ECONOMIC RESEARCH

Monetary Policy for 2007-08 – Review & Analysis

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Highlights of the Monetary Policy for 2007-08

Macroeconomic Review

- Inflation for 2007-08 targeted to be contained at 5.0%. Medium term inflation targeted in the range of 4.0%-4.5%
- M3 (broad money) expected to grow by 17.0%-17.5% in 2007-08
- GDP growth for 2006-07 estimated at 9.2%. The GDP growth for 2007-08 projected at 8.5%
- Deposits expected to increase by 19% (approx) in 2007-08
- Non-food credit growth projected in the range of 24.0%-25.0% in 2007-08
- Corporate sector expected to experience considerable growth and consolidation during 2006-07
- Global growth (real GDP) estimated to decelerate to 4.9% in 2007 from 5.4% in 2006
- Appropriate liquidity to be maintained to meet legitimate credit requirements, consistent with price and financial stability

Monetary Policy Measures

- LAF Repo Rate, LAF Reverse Repo Rate, Bank Rate and CRR kept unchanged
- Ceiling interest rate on FCNR (B) & NR(E)RA deposits reduced by 50bps
- Overseas investment limit for Indian companies enhanced to 300% of their net worth
- Aggregate ceiling on overseas investment by mutual funds enhanced to USD 4 billion
- Prepayment of external commercial borrowings (ECBs) without prior Reserve Bank approval increased to US $ 400 million
- The limit for portfolio investment abroad in listed overseas companies by listed Indian companies enhanced from 25% to 35% of net worth
- Limit for individuals for any permitted current or capital account transaction increased to USD 100,000 per financial year
- Risk weight on residential housing loans to individuals for loans up to Rs.20 lakh reduced to 50% as a temporary measure
- CCIL advised to start a trade reporting platform for Rupee Interest Rate Swaps (IRS)
- Average cut-off yield on 182-day Treasury Bills to be used as a benchmark rate for floating rate bonds
- Working Group on Currency Futures to be set up to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework
- Banks and primary dealers to be permitted to begin transacting in single-entity credit default swaps (CDS)

Stance of Monetary Policy

The stance of Monetary Policy for 2007-08 is:

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum
- To re-emphasize credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations and the growth momentum

In the Annual Monetary Policy announced today, the Reserve Bank of India decided to maintain the LAF Reverse Repo and LAF Repo rates at 6.00% and 7.75% respectively. The Bank Rate and CRR too were kept unchanged at 6.0% and 6.5% respectively. A section of the market was expecting the RBI to hike the LAF Repo rate by 25bps in continuation of its fight to contain inflationary pressures in the economy. However, this time around the RBI seems to have adopted the wait and watch approach, to have a better gauge on the economic outlook going forward.

Monetary Policy continues to emphasise price stability

Nonetheless, the stance of RBI continues to emphasize the need for maintenance of price stability to ensure stable economic growth. In the Annual Monetary Policy statement the RBI has alluded to both the rise in domestic demand and increasing supply side constraints as major contributors for higher inflation in 2006-07. Buoyant corporate performance, highest credits off take in industrial sector, above 10% growth in IIP and a 9.2% growth in GDP; have been fitting reflections of demand side pressures in the economy and the resultant higher inflation. Talking of supply side pressures, the statement also mentions about the strains on domestic production capacities in regard to basic and intermediate goods as adding to inflationary pressures. Moreover, infrastructure bottlenecks i.e. mismatch between demand growth and supply response have been a major contributors towards overheating in the economy. As a result, it is anticipated that the RBI would continue to provide timely and appropriate responses to any unfavorable developments on price movements; and use any or all policy instruments at is disposal.

Macroeconomic Outlook for 2007-08

The RBI puts GDP growth target for 2007-08 at 8.5%. The growth impetus is expected to emanate in a larger part from the industrial and services sector. Also, steady rise in the gross domestic savings rate, step-up in investment rate and improvement in efficient use of capital is expected to aid the growth momentum. Apart from domestic buoyancy, increasing international competitiveness is expected to augur the growth further. This is reflective of consistent rise in ratio of merchandise exports to GDP and equivalent buoyancy in software and business services export.

Target for non-food credit growth in 2007-08 higher, despite a tight Monetary Policy scenario

However a bit of surprise at the Annual Monetary Policy review has arisen in form of setting of higher growth targets, as compared to previous fiscal, for money supply, deposits and non-food credit. Money supply is targeted to grow in the range of 17.0%-17.5%. The money supply growth was noted at 21.0% and 20.7% for 2005-06 and 2006-07 respectively. Moreover, a substantial growth in money supply in 2006-07 has been contributed by a 22.4% growth in Reserve Money. The extraordinary growth in Reserve Money was primarily a result of the RBI interventions in the forex market to the tune of USD 24 billion. Aggregate deposits are expected to grow by 19% (approx) in 2007-08, which considerably higher than 15.8% (approx.) growth targeted in 2006-07. Moreover, substantial rise in the deposit base has been contributed by the growth in money supply. Non-food credit is targeted to grow in the range of 24.0%-25.0% in 2007-08. Non-food credit grew by 28.0% in 2006-07; over and above a growth of 31.8% seen in 2005-06. The growth target seems humungous considering a higher base and some moderation expected to take place as a result of continued tight monetary policy.

Easing of Capital Account Norms

Following measures have been announced at the Annual Monetary Policy Review of 2007-08 as steps towards achievement of convertibility of rupee on the capital account and which are broadly in line with roadmap given by the second Capital Account Convertibility Committee headed by Dr. S. Tarapore. Some of the measures can be interpreted as creating an enabling environment for capital outflows from the country, in light of heavy inflows noted in 2006-07 that lea to sharp appreciation of the rupee.

Overseas investment limit for corporates increased to 300% of their net worth

- Overseas investment limit (total financial commitments) for Indian companies enhanced to 300% of their net worth
- Listed Indian companies limit for portfolio investment abroad in listed overseas companies enhanced to 35% of net worth
- The aggregate ceiling on overseas investment by mutual funds to be increased from USD 3 billion to USD 4 billion
- Prepayment of external commercial borrowings (ECBs) up to USD 400 million to be allowed as against the existing limit of USD 300 million by authorized dealer banks without prior approval of the Reserve Bank, subject to compliance with stipulated minimum average maturity period as applicable to loans
- The present remittance limit of USD 50,000 to be enhanced to USD 100,000 per financial year for any permitted current or capital account transaction or a combination of both by individuals

- The forward contracts entered by residents for hedging overseas direct investments to be allowed to be cancelled and rebooked
- Resident individuals to be permitted to book forward contracts without production of underlying documents up to an annual limit of USD 100,000 which can be freely cancelled and rebooked
- Permit remittances on account of donations by corporates for specified purposes, subject to a limit of 1% of their foreign exchange earnings during the previous three financial years or USD 5 million, whichever is lower
- Permit Indian companies to remit up to USD 10 million as against the current limit of USD 1 million for consultancy services for executing infrastructure projects
- Allow remittance of foreign exchange towards reimbursement of pre-incorporation expenses incurred in India where the remittance does not exceed 5% of the investment brought into India or USD 100,000 whichever is higher, on the basis of certification from statutory auditors

Forward contracts by residents allowed to be cancelled and rebooked

- Permit remittances on account of cash calls for the purpose of oil exploration, provided the operator/ consortium member in India submits documents to the satisfaction of the authorised dealer
- Allow remittances on account of requests from Business Process Outsourcing (BPO) companies towards payment of the cost of equipment to be installed at overseas sites in connection with setting up of International Call Centres, subject to specified terms and conditions
- Open foreign currency accounts in India for ship manning/ crew managing agencies that are rendering services to shipping companies incorporated outside India
- Remit winding up proceeds of companies under liquidation, subject to orders issued by the official liquidator or a court in India or under any scheme framed by the Government of India and also subject to tax compliance
- Authorized dealers to be allowed to open escrow/ special accounts on behalf of non-residents corporates, subject to specific conditions where such accounts are required to be opened in terms of the SEBI regulations for open offers/ delisting offers/exit offers and the like
- The facility of operation of accounts by power of attorney holder is to be extended to NRO account holders
- At the request of the depositor, authorized dealers to be allowed to permit remittance of the maturity proceeds of FCNR (B) deposits to third parties outside India, provided the authorized dealer is satisfied about the bonafides of the transaction

Reforms in G-Sec and SDL Market

Following measures have been announced with the intention of deepening and widening the Government Securities market, in light of implementation of the FRBM Act, 2003:

- Buy-back of SDLs following recent accumulation of surplus cash balances and negative spread earned on the investment of such balances
- Operational modalities for introduction of an indicative calendar for SDL auction being finalized

Reissuance of SDLs considered for improving secondary market liquidity

- Facility of non-competitive bidding to be extended at the primary auction of SDLs
- Reissuance of SDLs with a view towards improving the secondary market liquidity
- Usage of average cut-off yield on 182-day Treasury Bills as a benchmark rate for the Floating Rate Bonds to be issued in future
- Commencement of active consolidation of Central Government Securities, for which budgetary provision of Rs 2,500 cr already made towards premium payments for consolidation

Reforms to Improve Market Infrastructure

Repos in coroprate bonds under consideration

- Repos in corporate bonds to be considered post successful establishment of, proposed trading platforms and robust clearing and settlement systems
- CCIL being advised to start a trade reporting platform for Rupee Interest Rate Swaps
- A Working Group is being set up to go into all the relevant issues relating to interest rate derivatives and to suggest measures to facilitate the development of interest rate futures market
- Working Group on Currency Futures to be set up to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework

Prudential Measures

Proposal put forth for transacting in credit default swaps

A proposal has been put forth to permit banks and primary dealer to begin transacting in single-entity credit default swaps. This forms a part of gradual progress of financial sector liberalization. This has been in the backdrop of strengthening of the risk management techniques of banks and the progress of the banking system towards becoming Basel II compliant.

It has been proposed to reduce the risk weight on the residential housing loans to individuals upto Rs 20 lakh from current 75% to 50%. This proposal has been put forth as the banks are gearing towards becoming Basel II compliant. Under Basel II's standardized approach for credit risk, the risk weight on residential property fully secured by mortgages is prescribed at 35%. However, the above proposal for reduction of risk weight to 50% is only temporary in nature and will be reviewed after a period of one year.

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