`

RBI POLICY REVIEW

RBI raises policy rates; guides for a persistent anti-inflationary stance

January 25, 2011

The Reserve Bank of India (RBI) lifted both repo and reverse repos rates by 25bps, to 6.50% and 5.50% respectively, thereby maintaining the LAF corridor at 100bps. It left CRR unchanged. The policy was hawkish on inflation and cited it as the dominant concern. RBI acknowleged its limited role in directly controlling inflation that has continued to rise owing to structural constraints in the agri sector and rising commodity prices globally. Hence, key motivation behind the policy move was to contain the spillover from rise in food and fuel prices to generalised inflation and to rein in rising inflationary expectations. In its guidance, RBI said that it will continue its anti-inflationary monetary stance given the growth and inflation dymanics.

Further, RBI extended additional liquidity support to banks to up to 1% of net demand and time liabilities (NDTL) until April 08, 2011. This was since the existing level of liquidity tightness is above RBI's comfort zone, despite better liquidity conditions. Going forward, the central bank expects liquidity conditions to ease with government spending picking up further.

On the macroeconomic front, RBI is comfortable with the current economic growth, but is concerned over inflation, the widening current account deficit (CAD) and risks to fiscal consolidation (as it was based on one-off receipt and, hence, is unsustainable). What also worries RBI is the impact on inflation from government subsidies (they may keep supply-side inflationary pressure in check over short term, but could negate the benefit by adding to aggregate demand). RBI increased the base line projection for WPI inflation for March 2011 to 7.0% from 5.5%. It retained real GDP growth forecast at 8.5% for FY11 and expected CAD to be ~3.5% of GDP in FY11.

Owing to structural demand-supply mismatches in non-cereal food items, high commodity and fuel prices, sticky non-food manufacturing inflation and some evidence of rising demand pressures, inflation is expected to remain uncomfortably high. This would require measures which would contain inflation and anchor inflationary expectations. Therefore, going ahead, we expect RBI to continue its interest rate tightening cycle, with further hike of 75bps likely in the current calender year.

Worried on inflation; comfortable on growth

Inflation, which was already at uncomfortably high levels, rose again in December 2010 due to spike in primary food articles and oil prices. Non-food manufacturing inflation also remained sticky, reflecting buoyant demand conditions. Current spike in food prices is due to transitory and structural demand-supply mismatches. While impact of transitory factor is expected to wane, price pressures due to structural factor will persist. These factors, along with high commodity and oil prices and rising demand pressures, have led RBI to increase its base line projection for WPI inflation for March 2011, to 7.0% from 5.5%.

Kapil Gupta
+91-22-4063 5406
kapil.gupta@edelcap.com

Dipojjal Saha
+91-22-6623 3377
dipojjal.saha@edelcap.com

RBI is comfortable with the current growth momentum; hence, it retained real GDP growth forecast at 8.5%, with upside bias for FY11 (comfort based on recent data on agricultural output, corporate sales, tax revenues, bank credit and service sector indicators - all indicative of continued momentum in the economy). The central bank is, however, worried on: (1) The widening of CAD, stating that the current magnitude is not sustainable; (2) the fiscal front, as it was based on one-off receipt (3G and broadband auction receipts) which is not sustainable; and (3) the impact of government subsidies on inflation, as they could keep supply-side inflationary pressure in check over short term, but can more-than-offset the benefit by adding to aggregate demand.

RBI retained its projections on credit growth and money supply (M3) growth of 20% and 17% for FY11 respectively. In FY12, central bank expects GDP growth rate to decline marginally, as agriculture reverts to its trend growth. It also expects inflation to moderate in the first quarter of FY12, although there are upside risk to this outlook. The upside risk arises from high food and fuel inflation spilling to general inflation and accentuated demand-side pressures.

- **Liquidity condition expected to ease**

  Liquidity condition, which was excessively tight in December 2010, is beginning to improve. Average injection from RBI's LAF window in January 2011 is at ~INR 852 bn against INR 1,204 bn in December 2010. This is mainly on account of the government spending, resulting in reduction of its cash balances. After lagging in the first half of the year, banks have increased deposit rates, to address the widening difference between credit and deposit growth. Going forward, RBI expects the liquidity condition to ease as government spending picks up further.

  Nevertheless, as liquidity tightness is much above its comfort zone (1% of NDTL), RBI has extended additional liquidity support to banks to up to 1% of net demand and time liabilities (NDTL) until April 08, 2011.

- **RBI to continue interest rate tightening**

  Owing to structural demand-supply mismatches in non-cereal food items, high commodity and fuel prices, sticky non-food manufacturing inflation and some evidence of rising demand pressures, inflation is expected to be uncomfortably high. On the other hand, the economy is expected to grow robustly. Hence, there is a need for an anti-inflationary monetary stance to contain inflation and anchor inflationary expectations. Therefore, going ahead, we expect RBI to continue to tighten interest rates, with further hike of 75bps likely in the current calender year.

Chart 1: Inflation on upward trend

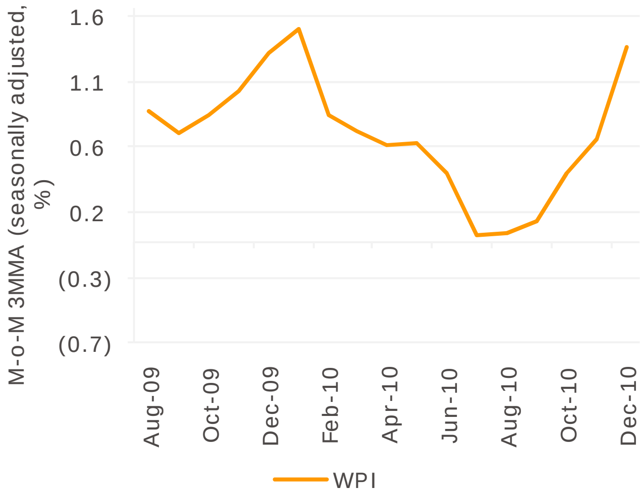


Chart 2: Led primarily by primary articles

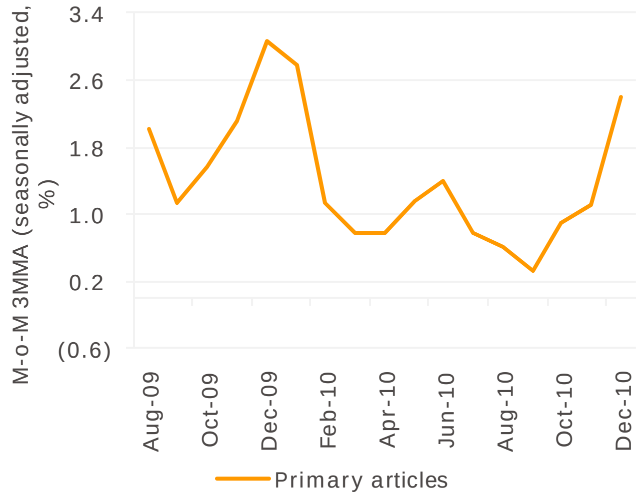


Chart 3: Manufactured product inflation also showing an uptick

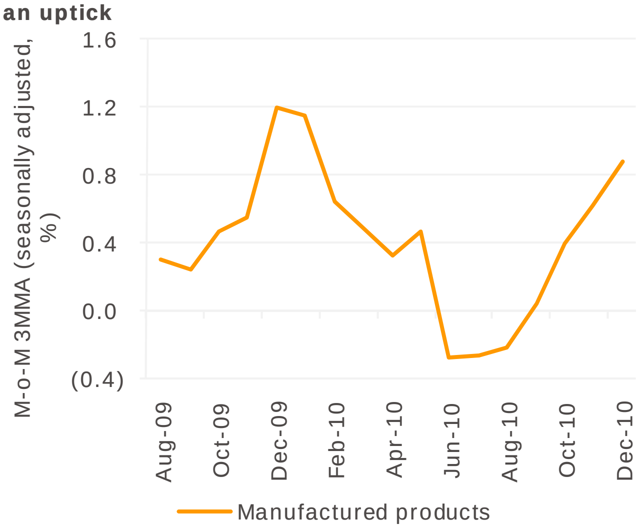


Chart 4: IMF Price Index - Global commodity prices exerting upward pressure on Inflation

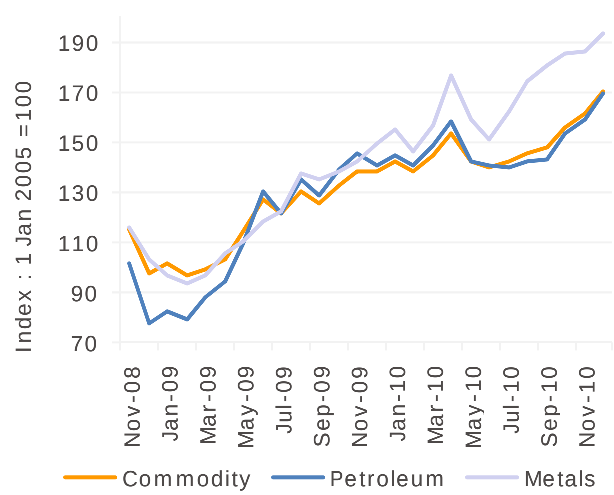


Chart 5: LAF-in injection mode

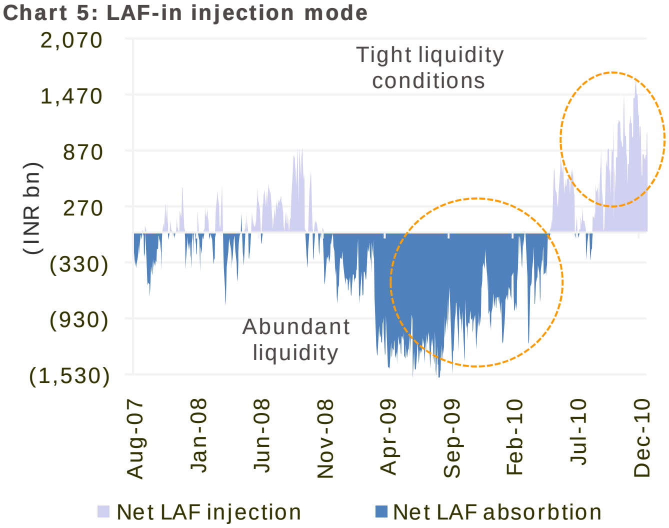
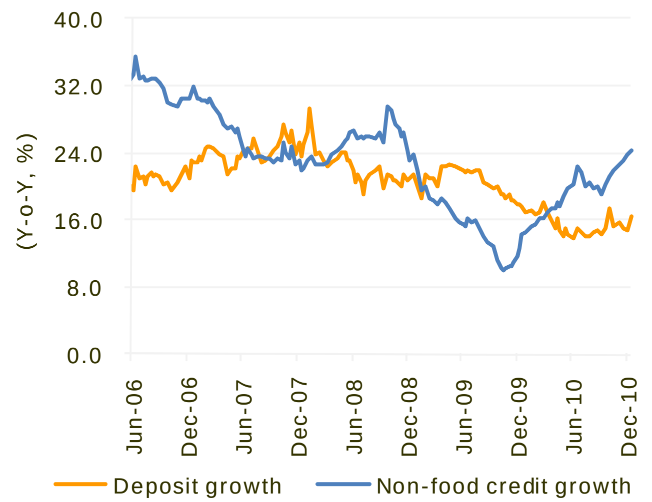


Chart 6: Difference between credit and deposits growth



Source: CMIE, Bloomberg

Annexure 1

Non-food bank credit–Sectoral deployment **(INR bn unless specified otherwise)**

Sector/Industry	19-Nov-10*	19-Nov-10		20-Nov-09	
		Absolute	(%)	Absolute	(%)
Non-food gross bank credit	**33,153**	**5,991**	**22.1**	**2,557**	**10.4**
1. Agriculture and allied activities	**4,118**	**687**	**20.0**	**605**	**21.4**
2. Industry	**14,655**	**3,118**	**27.0**	**1,435**	**14.2**
3. Personal loans	**6,353**	**676**	**11.9**	**40**	**0.7**
Consumer Durables	89	9	11.2	(11)	(11.8)
Housing	3,274	356	12.2	198	7.3
Advances against Fixed Deposits	536	88	19.6	(60)	(11.8)
Advances to Individuals against share, bonds, etc.	29	6	25.1	(14)	(36.8)
Credit Card Outstanding	189	(37)	(16.5)	(74)	(24.7)
Education	424	80	23.2	82	31.0
Vehicle Loans	737	116	18.7	13	2.1
Other Personal Loans	1,074	58	5.7	(95)	(8.5)
4. Services	**8,027**	**1,510**	**23.2**	**477**	**7.9**
Transport Operators	563	159	39.2	39	10.6
Computer Software	149	41	38.5	25	30.1
Tourism, Hotels & Restaurants	265	108	69.0	29	22.7
Shipping	83	(10)	(10.6)	13	16.4
Professional Services	565	106	23.0	36	8.4
Trade	1,746	185	11.9	196	14.4
Commercial Real Estate	1,055	169	19.1	117	15.3
Non-Banking Financial Companies (NBFCs)	1,353	325	31.7	167	19.5
Other Services	2,248	427	23.4	(145)	(7.4)
Memo :					
Priority sector	**11,488**	**1,995**	**21.0**	**1,265**	**15.4**
Agriculture & Allied Activities	4,118	687	20.0	**605**	21.4
Micro & Small Enterprises	4,079	722	21.5	**543**	19.3
Manufacturing	2,156	312	16.9	**295**	19.0
Services	1,922	410	27.1	**248**	19.6
Housing	2,316	192	9.0	**281**	15.3
Micro-Credit	283	96	51.4	**33**	21.8
Education Loans	408	72	21.3	**76**	29.3
State-Sponsored Orgs. for SC/ST	25	2	9.2	**1**	3.4
Weaker Sections	1,891	434	29.8	**265**	22.2
Export Credit	293	77	35.3	**(81)**	(27.2)

Source: RBI

Edelweiss Securities Limited, 14th Floor, Express Towers, Nariman Point, Mumbai – 400 021,
Board: (91-22) 2286 4400, Email: *research@edelcap.com*

Vikas Khemani	Head	Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Nischal Maheshwari	Head	Research	nischal.maheshwari@edelcap.com	+91 22 6623 3411

Recent Research

Date	Topic	Title
21-Jan-11	**RBI Policy Preview**	25bps hike in policy rates anticipated
14-Jan-11	**Inflation**	Headline inflation rise in line With expectations
12-Jan-11	**IIP**	IIP comes in below expectations, driven down by consumer goods
11-Jan-11	**Edelweiss ET-Now Lead Indicator Index**	Be future ready
03-Jan-11	**External Trade**	Trade deficit shrinks in November