ANALYSIS OF THIRD QUARTER REVIEW OF MONETARY POLICY FOR FY10

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THIRD QUARTER REVIEW OF MONETARY POLICY 2009-10:

The Reserve Bank of India (RBI's) accommodative monetary policy stance, adopted since October 2008, in order to augment stronger recovery process has resulted in current macro-economic and liquidity conditions. These measures have successfully mitigated the spillover effect of global financial crisis and instilled confidence amongst market participants. However with the rising food inflation and evidences of excess liquidity in the system the RBI announced the first phase of exit from the expansionary monetary policy by restoring the Statutory Liquidity ratio (SLR) of scheduled commercial banks in the Second Quarterly Review of October 2009. In line with the above backdrop the Third Quarterly Review of RBI continues the stance of an exit policy in order to anchor inflation expectations and manage liquidity in the system. The Third Quarterly Review announces the following key policy measures:

- **Cash Reserve Ratio (CRR) of scheduled banks increased by 75 basis points to 5.75 per cent.**
- **Bank Rate retained at 6 per cent**
- **The Repo rate has been retained at 4.75**
- **The Reverse Repo rate has been retained at 3.25 per cent.**
- **The Gross Domestic Product (GDP) growth for 2009-10 has been revised upwards from 6 per cent in the Second Quarter Review to 7.5 per cent in the Third Quarter Review.**
- **The Wholesale Price Index (WPI) inflation for end-March 2010 has been revised upwards from 6.5 per cent in the Second Monetary Review to 8.5 per cent in the Third Quarter review.**
- **Non food credit growth projection has been revised downwards to 16 per cent and M3 growth to 16.5 per cent.**

Implications:

- A hike by 75 basis points in the CRR which is the most direct and effective monetary tool at monetary policy management will absorb around Rs.36,000 crore of excess liquidity from the system.
- Reduction in liquidity is likely to help anchor inflationary expectations and provide price stability as well as financial stability, maintaining the interest

rate environment which is conducive for the nascent growth recovery of the economy.

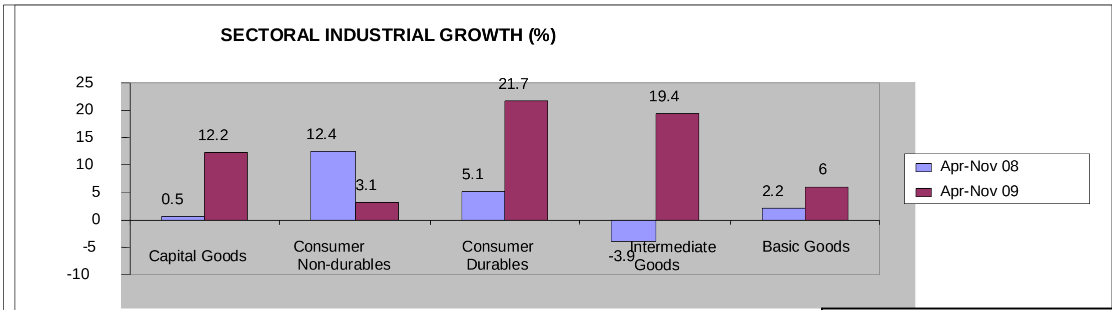
- A hike in CRR has meant an upward pressure on overnight call rates which have been lower than RBI's Reverse Repo lately. On January 28th, the call rates touched an intra-day low of 1 per cent reflecting excess liquidity in the system.
- An upward revision in the WPI for end-March 2010 to 8.5 per cent shows the prospects of inflationary pressures which are primarily supply-led. Thus the role of monetary measures to anchor inflationary pressures remains limited.

Economic Backdrop:

- ***The economy is showing tentative signs of a nascent revival***. Growth in GDP averaged 7 per cent in the first two quarters of FY10 as against 5.8 per cent in the previous two quarters. The Index of Industrial Production (IIP) grew by 11.7 per cent in the month of November, the second straight month of double-digit growth. Moreover the IIP growth in the April to November period stood at 7.6 per cent as against 3.9 per cent for the same period previous year. Lead indicators of aggregate demand such as private consumption demand and investment demand in gross fixed capital formation have shown signs of improvement in economy.
- ***The pace and shape of Recovery however remains uncertain.*** On a perusal of latest available IIP numbers it is revealed that some degree of sluggishness continues to underline the recovery in investment and consumption. For example in the April to November period, while growth in consumer durables (21.7 per cent growth) and intermediate goods (11.4 per cent) showed the strongest signs of recovery, the picture on the capital goods front was mixed. Capital goods production, often a barometer for investment perceptions in the economy, witnessed a growth of 7 per cent as against 8.4 per cent achieved in the previous year. While growth in this sector in November exceeded previous year figures on a month-to-month basis, the growth recovery appears to be still nascent and would require further nurturing from the policy perspective. Also growth in consumer non-durables

segment continued to remain tepid at 1.1 per cent in the April-November period as against 3.3 per cent in the same period previous year.

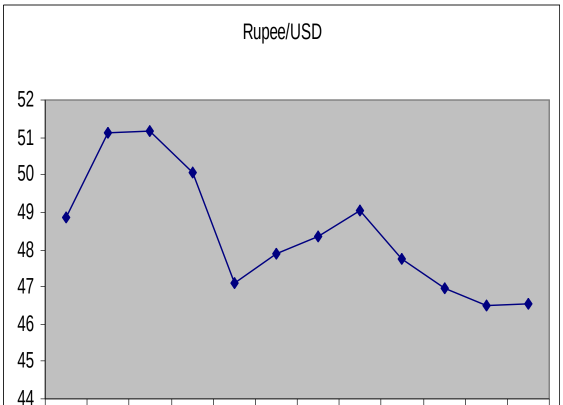
Graph 1: Growth revival has been uneven and nascent

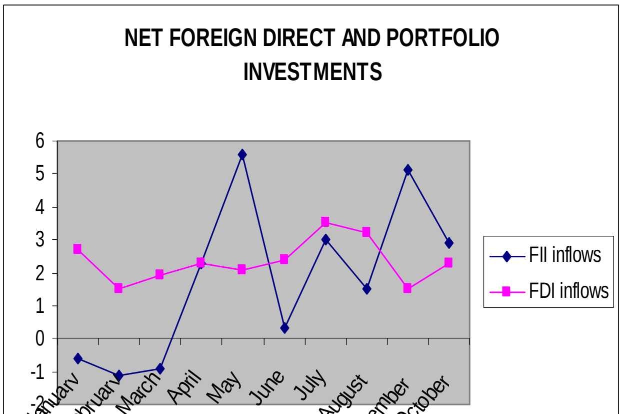


Source: MOSPI

A situation of surplus liquidity continues to remain in the system as testified by low overnight rates and significant amount in the reverse repo window. The amount of funds at the reverse repo window remains at Rs.80,000 crore. The liquidity situation has been accentuated by strong inflows of Foreign Investment Inflows (FIIs) witnessed in FY10 so far. While FII net inflows were around USD17 billion in 2009, inflows in the first 15 days of January 2010 stood at around USD1.8 billion. The increase in portfolio inflows has put an upward pressure on the rupee and accentuated the existing scenario of excess liquidity in the system.

Graph 2 and 3: An appreciation pressure is being exerted on the rupee due to a strong revival in portfolio inflows

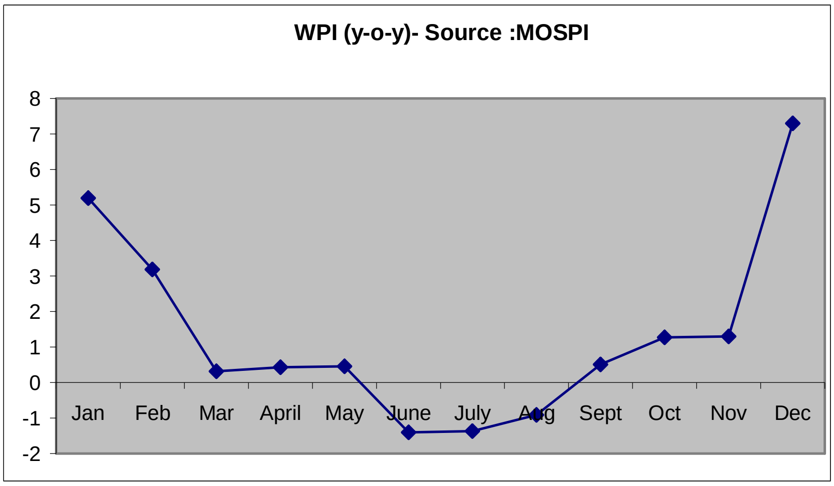




Source: Reserve Bank of India

- ***A poor Kharif season and rise in prices of primary articles has spurred inflation and inflationary expectations in the economy.*** The RBI has already revised its inflation estimates upwards to 8.5 per cent for end-March 2010. The rise in WPI for December stood at 7.31 per cent as against 4.78 per cent in November. As per the first advanced estimates, production of Kharif food grain and oilseeds is likely to decline by about 16% over the previous year, causing supply shortages.

Graph 4: Inflation is showing a rising trend



Policy stance & concluding remarks:

Amidst the backdrop of global and domestic macro-economic conditions, a nascent growth recovery process and prospective inflationary pressures, the RBI has asserted a gradual exit from expansionary monetary stance. While keeping a keen focus on anchoring inflation expectations, RBI is actively managing liquidity to ensure adequate supply of credit in productive sectors and maintaining an interest rate environment consistent with price stability and the growth process.

Going forward, it is important to see the role of managed liquidity (and other monetary policies) on inflation which is primarily supply-led without compromising the existing growth recovery process.