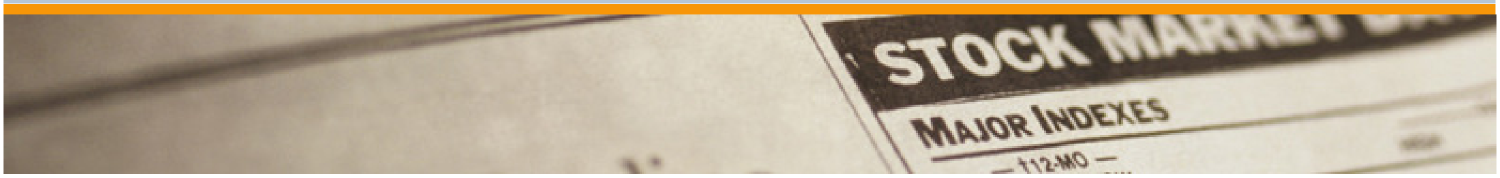
CANARA ROBECO

Post Monetary Policy Review

04-May-2011



The RBI's Annual Monetary Policy 2011-12 is characterized by an aggressive policy decision after a long-time with hawkish stance amid prevailing inflationary concerns. In order to contain inflation by reining in demand side pressures and anchor inflationary expectation while sustaining growth in medium term, though the same may hurt growth in short-term, RBI increased both **Reverse Repo rate and Repo rate by 50 bps from 5.75% to 6.25% and 6.75% to 7.25% with immediate effect.**

The Marginal Standing Facility rate, at which Banks can borrow up to 1% of their respective Net Demand and Time Liabilities, **is determined at 8.25% with effect from May 7, 2011, and the savings bank deposit interest rate increased from the present 3.5% to 4% with immediate effect.**

On banking regulations front, RBI enhanced provisioning rates on advances classified as Non Performing Assets and Restructured Assets, and also regulated bank's investment in liquid schemes.

Policy Stance & Framework

RBI stated the Monetary Policy stance as to maintain an interest rate environment that moderates inflation and anchors inflation expectations, to foster an environment of price stability that is conductive to sustaining growth, and to manage liquidity to ensure that it remains broadly in balance.

The RBI implemented the Monetary Policy operating procedure recommended by the Working Group chaired by Mr Deepak Mohanty, thus going forward weighted average overnight call money rate will be the operating target of Monetary Policy and only one independent varying policy rate will be Repo rate with Reverse Repo rate fixed at 100 bps below Repo Rate and Marginal Standing Facility fixed at 100 bps above the repo rate.

RBI's Domestic Outlook

- GDP growth: High oil and commodity prices and the impact of anti-inflationary monetary stance will moderate growth to around 8% in FY2011-12, on the assumption of a normal monsoon and crude oil prices averaging USD 110 / barrel.
- Inflation: Inflation is likely to remain at an elevated level, close to March 2011 levels, in the first half of the year due to expected pass though of increase in global oil prices to domestic fuel prices and continued pass through of high input prices into manufactured prices. The baseline projection for WPI inflation for March 2012 is placed at 6% with an upward bias.

- M3, Deposit and Credit: M3 growth is projected at 16% for FY2011-12, while Non-Food Credit and Deposits growth are projected at 19% and 17%, respectively for FY2011-12.

Our view on the Policy Actions

RBI's 50 bps hike in policy rates was much required in order to contain persistent inflation pressure. The core inflation is likely to remain elevated, given a substantial increase in oil and input costs for manufactures is not yet fully passed on to consumers. Magnitude of food & primary inflation would much depend on monsoon, while fuel inflation would elevate from current levels as government decides increasing petrol and diesel prices which would again be having a cascading impact on manufactured inflation.

The systematic issues pertaining to slowdown in investment activities and higher commodity and energy prices are likely to remain intact, amid a high build-up in core inflation, we expect RBI to increase rates by another 50 bps in remaining period of the current calendar year.

RBI will have to continuously balance the twin challenge of expected moderation in growth and upside risk from inflation. On the growth front, we expect a GDP growth of around 7.5% for 2011-12.

Impact & Outlook for Bond Markets

- The 10 year G-Sec trading range is expected to shift towards 8.15% - 8.30% between May - June, followed by a possibility of a shift towards 8.50% in July to September. Going ahead, the yields would be impacted by inflation and global oil price movement
- We expect the money market rates to start inching upwards by mid of May 2011, the rates are likely to move up by 30 - 50 bps across the short-term yield curve.

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