

Inflation on uptrend, spilling into manufactured goods

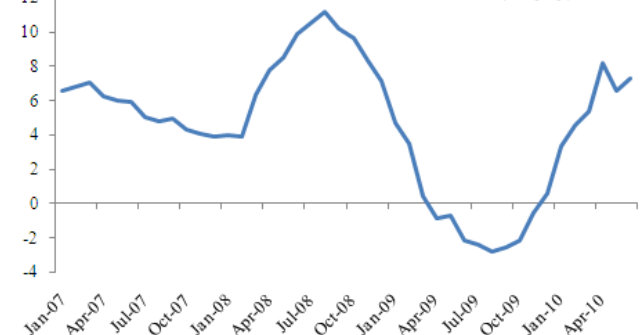
WPI Inflation was 10.55% in June



Inflation remains in double digits for five consecutive months. Primary product inflation remains high. Concern on sharp revisions in historical data (e.g. April data was revised from 9.6% to 11.2%).

Inflation becoming more generalized

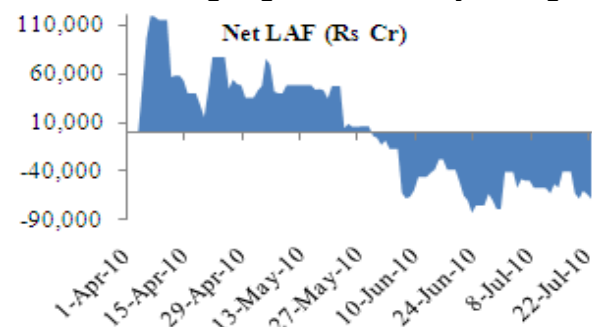
Non-Food Manufactured Product Inflation (% yoy)



Non-Food manufactured goods inflation rose to 7.3% in June vs 0.6% in last Dec due to increased demand, capacity constraint, pricing power of manufacturers.

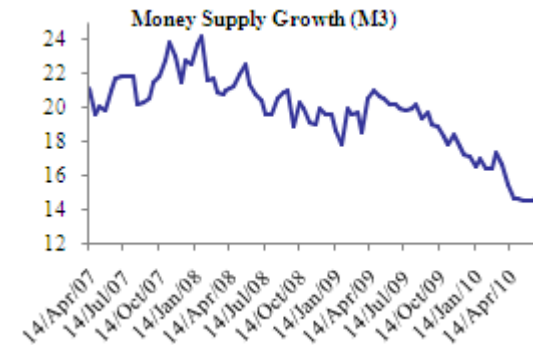
Liquidity in the system remains tight; Money Supply growth anaemic

Banks borrowing avg Rs 550bn daily through LAF



Call money rates moved to 5.8% at the upper end of the LAF corridor.

Money Supply is at 15.3% vs RBI's target of 17%



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

Date	Measures
16 th Sep'08	<ul style="list-style-type: none"> • Raised interest rate ceilings on NRI deposits. • Provided additional liquidity by: <ul style="list-style-type: none"> (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 (b) Extended the Secondary LAF (SLAF) to a daily basis.
6 th Oct'08	<ul style="list-style-type: none"> • Reduced the Cash Reserve Ratio by 50bps to 8.5% - first cut since June 2003.
10 th Oct'08	<ul style="list-style-type: none"> • Reduces CRR by 100bps to 7.5%
14 th Oct'08	<ul style="list-style-type: none"> • Announces 14-day Term Repo Facility to meet liquidity requirements of Mutual Funds.
15 th Oct'08	<ul style="list-style-type: none"> • RBI cuts CRR by 100bps to 6.5%. • Allowed banks to borrow up to 0.5% of their NDTL to meet liquidity requirements of Mutual Funds. • Special Mkt Operations for Oil bonds instituted once again • Interest rates on NRI Deposits increased. • Rs250bn under the Agricultural Debt Waiver Scheme made available to banks immediately.
20 th Oct'08	<ul style="list-style-type: none"> • RBI cuts Repo Rate by 100bps to 8%.
24 th Oct'08	<ul style="list-style-type: none"> • During its policy meet on 24th Oct, RBI maintained status quo and kept rates unchanged at: <ul style="list-style-type: none"> - Repo Rate: 8%; Reverse Repo Rate: 6%; CRR: 6.5%
1 st Nov'08	<ul style="list-style-type: none"> • Repo rate cut by 50bp to 7.5%. CRR cut by 100bp to 5.5%. SLR cut of 100bps to 24%. • 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. • 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%. • Buy back of MSS securities to fund fiscal slippage.
7 th Nov'08	<ul style="list-style-type: none"> • 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.
6 th Dec'08	<ul style="list-style-type: none"> • RBI reduced policy rates: <ul style="list-style-type: none"> - 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. - 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. • Measures for troubled sectors such as Real Estate, SME Segment, Exporters, and FCCBs.
2 nd Jan'09	<ul style="list-style-type: none"> • 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%.
27 th Jan'09	<ul style="list-style-type: none"> • No changes to rates in 3Q Policy Review, but timelines for refinance facilities extended to Sept'09.
4 th Mar'09	<ul style="list-style-type: none"> • RBI Reduces Repo, Reverse Repo Rates by 50bps each to 5% and 3.5% respectively.
21 st Apr'09	<ul style="list-style-type: none"> • RBI cut repo and reverse repo rate by 25 bps to 4.75% and 3.25%. CRR left the unchanged.
28 th July'09	<ul style="list-style-type: none"> • Left key rates unchanged
27 th Oct'09	<ul style="list-style-type: none"> • Key policy rates unchanged. SLR hiked back to 25%. • Unconventional measures withdrawn. Provisioning for banks increased.
29 th Jan'10	<ul style="list-style-type: none"> • CRR hiked by 75 bps in two stages from Feb 13, Policy rates kept unchanged.
19 th Mar'10	<ul style="list-style-type: none"> • Repo and Reverse Repo rates hiked by 25 bps in an inter-meeting move.
20 th Apr'10	<ul style="list-style-type: none"> • CRR, Repo and Reverse Repo rates hiked by 25bps to 6%, 5.25% and 3.75% respectively.
2 nd July'10	<ul style="list-style-type: none"> • Repo and Reverse Repo rate hiked by 25 bps, Additional liquidity measures announced.
27 th July'10	<ul style="list-style-type: none"> • Repo rate hiked by 25 bps to 5.75%, Reverse Repo by 4.50%, CRR left unchanged.

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