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REPO AND REVERSE REPO RATES HIKE BY 25 BPS EACH

Monetary Policy Measures

On an assessment of the current macroeconomic situation, the RBI raised its key policy rates by 25 basis points as a part of the calibrated exit from the expansionary monetary policy.

- ✓ *Repo rate hiked by 25 basis points from 5.25% to 5.50% with immediate effect.*
- ✓ *Reverse repo rate hiked by 25 basis points from 3.75% to 4.0% with immediate effect.*

RBI raised the key policy rates for the third time in a year by 25 basis points, three weeks ahead of its quarterly policy review. It had last raised the rates by 25 basis points each on March 19 and April 20, lifting the repo rate to 5.25% and reverse repo rate to 3.75%.

This move was largely expected, as inflation for May'10 touched double digit and was the highest in last 19 months. There is now a clear demand-side push on inflation which is threatening to become more generalized now from being restricted to food prices a few months back. The upward pressure seen in core inflation is something that has worried the policy makers and has led to this hike. The fuel price hike announced last week is likely to put further pressure on inflation to the tune of 100 bps.

We expect RBI to hike both repo and reverse repo rates by another 25 bps each in the policy review on July 27, as growth and demand conditions are fairly strong.

Triggers to the measures taken ahead of the July 27 policy review

There have been significant macroeconomic developments since the April 2010 Monetary Policy Statement. At the global level, the recovery is strengthening. However, the outlook continues to be clouded by uncertainty in the Euro area.

On the domestic front, GDP growth at 7.4% for FY10, better than expected, suggests that the recovery is consolidating. The manufacturing sector has recorded robust growth and outperformed service sector, aided by expanding exports. The strong underlying growth momentum is also evidenced by the sharp upturn in the capital goods sector (72.8% in Apr'10), acceleration in credit growth (19% as on 4 Jun' 10) and the widening current account deficit (US\$ 38.2bn in 2009-10). The monsoon situation for FY11 is expected to be better as compared to last year, holding prospects for healthy agriculture growth.

The developments on the inflation front, however, raise several concerns. WPI inflation increased to 10.2% in May 2010, up from 9.6% in April 2010. Food price inflation and CPI inflation have remained at elevated levels. The recent increase in fuel prices will had further pressure on WPI inflation.

Impact Analysis

By raising repo and reverse repo rates but leaving the cash reserve ratio (CRR) intact, the RBI has given the clear signal that it does not wish to tinker with liquidity that is running tight due to a variety of factors such as 3G auctions payout, broadband auction payout and advance tax outflows. The monetary measures taken by the RBI are expected to contain inflationary pressure while not hurting the recovery process.

There will be no impact on base rate which can be reviewed once a quarter. The only scenario of base rate to go up is any push up in its components. The deposit growth is only 14% as on Jun 04, much lower than credit growth at 19% (as on June 04). Depending on liquidity pressures, hike in key policy rates may have an impact on lending rates with a lag. However, an immediate hike in lending rates is not expected.

