



Review of the Third Quarter Monetary Policy 2009-10

Key Highlights:

- Repo rate kept unchanged at 4.75%
- Reverse Repo rate retained at 3.25%
- CRR hiked by 75 bps from 5% to 5.75%
- SLR kept unchanged at 25%
- Bank rate kept unchanged at 6%
- GDP growth projection for FY 2009-10 revised upwards to 7.5%
- FY 2009-10 March end WPI inflation projection revised upwards to 8.5%

The Third Quarter Review of the Annual Policy statement 2009-10 comes amidst the classical dilemma of maintaining price stability vis-à-vis spurring economic growth faced by the Central Bank. The Review exhibits the clear shift of stance from 'managing the crisis' to 'managing the recovery'. The Review substantiates the need to support nascent growth while bearing in mind the pernicious outcome of inflationary expectations in the future. It treads ahead in the 'exit' process started in the October Policy by explicitly raising the CRR by 75 bps.

Backdrop of the Policy Review:

- Improving global and domestic scenario

The RBI Governor unveiled the Third Quarter Policy Review amidst recognition of the different challenges faced by the advanced and emerging economies on the path of recovery. Amidst the global recovery, the Policy cautions the downside to the Indian economy and continues the process of withdrawal of monetary stimulus measures announced last year.

Domestic outlook:

- CRR hike by 75 bps to 5.75%

- Inflation projection for March-end FY 2010 set at 8.5%

The Policy explicitly highlights the upside risks to domestic inflation, already at disconcerting levels. The Review cautions against factors exacerbating the same going ahead; viz. high levels of global liquidity contributing to rising asset prices as well as rising commodity prices, the additional liquidity pumped into the system via the OMO route to ensure a non-disruptive Government borrowing, the rising levels of capital inflows, low slack in resource utilization in domestic economy, uncertainty over rainfall in the coming year leading to further price pressures in food articles, gradual pick up in demand side pressures and build up of over all inflation expectations. The Central Bank clearly expresses discomfort on rising price pressures and deems appropriate to contain the surplus liquidity that can feed into future inflationary pressures. The RBI, thus, raised the CRR by a



steep 75 bps from 5% to 5.75%, to be effective in two tranches. Accordingly, the baseline projection for WPI inflation for end March 2010 is revised upwards to 8.5% from 6.5% (with an upward bias) which was stated in the October Policy. The Policy endeavors to contain perception of inflation in the range of 4-4.5% bearing in mind the medium-term objective of 3% inflation.

*- GDP growth forecast
pegged at 7.5%*

The Central Bank recognises the improved sentiment on the domestic front in terms of the robust industrial growth, the rising FII inflows, an appreciating currency, recovery in the equity and commodities market as well as the robust improvement in the GDP on the whole in Q2 FY 2009-10 (at 7.9%). The Policy is optimistic on the industrial growth and the services sector while tracking the improved corporate performance and increased business optimism. Expecting a limited growth potential from the agricultural sector due to deficient rainfalls the Policy revises its growth outlook to 7.5% from 6% as stated in the October policy.

*- Repo, Reverse Repo rates
unaltered*

The Policy lays emphasis on strengthening the recovery process without compromising on price stability. Taking into consideration that large capital inflows would lead to asset bubbles, the Central Bank recognises that any hike in the interest rates would accelerate foreign capital inflow. Managing the sharp rise in inflows could complicate exchange rate and monetary management. Apart from adding to the systemic liquidity, these inflows could imply adverse fiscal costs of sterilisation. Appreciation in the domestic currency because of the inflows, would impact the positive signs of growth seen in the exports sector. The Central Bank realises that the signs of economic recovery globally are in wake of public spending and still need to be supported by the fiscal stimuli provided by the governments. The RBI thus holds its hand back in raising the LAF rates, specifically the Reverse Repo rate.

*- Non-food credit growth
projected at 16%*

The Policy notes that despite the decline in the headline non-food credit growth rate, the corporates continued to access funds from several non-bank sources of funds. Since the non-bank sources of finance have to a large extent mitigated the impact of slow down in bank credit growth, the indicative adjusted non-food credit growth projection for 2009-10 is now reduced to 16%. With completion of major part of the Government borrowing, the pressure on M₃ is expected to ease. Based on the same and projected credit growth the projected M₃ growth in 2009-10 has been reduced to 16.5% from 17% as in the October

*- M₃ growth projection set at
16.5%*

*- Deposit growth projection
set at 17%*

Policy. Accordingly the aggregate deposits are projected to grow at 17% (against 18% stated in October Policy).

Monetary Policy Stance:

The Policy stance has explicitly stated the shift from ‘managing the crisis’ to ‘managing the recovery’. The RBI reiterates the need to carry forward the process of exit. With positive outlook towards growth, the RBI adopts a cautious stance against transmission of higher input and wage costs into product prices. While the recovery is yet to take firm root, strong anti-inflationary measures could deter private investment and consumer spending and stall the recovery process. The RBI thus raised the CRR to contain liquidity and hence rein in potential demand pressures and retained the interest rates at their low to aid growth.

The Review thus explicitly highlights the Policy stance as follows:

1. Anchor inflation expectations and keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments as warranted
2. Actively manage liquidity to ensure that credit demands of productive sectors are adequately met consistent with price stability
3. Maintain an interest rate environment consistent with price stability and financial stability, and in support of the growth process

The stance is on similar lines to that mentioned in the October Policy, the specific addition being ‘anchor inflation expectations’, which clearly states RBI’s goal to curb inflation.

With this stance, the Central Bank expects to reduce the excess systemic liquidity and help anchor inflationary expectations. No alteration in the interest rates is aimed at supporting the recovery process. This calibrated exit would align policy instruments with the current and evolving economic state.

The way ahead:

The Central Bank raises explicit concern over the huge fiscal deficit and the large borrowing program expected for the next fiscal year as well. The Policy emphasizes the urgency for fiscal consolidation. The Review highlights the impediments in managing a large borrowing program



for the next year, viz. limited scope of aid from liquidity supporting tools such as MSS buyback, OMO purchases, etc and the pick up in credit that could exert upward pressure on interest rates. While supporting a co-ordination in fiscal and monetary exit, the Policy urges the need for a roadmap for fiscal consolidation and roll back of transitory components.

The Policy reflects a hawkish stance, aiming to tame inflation while at the same time allowing the recovery to get deeply entrenched. We expect the RBI to begin its rate hike cycle in the upcoming April Policy. The RBI may adopt a wait and watch policy till further signs of continued global economic revival emerge. The improvement in global economies would ensure that the domestic economy does not face any headwinds. As the global recovery takes shape and gains pace, the RBI may look to tighten the Repo rate and Reverse repo rate by 50 bps in the forthcoming policy in April.



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