Monetary policy review

The CRR hike is a policy decision to manage capital flows rather than arising from inflationary concerns

Surging capital flows remain RBI's key concern

The Reserve Bank of India (RBI) decided to hike the cash reserve ratio (CRR) by 50 basis points to 7.5%, while keeping other policy rates unchanged. The decision to hike the CRR is more of a policy decision to manage the liquidity condition in the banking system rather than that arising from inflationary concerns. RBI has mentioned that the inflationary expectations have been contained and the decision to hike CRR is mainly to moderate the surging money supply growth resulting from excessive net capital inflows. Liquidity management seems to be the key focus area of RBI, hence further CRR hikes cannot be ruled out if capital flow doesn't moderate resulting in a more acceptable money-supply growth.

Key policy highlights

- Bank rate, repo rate, and reverse repo rate kept unchanged.
- CRR increased by 50 basis points to 7.5% effective November 10, 2007.
- Gross domestic product (GDP) growth forecast retained at 8.5 % during 2007-08, assuming no further escalation in international crude prices and barring domestic or external shocks.
- Inflation to be contained close to 5% during 2007-08 with a medium-term objective of around 3.0 % inflation.

Impact of CRR hike across different markets

There was a 33% chance of a 50-basis points hike in the CRR, hence we believe markets were more or less discounting the action to some extent. The equity market (Sensex) didn't correct significantly, however it closed almost 200 points below its previous day's closing at 19,783. Bond yields at the longer (10-year) and shorter (1-year) end remained stable, while the rupee showed an appreciation of seven basis points to close at Rs39.36 per US dollar.

Domestic inflation concerns still remain

RBI has stated that while the recent headline inflation is indicative of reasonably well-anchored inflation expectations, some of the recent developments have shown that there are major risks to this assessment that are still evolving. Consumer price index (CPI) level is at 7.3% indicating that the softening of wholesale food prices has not set in at the retail level. The global environment with crude at above $90 per barrel and elevated food and metal prices pose a significant pass-through risk to inflation going forward. Finally, the domestic monetary and liquidity conditions prevalent currently could carry the seeds of future inflation.

At a global level inflation expectations have resurfaced

The expansion of global liquidity conditions in the wake of the recent financial market turmoil has occurred in a period when global central banks were concerned about inflation expectations. The massive injection of liquidity by mature central banks reflects a deviation from their stance on inflation in order to ensure financial stability, which could potentially weaken their ability to fight inflationary pressures.

RBI's view on the economic prospects of key sectors

Agriculture: Rainfall in the current season has been above normal and reasonably well-distributed. Thus Kharif sowing has been higher than that in last year's season reflecting expectations of higher production than that in the preceding year. These developments have improved the outlook for agriculture. The positive prospects for agriculture augur well for the economy as a whole in terms of both aggregate supply conditions and food prices, which, until early 2007, were the main drivers of inflation.

Manufacturing: the manufacturing sector continued to record a double-digit growth despite some modest deceleration in the industrial activity. There are indications that the industrial activity will continue to sustain its momentum on the back of strong fundamentals. Contraction in the output has occurred mainly in the consumer goods segment, transport equipment, metal products, paper and textiles, which could be reflecting transitory factors. A marginal moderation in the overall industrial activity over the rest of 2007-08 may not be ruled out within the generally positive prospects for the industrial sector.

RBI survey gives mixed responses

RBI'S survey for manufacturing companies indicates stable business conditions. While other surveys including services sector present a somewhat mixed picture with business confidence reporting a fall of 8.9% in July-December 2007 relative to its previous survey, thereby reflecting some increase in the cost of finance and rising prices of raw materials.

Concerns expressed by RBI

Domestic: Foreign direct investment (FDI) to India has been running higher in the current financial year. It is necessary to note that a significant portion of these flows is attributable to private equity and venture capital, which are essentially in the nature of portfolio flows. There has been a rapid escalation in asset prices, particularly equity and real estate, which are significantly driven by capital flows. These pools of private, opaque, highly leveraged and largely unregulated capital flows continue to worry RBI and we could expect some policy action in these sectors going forward if capital flows doesn't moderate in these sectors.

Global: RBI seems to be bothered by the unknown possible impact of the US subprime saga and the possible spill-over effect of enhanced global liquidity post the accommodative stance adopted by global central banks on India.

Impact of the above global concerns on India

RBI perceives that the most important issue for India at the current juncture is the possible affect of these global developments on the domestic financial markets. The impact of the same could be felt in our financial sector, balance sheet, trade, and inflation channels. In regard to the financial sector channel, the primary channel in India is through the equity markets. The currency markets are affected through equity market players. Thus RBI feels that the immediate task for public policy in India is to manage the possible financial contagion, which is in an initial stage with highly uncertain prospects of being resolved soon.

Capital flows remain the key challenge in conduct of domestic monetary policy

RBI has stated that though the monetary policy has operated reasonably well on the domestic demand-supply and credit-deposit balances even as the liquidity emanating from the capital flows has been absorbed in the short run, the key future challenge is the liquidity management taking into account the current levels of the capital flows. The persistence of these flows has implications for domestic financial stability and future inflation with potential lagged effects on the aggregate demand. "Consequently, monetary policy will have to address not only the liquidity overhang but also incremental flows in the future if they continue at

Banking stock performance and impact of CRR hike on FY2008E PAT

Banks	BSE prices			Likely decline in FY08E PAT after CRR hike
	29-Oct-07	30-Oct-07	% chg	
Allahabad Bank	102.00	101.55	-0.4	2.2
Andhra Bank	89.45	87.80	-1.8	2.0
Bank of Baroda	325.85	326.35	0.2	2.4
Bank of India	315.95	372.60	17.9	2.0
Canara Bank	283.95	285.70	0.6	2.4
Corp Bank	415.10	426.90	2.8	2.0
HDFC Bank	1638.70	1618.25	-1.2	1.8
ICICI Bank	1249.40	1240.25	-0.7	1.8
Punjab National Bank	539.15	510.85	-5.2	1.9
State Bank of India	2117.85	2062.20	-2.6	2.2
Union Bank of India	161.05	174.05	8.1	2.5
Axis Bank	925.45	909.05	-1.8	1.9
Sensex	19977.67	19783.51	-1.0	-
Bankex	10649.71	10550.09	-0.9	-

present levels." In view of the above statement made in the policy review we feel that the monetary policy stance has not moderated and would continue to be guided by the capital flows and the global factors more than the domestic factors at the current juncture.

Further policy actions cannot be ruled out

The RBI has also said that it will continue with its policy of active management of liquidity through appropriate use of CRR and other policy instruments at its disposal as and when the situation warrants.

Policy highlights related to the banking sector

Impact of CRR hike: The guidelines on the issue of preference shares announced yesterday was a sweetener for the banking sector, however the 50-basis points CRR hike is likely to reduce FY2008 profit after tax (PAT) by 1-2.5% on an annual basis, as banks don't get to earn any interest income on such reserve balances.

Expected reaction from the banking sector: We don't expect banks to pass on the increased cost to its borrowers when credit demand is low, but rather expect banks to start cutting deposit rates to protect the margins.

Banks need to be careful on recovery tactics as RBI sounds tough

The RBI has decided to consider imposing a temporary ban (or even a permanent ban in case of persistent abusive practices) on those banks and their directors or officers where strictures have been passed or penalties have been imposed by a high court or the supreme court with regard to the abusive practices followed by their recovery agents. An operational circular in this regard is expected to be issued by the reserve bank in November 15, 2007.

Discussion paper on holding companies in banking groups— The guidelines in this regard is expected to be issued by end-November 2007. These guidelines assumes significance for ICICI Bank and the State Bank of India as these two banks are in advance stages of forming such holding companies.

Policy highlights related to the foreign exchange market

- Reinstatement of the eligible limits under the past performance route for hedging facility to be permitted.
- Oil companies to be permitted to hedge foreign exchange exposures by using overseas over-the-counter/ exchange traded derivatives up to a maximum of one year forward.
- Importers and exporters having foreign currency exposures to be allowed to write covered call and put options in both foreign currency/ rupee and cross currency, and receive premia.
- Authorised dealers to be permitted to run cross currency options books subject to the reserve bank's approval.

Conclusion

We feel the major challenge for RBI currently is not growth and inflation, but managing the dollar deluge in the system. Thus the hike in CRR is to moderate the surging money-supply growth rather than the inflation worries, which the central bank feels to have been contained. Markets to some extent expected a 50-basis points CRR hike, hence across the markets we haven't witnessed any major correction. Liquidity management seems to be the key focus area of RBI, hence further CRR hikes cannot be ruled out if capital flow doesn't moderate resulting in a more acceptable money-supply growth. Banks are likely to get affected from the CRR hike but we don't expect lending rate hike is possible, rather banks should start cutting deposit rates aggressively if credit growth doesn't pickup to maintain the margins. RBI has also expressed concerns on surging asset prices and capital flows via private equity route to real estate. Some policy action could also be expected in this sector. Economic growth outlook remains stable at 8.5% for FY2008, however some moderation in industrial activity is not ruled out.

The author doesn't hold any investment in any of the companies mentioned in the article.