

Introduction

The monetary policy for 2010-11 were amidst conditions where signs of inflation were visible, mainly driven by food prices and growth was just about picking up pace. However the current monetary policy for 2011-12 is in an atmosphere where growth is seen to be moderating, the main concern remains uncontrollable inflation which is more broad-based now primarily driven by rising international commodity prices.

Changes in operating procedures of monetary policy

- The weighted average overnight call money rate will be the operating target of monetary policy for RBI
- There will be only one independently varying policy rate, Repo rate. The reverse repo rate is continued to be operative and it is fixed at 100 basis points below the repo rate.
- Marginal Standing Facility (MSF) where banks can borrow overnight from MSF up to 1% of their respective Net Demand Time Liabilities. The rate of interest on this facility will be 100 basis points above the repo rate. The MSF will come into force from May 07, 2011.
- The revised corridor will be fixed at a width of 200 basis points. Repo rate will be in the middle where reverse repo rate will be 100 basis points less than it and MSF will be 100 basis points more than it.

Measures

- The repo rate under the Liquidity adjustment facility (LAF) has been increased by 50 basis points. Accordingly the rate goes up from 6.75% to 7.25%.
- The reverse repo rate under the LAF, determined a 100 basis points spread below the repo rate and adjusted at 6.25%.
- The Marginal Standing Facility (MSF) rate, determined a 100 basis points spread above the repo rate and adjusted at 8.25%.
- The cash reserve ratio (CRR) remains unchanged at 6% of NDTL of scheduled banks.
- The bank rate remains unchanged at 6%.
- Savings bank deposit rates have been increased from the present 3.5% to 4% with an immediate effect.

Financial markets initiatives

- RBI will shortly issue the guidelines on credit default swap.
- The period of short sale in government securities will be extended from the existing 5days to a maximum of 3months.
- FIIs will be allowed to cancel and rebook up to 10% of the market value of the portfolio at the beginning of the financial year.
- Provide banking access to villages with population of over 2000 by March 2012. There are 72,800 villages identified under this category. Commercial banks should ensure that at least 25% of new branches being opened during the fiscal are located in tier 5 and tier 6 cities.

Outlook

The Indian economy is estimated to have grown by 8.6% for FY11 driven by a rising agriculture growth (on account of normal monsoons) and an IIP growth of 7.8%. However the fiscal was impacted by a slowdown in capital goods production and investment spending. Going forward the RBI expects the GDP growth to come down to 8% for FY12. The major risk factor affecting growth is high oil price which is assumed at USD110/barrel, which will lead to

- High Inflation: Baseline projection for WPI Inflation for March 2012 is 6% with an upward bias as against the current rate of 8.31%.
- Higher fiscal deficit: The budgeted targets for Fiscal Deficit are unlikely to be achieved due to higher than expected fuel subsidy expenditure.
- Apart from these internal risks, the RBI also foresee risk on the external front through a higher than expected current account deficit. The RBI believed that with high inflation and slowing growth financing the current account deficit could be a challenge, as capital inflows could be restricted.

Given the above macro economic conditions, we expect that the RBI to remain hawkish for the next 12 months, there is a high possibility of further interest rate hikes in the 6-12 months which is negative for equity and fixed income.

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