Policy Impact

RBI has clearly signaled its intent to prioritize its fight against inflation, breaking from the recent past and hiking policy rates by 50 bps compared to the previous 8 rate decisions which were all 25 bps each. *It is evident from the hawkish tone of the policy statement that RBI is keen to combat inflation aggressively from now on even if it means partially compromising growth objectives in the short run, in order to ensure that long term investment and growth is not destabilized.*

Both core and headline WPI inflation are well above RBI's comfort level and we believe that the hike in the policy rates is in response to moderating any further sharp rise in inflation.

RBI is factoring in higher final inflation figures for the months of February and March 2011 (January provisional number was sharply revised upwards by 110 bps) and higher inflation in the coming months starting April'11, in light of the impending fuel price hike since fuel prices have not been revised since mid December 2010, despite a sharp run up in global crude prices.

We expect that the hike in key policy rates by 50 bps will curb demand side pressures and moderate growth in the short term, since RBI indicated that the economy is already working at full capacity. So temporarily curbing demand will help to ease supply pressures until new capacities are in place.

RBI's growth rates for deposit and credit at 17% (15.8%) and 19% (21.2%), forecast a narrowing of the gap to about 200 bps as against almost 500 bps in the previous fiscal. However, money supply growth (M3) is forecast to slow down to 16% (17% in FY 2011), reflecting RBI's intent to keep the system structurally in deficit mode.

Under the assumptions of crude at USD 110 bps and a normal monsoon, RBI has forecast FY12 GDP growth at 8% (Government had projected 9% in its Union Budget and assumed oil at USD 90/bbl)

Other key changes effected in the Policy

- Savings bank deposit rate hiked by 50 bps - Savings bank deposits constitute 22% of all bank deposits, and has been hiked, keeping in line with the general upward movement in all rates and probably as a precursor to eventual deregulation of savings rate.
- Operating policy of monetary policy changed - a new window called the Marginal Standing Facility (MSF), which will facilitate banks to borrow from RBI, once they reach the statutory floor of 24% on SLR holdings. Banks will be allowed to borrow upto 1% of their Net Demand and Time Liabilities (NDTL) through this window and for a minimum period of 15 days. However the financing rate here has been fixed at 100 bps over repo. Thus the existing ad-hoc borrowing facility for banks has been regularized though the rate has been set higher by 100 bps.
- Bank investments in liquid schemes of debt oriented mutual funds will be capped at 10% of their previous year networth. Networth of the banking system including large PSU banks as at end March 2010, was approx. INR 3300 bio. We expect that networth at the end of March 2011 should be higher by 18-20%, given good growth in the first three quarters plus recapitalization in few of the PSU banks by the Government.

Rate Outlook

Post policy, short term yields are up 20 bps in the 3 month segment while 6m is up by 20-25 bps. There was no issuance in 12 months today, but we expect the 1 year CD to trade higher by 10-15 bps.

The 10Y G sec lost 13 bps through the day and is now trading at 8.23%, signalling a negative bias and fundamental concerns on inflation and impact from rising oil and global commodity prices.

Despite RBI's bias on keeping system liquidity negative and policy rates moving up by 50 bps, we expect intra quarter liquidity (ending June 11) to remain satisfactory going forward, given fewer CD issuances (from banks) and good bidding interest from banks and mutual funds on short term securities.

The market expects a cumulative hike of 50 bps over the next two policies (could be 50 bps in the next policy or 25 bps each in the next two policies), as the full impact of the fuel price hike which should happen by mid month gets absorbed by the system.

Highlights of the Monetary Policy Statement for 2011-2012

Monetary Policy Stance

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.

Changes in Operating Procedure of Monetary Policy

- The weighted average overnight call money rate will be the operating target of monetary policy of the Reserve Bank.
- There will henceforth be only one independently varying policy rate, and that will be the repo rate.
- The reverse repo rate will continue to be operative, but it will be pegged at a fixed 100 basis points below the repo rate.

Monetary Measures

On the basis of the policy stance outlined above, and in accordance with changes in operating procedure as set out, RBI has decided to take the following policy measures:

- The repo rate under the liquidity adjustment facility (LAF) has been increased by 50 basis points. Accordingly, it goes up from 6.75 per cent to 7.25 per cent.
- As per the new operating procedure, the reverse repo rate under the LAF, determined with a 100 basis point spread below the repo rate, will stand adjusted at 6.25 per cent.
- The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, gets calibrated at 8.25 per cent.
- The Bank Rate remains at 6.0 per cent.
- The cash reserve ratio (CRR) remains unchanged at 6 per cent of NDTL of scheduled banks.

Savings Bank Deposit Interest Rate

RBI has decided to increase the savings bank deposit interest rate from the present 3.5 per cent to 4.0 per cent with immediate effect

Expected 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.
- The Reserve Bank's baseline inflation projections are that inflation will remain elevated, close to the March 2011 level over the first half of 2011-12, before declining.

Two key regulatory measures for commercial banks measures:

- First, the provisioning requirements on certain categories of non-performing advances and restructured advances will be enhanced.
- Second, investment by banks in liquid schemes of debt oriented mutual funds will be subject to a prudential cap of 10 per cent of their net worth as on March 31 of the previous year.

Source: Policy Statement of the RBI - May 2011