Third Quarter Monetary Policy Review

ING ORANGE FLASH

January 25, 2011

Policy Measures

1. RBI hiked Repo rate and Reverse Repo rate by 25 bps each to 6.50% and 5.50% respectively.
2. CRR was unchanged at 6.00%.
3. Additional liquidity support under LAF (Liquidity Adjustment Facility) reduced from 2% to 1% for period from December 18, 2010 to January 28, 2011 has been extended up to April 8, 2011.
4. The second LAF will be conducted on a daily basis up to April 8, 2011.

Economic Assessment

1. RBI noted that global economy is showing signs of improvements. However, in advanced economies, earlier fears of deflation have given way to early signs of inflation.
2. Inflationary concerns are likely to be reinforced by rising costs of energy and commodity prices.
3. Domestic growth momentum remains strong as witnessed in IIP growth and other indicators. RBI has retained its projection of 8.5% growth in GDP for FY11.
4. WPI inflation moderated to single digits and softened to 7.5% in November 2010. However, in December 2010 inflation rose to 8.4% yoy due to higher food and fuel inflation.
5. Money supply growth moderated reflecting slower deposit growth. M3 increased to 16.5% by December 2010, in line with RBI projection of 17%.
6. Liquidity remained tight throughout the third quarter of 2010-11. While overall liquidity deficit in the system remains consistent with the policy stance, high government cash balances contributed to frictional liquidity deficit. The gap between credit growth and deposit growth accentuated the structural liquidity deficit.

ING IM Assessment

1. We believe that the monetary policy stance would continue to target inflation as it could surprise on the upside due to strengthening commodity prices. RBI may hike rates by another 75-100 bps during FY2011-12.
2. We believe that liquidity in the system would continue to be in deficit mode for most of the remaining FY11. However, if it becomes too strained, RBI may take necessary steps to reduce the strain on liquidity.
3. There could be a pull back from current yields after Gsec auction supply gets over in mid February 2011 and due to expectation of lower fiscal deficit. However, yields would start inching up after the new borrowing calendar is announced.
4. We believe that markets will remain range bound between 8.00%-8.30% in the short term.

Source: www.rbi.org.in