

First-Quarter Monetary Policy Review

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- RBI hikes the Repo rate by 50bps to 8.0% and accordingly the reverse repo stand adjusted at 7.0% and MSF (Marginal Standing Facility) at 9.0%
- RBI even more hawkish than last time as it sees strong demand side pressure still persisting with inflation remaining higher than expected
- Silver linings - Moves inflation target to 7% which looks more realistic, GDP growth target still at 8%. Shows that RBI's reluctantly willing to bear higher inflation with growth
- We expect the banks to hike lending and borrowing rates by 25-50bps. Bond yields have already fallen in line. Expect more hikes if inflation doesn't fall below 9% by Oct-11

Raise repo rate by 50bps to 8.0%

RBI hikes the Repo rate by 50bps to 8.0% and accordingly the reverse repo rate and the marginal standing facility stand adjusted at 7.0% (100bps spread below repo rate) and 9.0 per cent. The SLR, CRR remains unchanged and so does the bank rate.

	Repo.	Rev. Repo.
July 2010	4.50	5.75
Sept. 2010	6.00	5.00
Nov. 2010	6.25	5.25
Jan 2011	6.50	5.50
March 2011	6.75	5.75
May 2011	7.25	6.25
June 2011	7.50	6.50
July 2011	8.00	7.00

Source: RBI, Emkay Research

Extremely hawkish on inflation management

RBI has explicitly expressed concern over core inflation which remained higher at 7.2 % in June 2011, much above its medium-term trend of 4%. As inflation continues to remain at elevated levels, RBI has turned its full attention to inflation management now and it is okay with some moderation in growth until and unless the growth falls significantly below trend.

"...growth is beginning to moderate, particularly in respect of some interest rate sensitive sectors. However, there is no evidence, as yet, of a sharp or broad-based slowdown"

"Actual inflation so far has been even higher than expected. In particular, non-food manufactured product inflation has been significantly higher than the average rate of 4 per cent over the last six years."

- Governor's press statement post First-Quarter Monetary Policy Review: July 2011

More rate actions if inflation doesn't fall to around 9% by October 2011

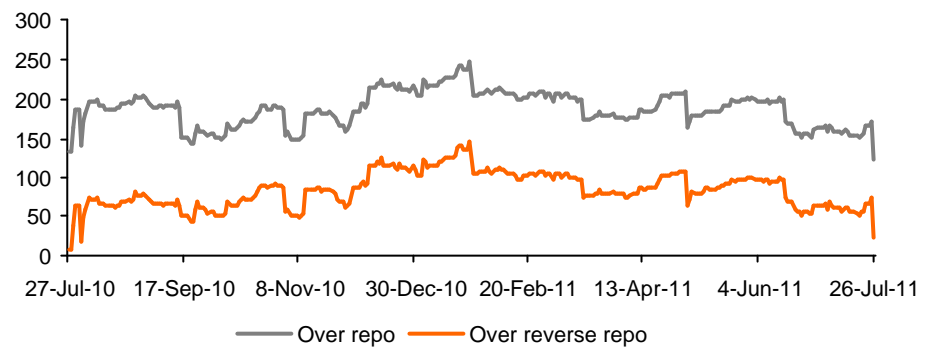
The RBI has already kept its inflation targets at around 9.5-9.8% for Q2FY12. The significantly higher inflation target for Q2FY12 are driven by (1) a direct 70bps increase in the petro-product prices (hiked in Jun-11) and (2) a follow on spill over the same into manufactured inflation.

However, key risks to the inflation projections could arise from (1) global commodity prices, especially crude oil and consequent transmission into product prices, (2) worse than forecast southwest monsoon and (3) spirally fiscal deficit.

G-Sec yields to move up further, as spread over repo has declined

With the recent increase, the differential between the one year G-Sec and repo rate has declined significantly to 24bps. We believe that with no signs of moderation in the tight monetary policy, the short end bond yields could move up by another 30-40bps. Any move beyond that range would be detrimental for smooth floating of the government borrowing programme and may require RBI intervention.

1 year G-Sec yields spread over repo and reverse repo rate



Source: Bloomberg, Emkay Research

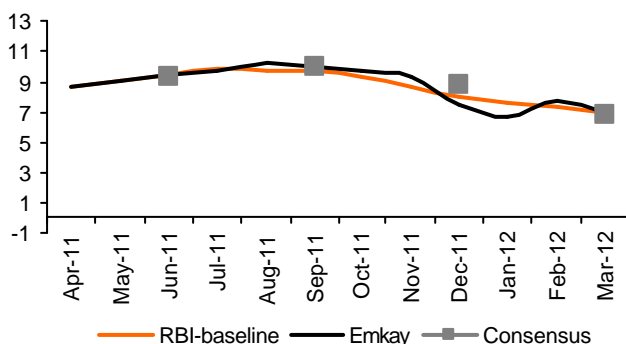
Lending and deposit rates to go up

We expect banks to hike both lending and deposit rates, though the quantum could vary from bank to bank in the range of 25-50bps, depending on their comfort on ALM.

New inflation target of 7% looks more realistic

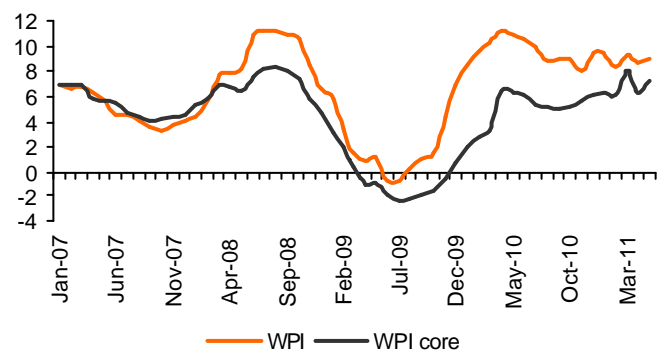
Alongside raising the specter of more rate hikes, the RBI has also raised its inflation target to 7%. We believe that the new inflation target looks more achievable. The high capacity utilizations and pricing power of the producers is likely to keep inflation high for a while. The RBI's new target also matched with consensus estimates on inflation as reflected in most recent professional forecasters' survey.

Inflation Projection



Source: RBI *Note: Consensus - Average WPI increase for quarter based on the sixteenth round of professional forecasters' survey by RBI done in June 2011

Rising Core inflation a worry for RBI



Source: Ministry Of Commerce & Industry

What could prompt policy pause or reversal?

While the inflation is likely to be key driver of the monetary policy going forward, few factors can result in a pause or reversal in the current policy stance as follows:

- A sustainable downturn in inflation which according to us can set in only after Nov-11
- Sharper deceleration in growth even with slightly higher inflation – RBI has still kept the GDP growth target higher at 8%
- A sudden withdrawal of global capital flows which can create problems of liquidity in the system and also of funding the current account deficit. This could be driven by pressure on the sovereign positions in both, US and Eurozone countries

Other macro targets

Growth in (%)	Initial Targets for FY11	FY11A	Earlier Targets for FY12	New Target- FY12
GDP	8.0	8.6	8.0	8.0
WPI	5.5	9.0	6.0	7.0
M3	17.0	15.9	16.0	15.5
Non-food credit	20.0	21.2	19.0	18.0

Source: RBI

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