THIRD QUARTER REVIEW OF ANNUAL POLICY

A cautious move

Edelweiss
Ideas create, values protect

February 5, 2007

Manika Premsingh
+91-22-4109 4847
manika.premsingh@edelcap.com

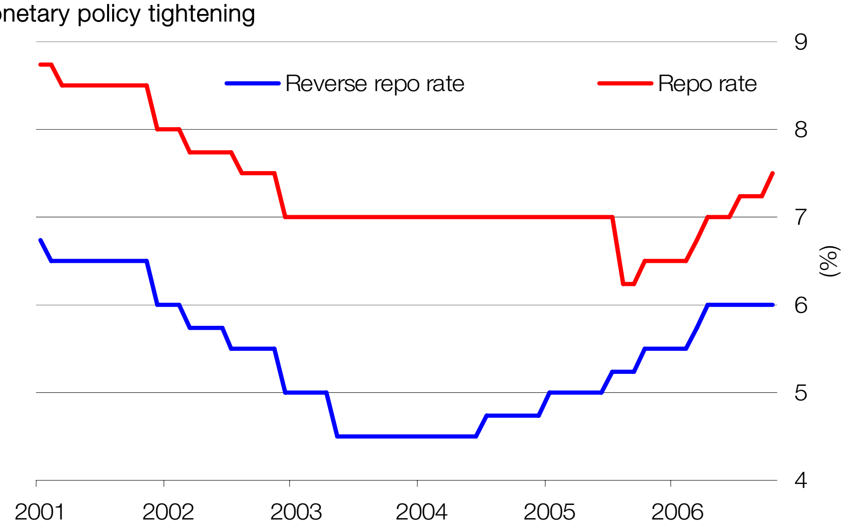
The RBI treaded cautiously once again—hiking only the repo rate by 25bps to 7.5%, while leaving the reverse repo rate unchanged at 6%. All other key policy instruments—bank rate, CRR, and SLR—were left untouched as well.

The hike in the repo rate is essentially an indication to banks to keep their liquidity management in check. This is not as strong a stance as would have been if the reverse repo rate had also been increased, since that would have been a clear indicator of a further rise in lending rates. This is a welcome move, since there has been significant monetary tightening already. The biggest bite so far was the CRR hike as late as December, the pass through effect of which has not yet kicked in.

This does not, however, mean that the RBI is no longer hawkish on credit growth or inflation stemming from its unabated rise. It has made a series of provisioning moves and also lowered interest rates on non-resident deposits to keep liquidity arising from capital flows in check. It has pointed to a number of actual or potential hot-spots in the economy that require attention: (a) rising inflation rate; (b) the still excessive credit growth; and (c) skewed credit quality.

The policy statement suggests that the central bank is likely to tighten further in an inter-meeting hike. We place a high probability on another 25bps hike in CRR and do not rule out a reverse repo rate hike either. We expect the move around mid-March 2007.

Monetary policy tightening



Source: RBI, Bloomberg, CMIE

Monetary moves: Walking a tightrope

For second monetary policy meeting in a row, the RBI kept the reverse repo rate unchanged while increasing the repo rate by 25bps. In our view, this is a reflection of the tight rope walk that the RBI is doing at the current juncture. On one hand is the still very evident fear of potential or actual overheating, on the other, is the fear of a sharp slowdown arising from the lagged impact of rate and CRR hikes that have been effected.

A hike in the reverse repo rate would have meant a clear signal by the central bank that lending rates need to rise further, given the excessive credit growth and its resultant reflection on inflation. But it has been cautious, given the current context of: (i) the lagged impact of monetary tightening yet to flow in; and (ii) the fact that a significant part of current inflation rise is due to primary articles, for which monetary tightening is ineffective. For now, the RBI has kept the reverse repo rate on hold, in line with our assessment *(see: RBI Watch "To hike or not to hike – 5 reasons for the RBI not to raise rates", Jan 29, 2007)*, that it may have been too much too fast.

By hiking the repo rate and increasing provisioning for certain sectors, it has chosen to fine tune the monetary policy this time around. By increasing the repo rate, the central bank has indicated, yet again, that it would like banks to manage their liquidity better. In other words, it has left banks with the option of either raising more deposits or reducing their credit give out, or both. By increasing provisions on certain sectors, RBI has suggested that credit quality needs to be checked. The move to lower deposit rates on NRI deposits is also partially a step in this regard, in so far as these deposits may find their way into assets thus raising asset price inflation.

The lowering of rates on NRI deposits is also a move to contain flow of foreign liquidity into the system. In fact, strong capital inflows have also been flagged as a matter of concern by the RBI.

Looking forward: We are not done yet

The RBI has made it abundantly clear that it is not done with monetary tightening just yet. The stance of the monetary policy going forward is mentioned in three points:

- 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-emphasise credit quality** and orderly conditions in financial markets for securing macro economic 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.

The third point, in our view, is a give away. In FY07 so far, an inclusion of the word "swiftly" or "promptly" in the monetary policy stance has been followed by an inter-meeting monetary tightening.

The possible reasons why further tightening would occur are evident in the first two points on the monetary policy stance—inflation and credit quality. We maintain a fairly bearish view on inflation. Our forecasts suggest that it will continue to rise through the remaining part of FY07, though this is largely on a low base effect *(refer to our report: India inflation-Theme piece, September 2006)*. While the recent fiscal measures are likely to have some impact, we do not believe they will make a substantial difference immediately.

With respect to the second point, while the RBI has expressed specific concern over credit quality, elsewhere it has also expressed concern over the level of credit growth. We are tilted towards the belief that little letup in credit growth and strong capital inflows together are likely to keep the central bank cautious. It needs to be added that the RBI has upped its GDP forecast to 8.5-9.0% for FY07 from around 8.0% , and this strengthening in growth is also likely to play on its mind.

Going ahead, we believe that the RBI will undertake more monetary tightening for FY07. We attach a high probability to another 25bps CRR hike and additionally, we cannot rule out a 25bps hike in the reverse repo rate too.

Annexure: Measures undertaken in the third-quarter review of annual policy

- Monetary measures

  1. Repo rate increased by 25bps to 7.25%
  2. Repo rate, CRR, bank rate, and SLR remain unchanged

- External account

  1. Interest rate on NR(E)RA reduced by 50bps
  2. Interest rate on FCNR(B) reduced by 25bps
  3. Prohibition on granting fresh loans in excess of INR 20 lakh against NR(E)RA and FCNR(B) accounts

- Provisioning norms and risk weights

  1. Increase in provisioning requirements of loans and advances on: (i) real estate sector (excluding residential housing loans); (ii) outstanding credit card receivables; (iii) loans and advances qualifying as capital market exposure; and (iv) personal loans to 2% from the existing level of 1%
  2. Increase in provisioning requirements for banks' exposure to NBFCs to 2% from the existing level of 0.4%
  3. Increase in risk weights for exposure of banks to NBFCs to 125% from 100%

Edelweiss Securities
14th Floor, Express Towers,
Nariman Point, Mumbai – 400 021
Board: (91-22) 2286 4400
Email: *research@edelcap.com*

Naresh Kothari – 2286 4246	Head, Institutional Equities
Vikas Khemani – 2286 4206	Head, Institutional Equities

INDIA RESEARCH			SECTOR	INSTITUTIONAL SALES		
Shriram Iyer	-	2286 4256	Head – Research	Nischal Maheshwari	-	2286 4205
Gautam Roy	-	2286 4305	Airlines, Textile	Rajesh Makharia	-	2286 4202
Ashutosh Goel	-	2286 4287	Automobiles, Auto Components	Shabnam Kapur	-	2286 4394
Vishal Goyal, CFA	-	2286 4370	Banking & Finance	Amish Choksi	-	2286 4201
Revathi Myneni	-	2286 4413	Cement	Balakumar V	-	(044) 4263 8283
Sumeet Budhraja	-	2286 4430	FMCG	Monil Bhala	-	2286 4363
Harish Sharma	-	2286 4307	Infrastructure, Auto Components, Mid Caps	Ashish Agrawal	-	2286 4301
Priyanko Panja	-	2286 4300	Infrastructure, Engineering, Telecom	Nikhil Garg	-	2286 4282
Hitesh Zaveri	-	2286 4424	Information Technology	Swati Khemani	-	2286 4266
Parul Inamdar	-	2286 4355	Information Technology	Neha Shahra	-	2286 4276
Priyank Singhal	-	2286 4302	Media, Retail	Priya Ramchandran	-	2286 4389
Prakash Kapadia	-	2286 4432	Mid Caps	Anubhav Kanodia	-	2286 4361
Niraj Mansingka	-	2286 4304	Oil & Gas, Petrochemicals	Tushar Mahajan	-	2286 4439
Nimish Mehta	-	2286 4295	Pharmaceuticals, Agrochemicals	Harsh Biyani	-	2286 4419
Manika Premsingh	-	4019 4847	Economist	Nirmal Ajmera	-	2286 4258
Sunil Jain	-	2286 4308	Alternative & Quantitative	Ankit Doshi	-	2286 4671
Yogesh Radke	-	2286 4328	Alternative & Quantitative	Ravi Pilani	-	4009 4533
				Dipesh Shah	-	2286 4434

Email addresses: firstname.lastname@edelcap.com **e.g.** naresh.kothari@edelcap.com *unless otherwise specified*

RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period