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Banking

Quarterly Review of Monetary Policy

Sector Update

January 25, 2011

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- **RBI raises repo and reverse repo rate by 25bps, leaving the CRR unchanged**
- **Inflation would be the predominant focus of near-term monetary policies**
- **Rate calibrations to continue in light of growth momentum and building demand pressures**
- **Improved global growth prospects pose concerns over the current account and fiscal deficit**

RBI rate calibration continues as expected

The RBI raised the repo and reverse repo rates by 25bps each to 5.5% and 6.5%, leaving the CRR unchanged. The additional liquidity support extended to scheduled commercial banks (SCB's), up to 1% of their net demand and time liabilities (NDTL), have been extended upto April 08, 2011. The second LAF (SLAF) shall also continue till April 08, on a daily basis.

	CRR	Repo	Rev. Repo
Sept. 2008	9.00	9.00	6.00
Sept. 2009	5.00	4.75	3.25
Sept. 2010	6.00	6.00	5.00
Nov. 2010	6.00	6.25	5.25
Jan. 2011	6.00	6.50	5.50

Source: RBI, Emkay Research

Inflation to be the predominant focus of monetary policy

With headline inflation moving past the RBI's comfort level, driven by food and commodity prices, the emphasis is now to contain the current inflationary spiral and prevent it's spill over into generalised inflation. The RBI notes that the structural nature of food price inflation clubbed with global commodity price increase has persisted for a while. Any continuation in this trend, it feels, would exert an effect on inflation both in the domestic and the international scenario.

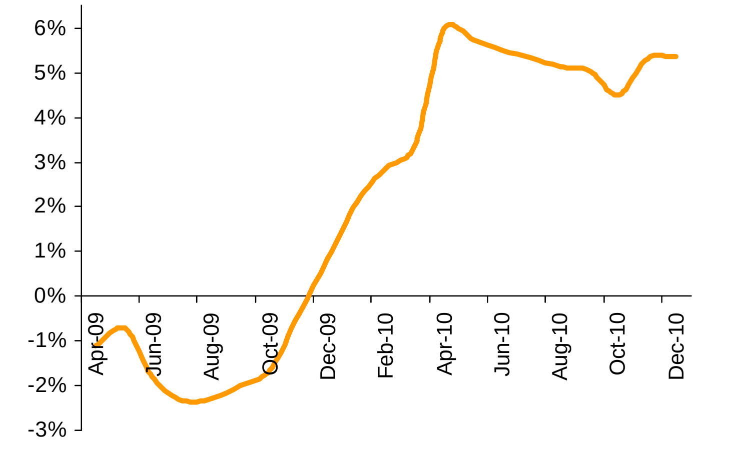
Retains GDP projection at 8.5%; persistence of growth momentum seen

Growth in H1FY11, feels the RBI, suggests that the economy is operating at levels close to its trend rate. Good Kharif production and promising Rabi outlook have reflected the strong contribution of agriculture to GDP growth in FY11. With risks to growth remaining on the upside, the RBI has maintained its GDP projection at 8.5%. In addition, improved corporate sales, indirect tax collections, advance tax payments and service sector indicators suggest the persistence of growth momentum.

Build-up in demand side pressures seen; rate calibrations to continue

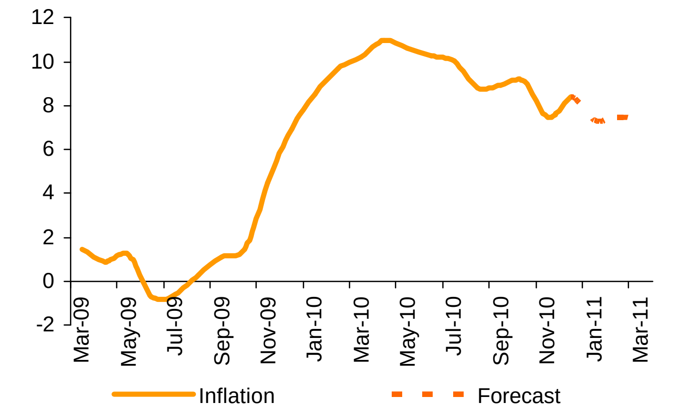
The RBI views the increase in tax revenues, strong corporate sales and rapid growth of bank credit to represent demand side pressures. It feels the need to restrain inflationary expectations on the demand side, to contain the overall inflation. The RBI acknowledges that high credit growth along with lackluster deposit growth would not be sustainable. Moderation in credit growth is warranted here, to prevent the build-up in demand side pressures.

Core inflation (Non-food Manufacturing products)



Source: Ministry of Commerce and Industry, Emkay Research

Headline Inflation



Source: Ministry of Commerce and Industry, Emkay Research

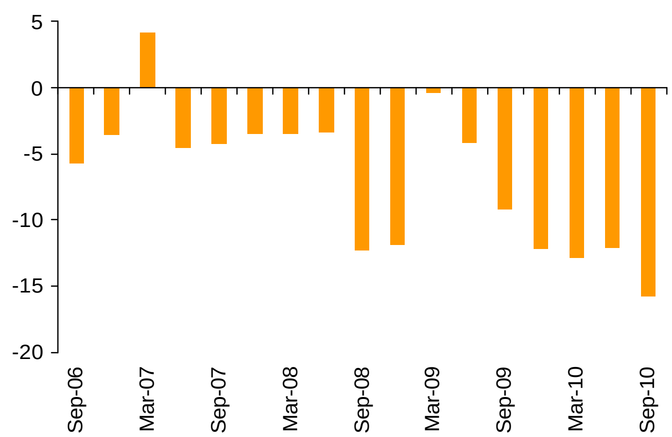
Non-food manufacturing inflation, that represents demand side pressures, though remains stable at 5.1% - 5.9%; is significantly above the RBI trend rate of 4%. Indications of increases in the share of wages (as a part of the total cost) in the corporate sector along with agricultural wage increase through MGNREGA wage indexation, would exert pressure on headline inflation through the channel of input costs; eventually impacting output prices.

With positive growth momentum and a likely build up in demand pressures, we feel the calibrated rate hikes would continue for the near term monetary policies. On headline inflation, we expect a southbound movement for the month of January, 2011 to 7.5% levels and range bound thereafter, with inflation for March FY11 hovering in the range of 7% - 7.5% levels.

Current account deficit (CAD) at unsustainable levels; calls for export diversification

The RBI spells concerns over the unsustainability of the CAD, currently at $15.8bn for Q2 FY11; expects it to remain at 3.5% of GDP for FY11. The capital flows that currently finance the CAD, are predominantly portfolio flows. The A faster than expected global recovery, it feels, would attract investment in advanced economies impacting capital inflows into India. This brings out the need to shift towards long term FDI for funding the CAD. The RBI is of the opinion that such a recovery would also push commodity prices further northward, widening the CAD. It calls for export diversification to tackle the problem of this widening deficit.

Current account deficit (Sep 2006 – present)

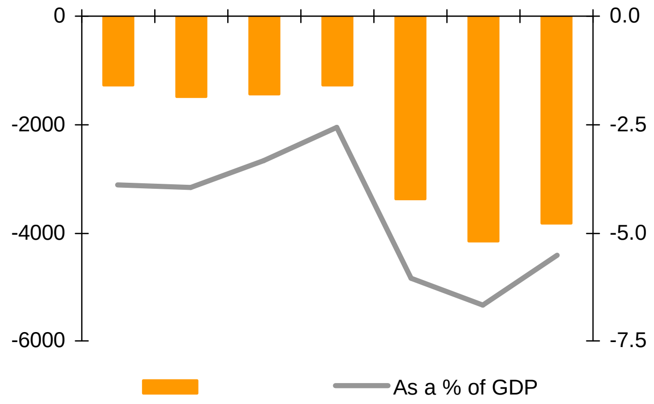


Source: RBI, Emkay Research

Fiscal deficit control for effective inflation targeting

Commodity price increases in the event of an early recovery pose problems on the fiscal front. The RBI sees the impact of increasing oil prices on the pricing of petroleum products and fertilisers. It opines that if such price increases do not percolate to the consumers and farmers, the government would have to make significant budgetary provisions that would restrict the ability to ease the fiscal deficit, undermining fiscal credibility. Trickle down of these prices to the consumers and the farmers; on the other hand, would further increase inflationary expectations, making inflation management extremely difficult.

Fiscal deficit (FY 05 – present)



Source: Bloomberg, RBI, Emkay Research

Government finances

Rs bn	FY2011E	FY2010RE	% yoy chg
Revenue receipt	7,522	5,773	30.3
Capital receipt	451	302	49.3
Total receipt	**7,273**	**6,075**	19.7
Non-plan expenditure	7,361	7,064	4.2
Plan expenditure	3,731	3,152	18.4
Total expenditure	**11,092**	**10,216**	8.6
Fiscal surplus/(deficit)	**(3819)**	**(4140)**	(7.8)
As % of GDP	**-5.5**		
Excess money on 3G/BWA auction	700		
Additional demand for grants	-580		
Likely fiscal deficit	**(3699)**		
As % of GDP	**-5.3**		

Source: Government accounts, Emkay Research

Macro Targets for FY11

Growth in	%	Comments
GDP	8.5	Unchanged
WPI	7.0	Revised upwards from 5.5%
M3	17.0	Unchanged
Deposits	18.0	Unchanged
Non-food credit	20.0	Unchanged

Source: RBI

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