Economics

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India Macro Weekly

Spotlight on the Base Rate System – Macro Implications

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- **Banks Shift to New Base Rate Lending —** Marking the end of an era for the Benchmark Prime Lending Rate (BPLR), over the last week, most banks have begun the shift to the new Base Rate system. This is as per the guidelines issued by the RBI and in line with the recommendations of the Working Group on the BPLR submitted late last year. The new norms are aimed at (a) increasing the transparency in lending rates (b) improving the transmission mechanism of monetary policy and (c) discouraging cross-subsidization of loans, all of which we view as positive.

- **Base Rate Explained —** The base rate is the minimum rate for all bank loans and is calculated by factoring (a) the cost of funds (b) adjustment of the negative carry of the SLR and CRR (c) unallocatable overhead costs of banks and (d) average return on networth. While using the base rate as a reference, banks have the flexibility of determining their actual lending rate by including customer specific charges as deemed appropriate. In addition to concessional loans for agri, export credit and other notified sectors, the RBI has specified that DRI advances, loans to banks' own employees and loans to banks' depositors against their own deposits could be priced without reference to the base rate. In order to improve transparency and increase the transmission of monetary policy, the RBI has specified that banks review their Base Rate at least once in a quarter and place in the public domain/RBI the base rate along with the actual minimum and maximum lending rates.

- **Why the Shift?** As has been highlighted in various reports, the shift from BPLR to the new regime is primarily on account of improving transparency and monetary transmission. This is reflected in the fact that (a) nearly 70% of the loans were at sub BPLR rates *(see p. 2 for details)* (b) downward stickiness of BPLRs (banks were quick to raise lending rates during an upturn in the rate cycle, but slow to bring them down in a downturn) and (c) cross subsidization in lending, with large/prime borrowers being offered a lower rate and SMEs/households being charged higher rates.

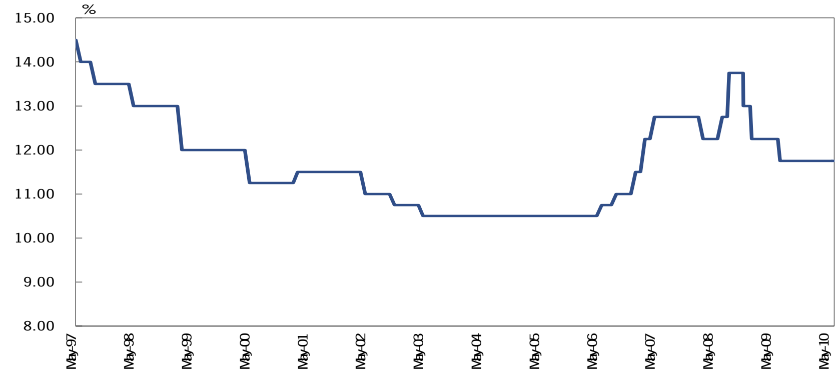
- **Macro Implications —** In addition to greater transparency and an improvement in the transmission mechanism, key positives under the new base rate system include (a) Banks would not be able to significantly lower rates to large/low risk borrowers. Thus while the smaller corporates could benefit, the larger corporates could increase their recourse to commercial paper market (b) To offer competitive base rates, banks would shore up their low cost deposit base which would aid financial inclusion. (*Rates announced so far include HDFC Bank at 7.25%, SBI, Axis Bank and ICICI Bank at 7.5%, Corporation Bank at 7.75% and most other state owned banks at 8%.)*

ALSO INSIDE:

Key Highlights

The new base rate system will replace the benchmark PLR in a bid to enhance transparency in lending rates, improve the transmission mechanism of monetary policy, and discourage cross-subsidization of loans

Figure 1. Trends in the Benchmark Prime Lending Rate (SBI)



Source: SBI

Over the years, because of competitive pressures banks have increasingly resorted to financing of various categories of borrowers at sub-BPLR rates such as corporates, housing and retail sector. As seen in Fig 2, sub-BPLR lending increased from 28.4% of total loans in Mar02 to 67% in Mar09. This raises concerns on transparency and monetary policy effectiveness

Figure 2. Sub-BPLR Lending of Commercial Banks (% share in total loans; March ended)

	2002	2003	2004	2005	2006	2007	2008	2009
1. Cash Credit	5.4	6.5	9.5	7.7	11.7	13.2	14.0	12.4
2. Consumer Credit	0.6	3.3	7.7	8.7	8.1	10.7	8.9	3.7
3. Demand Loans	5.9	6.9	7.6	8.2	7.4	6.4	8.5	6.9
4. Term Loans	16.5	21.0	31.3	34.4	41.9	46.6	44.3	43.9
a) up to 180 days	2.8	3.0	1.7	2.6	3.4	2.9	5.7	3.1
b) 180 days - 1 year	1.0	1.0	1.8	2.1	1.9	1.9	2.3	2.2
c) 1-3 years	1.6	1.9	3.4	4.6	5.6	5.2	6.1	5.3
d) 3-5 years	1.4	4.8	10.9	11.2	14.0	17.7	11.7	15.7
e) above 5 years	6.4	6.6	8.9	10.2	12.6	14.7	13.7	13.7
f) others	3.5	3.8	4.7	3.7	4.5	4.3	5.0	4.0
Total	**28.4**	**37.7**	**56.1**	**58.9**	**69.2**	**76.9**	**75.8**	**66.9**

Source: RBI Working Group on BPLR

The base rate is the minimum rate for all bank loans and is calculated by factoring (a) the cost of funds (b) adjustment of the negative carry of the SLR and CRR (c) unallocatable overhead costs of banks and (d) average return on networth.

While using the base rate as a reference, banks have the flexibility of determining their actual lending rate by including customer specific charges as deemed appropriate

The base rate can be decided on a quarterly basis

Illustrative Methodology for Computation of Base Rate

Base Rate = a + b + c+ d

a – Cost of Deposits/funds = D_{cost} (benchmark)

b = Negative Carry on CRR and SLR =

$$\left[\left[\frac{\{D\cos t-(SLR*Tr)\}}{\{1-(CRR+SLR)\}}\right]*100\right]-D\cos t$$

c = Unallocatable Overhead Cost = $\left(\frac{Uc}{D_{ply}}\right)*100$

d = Average Return on Net Worth = $\left[\left(\frac{NP}{NW}\right)*\left(\frac{NW}{D_{ply}}\right)\right]*100$

Where:

D_{cost} : Cost of deposits/funds

D: Total Deposits = Time Deposits + Current Deposits + Savings Deposits

D_{ply} : Deployable Deposits = Total Deposits less share of deposits locked as CRR and SLR balances, i.e. $D*[1-(CRR+SLR)]$

CRR: Cash Reserve Ratio

SLR: Statutory Liquidity Ratio

T_r: 364-day T-bill rate

U_c: Unallocatable Overhead Cost

NP: Net Profit

NW: Net Worth = Capital + Free Reserves

India – Markets in Pictures

FOREX MARKETS

Reflecting global trends of declining risk appetite, the rupee lost 1% against the dollar, ending at Rs46.87/US$ from Rs46.3/US$ in the previous week. Risk appetite worsened because of a slew of data from various economies indicating signs of slowing economic activity.

While we maintain our view of a marginally appreciating currency, the unit like all other risk assets is expected to continue to oscillate between risk on/off.

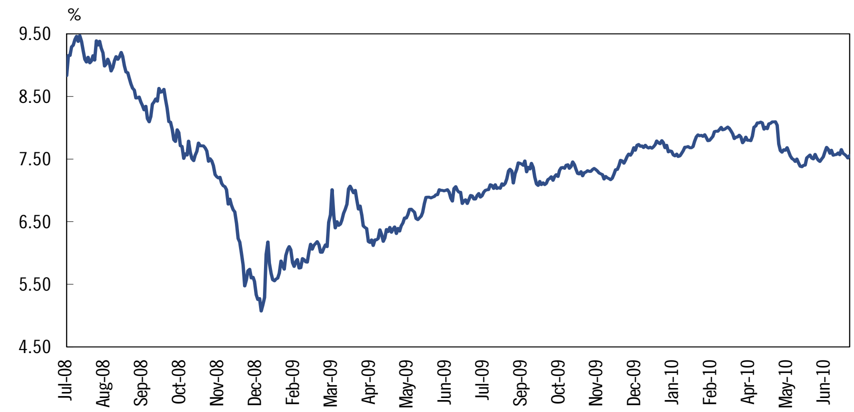
Figure 3. Trends in the Rupee (INR/USD)

Source: RBI

BONDS

The 10-year benchmark yield closed lower at 7.56% from 7.65% largely on the back of the decision to truncate the size of the week's auctions and dip in the weekly food inflation rate to 12.92% y-o-y from 16.90% in the previous week. Post market hours on Friday, the RBI in an inter-policy move, raised policy rates by 25bps. We expect bonds to trade slightly higher at 7.7%

Figure 4. Trends in 10-Year Bond Yields (%)

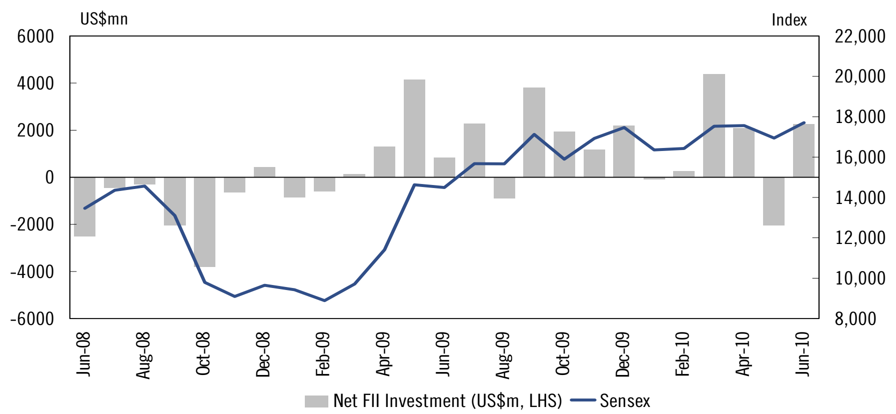


Source: RBI

EQUITY MKTS – *From Our Trading Strategy Team*

Indian mkts, though outperformers last week, had a topsy-turvy ride as global cues remained mixed - continuing poor data from the US offset by better than expected confidence shown in European liquidity system. Window Dressing Cash buying by funds on Jun 30 also helped support India last week. FIIs bought $200mn in cash for the week so far, DIIs booked $80mn worth of profits

Figure 5. Trends in Institutional Flows and the Sensex (Index, US$mn)



Source: SEBI, BSE, Bloomberg

Other Weekly Indicators

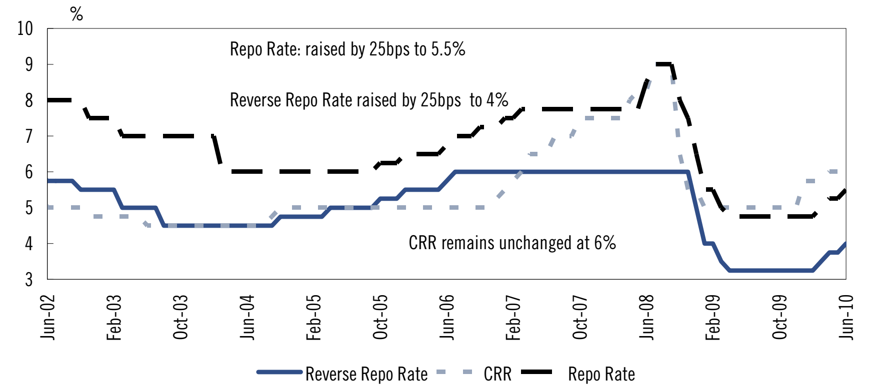
REPO, REVERSE REPO RAISED BY 25bps

In a widely-expected move, the RBI raised the repo and reverse repo rates by 25bps post-mkt hours on Friday.

Rate hikes are on the back of inflation becoming more generalized, and a consolidating economic recovery. the RBI also provided some relief on the liquidity front by extending liquidity management facilities offered earlier.

We expect further hikes of at least 50bps in 2010, with the next move likely in the policy on Jul 27. See https://www.citigroupgeo.com/pdf/SAP37799.pdf for note

Figure 6. Trends in Key Domestic Interest Rates (%)



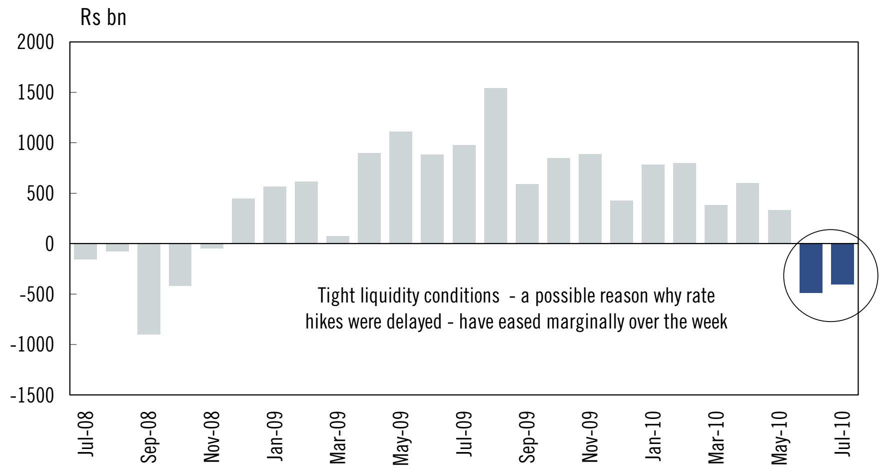
Source: RBI

TRENDS IN LIQUIDITY

Liquidity conditions remained tight with banks borrowing an average of Rs634bn on a daily average basis from the LAF window.

However, call rates which had moved to a three month high of 6.45% closed the week slightly lower at 5.40%-5.60%, as most banks appeared to have had already funded their reserve needs

Figure 7. Trends in Repo/Reverse Repo (Rs Bn)



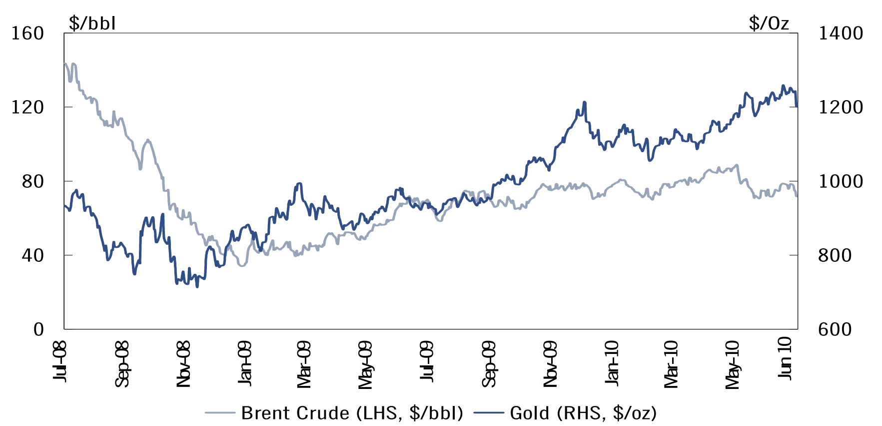
Source: RBI

TRENDS IN OIL AND GOLD

Despite dollar weakness, gold ended lower at US$1211.05/oz from US$1252.50/oz. as the market viewed that the safe haven asset play had run out of steam.

Brent ended sharply lower at $71.65/bbl from US$78.41/bbl following weak economic data from China and US.

Figure 8. Trends in Oil and Gold Prices (US$bbl/US$/Oz)



Source: Bloomberg

Financial Market Forecasts

India — Market Monitor

Figure 9. India Market Monitor

	Units	Latest	Previous	1M ago	3M ago	12M ago
Interest Rates						
Overnight	%	5.60	5.40	5.10	3.25	3.30
1 year Treasury Bill	%	5.65	5.60	5.22	5.06	3.81
1 year OIS	%	5.41	5.55	5.00	4.96	4.12
1 year MIFOR	%	3.55	3.75	3.10	3.10	4.03
5 year Corporate AAA spread over GOI	%	0.69	0.62	0.63	0.98	1.39
10 year GOI	%	7.56	7.65	7.50	7.94	6.87
Currency & Reserves						
USD/INR		46.77	46.28	46.99	46.02	44.84
EUR/USD		1.25	1.23	1.22	1.35	1.33
USD/JPY		87.58	89.68	91.80	89.09	114.60
12 Month INR Forward Premium	%	2.81	3.09	2.28	2.68	2.47
FX Assets (excl gold) As On (25-Jun-10)	US$ bn	251.38	250.37	247.26	252.76	253.73
Money & Banking						
Loan-Deposit Ratio	%	73.3	71.1	71.4	71.3	69.3
Money Supply – M3	% YoY	14.5	14.6	14.5	16.7	20.2

Source: RBI, Bloomberg

Financial Market Forecasts

Figure 10. Currency Forecasts and Forwards

			Mkt Data		Forecasts							
		Spot	3M Fwd	12M Fwd	0-3 Mos	6-12 Mos	Long-term	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Euro	EURUSD	1.25	1.25	1.25	1.19	1.29	1.33	1.19	1.23	1.26	1.29	1.30
Japanese Yen	USDJPY	88	88	87	92	91	90	92	92	91	91	91
Chinese Renminbi	USDCNY	6.78	6.77	6.66	6.75	6.62	6.45	6.75	6.70	6.67	6.62	6.55
Indian Rupee	**USDINR**	**46.3**	**46.7**	**47.6**	**45.0**	**43.0**	**40.0**	**45.0**	**44.0**	**43.5**	**42.5**	**41.5**
Korean Won	USDKRW	1221	1224	1226	1180	1080	1040	1180	1100	1180	1060	1040

Forecasts from *'Citi Foreign Exchange: Forecasts'* (June 18, 2010)
Source: Citi Investment Research and Analysis Estimates

Figure 11. Interest Rate Forecasts (% period end)

		Current	In 3M	In 6M	In 12M	3Q10	4Q10	1Q11	2Q11	3Q11
US*	Fed Fund Rate	0.25	0.25	0.25	0.75	0.25	0.25	0.25	0.50	1.00
	10–Year Treasuries	2.95	NA	NA	NA	3.45	3.65	3.65	4.00	4.20
EU*	Repo Rate	1.00	1.00	1.00	1.25	1.00	1.00	1.00	1.25	1.25
	10–Year Bunds	2.57	NA	NA	NA	2.90	2.95	3.00	3.05	3.10
JP*	Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
	10–Year JGBs	1.09	NA	NA	NA	1.30	1.40	1.40	1.40	1.40
CN	1–year deposit rate	2.25	2.52	2.52	3.06	2.52	2.52	2.79	3.06	3.33
	1-Month Shibor	3.51	2.50	2.40	2.51	2.50	2.40	2.30	2.50	2.90
	Government bond yield (5 –Year)	2.62	3.30	3.30	3.50	3.30	3.30	3.40	3.50	3.60
IN	**Overnight Repo Rate**	**5.50**	**5.75**	**6.00**	**6.50**	**5.75**	**6.00**	**6.25**	**6.50**	**6.75**
	Overnight Reverse Repo Rate	**4.00**	**4.25**	**4.50**	**5.00**	**4.25**	**4.50**	**4.75**	**5.00**	**5.25**
	10–Year Gilt	**7.54**	**7.75**	**7.75**	**7.75**	**7.75**	**7.75**	**7.75**	**7.75**	**7.75**

* Forecast as of Global Economic Outlook and Strategy (May 19, 2010)

Source: Datastream, CEIC Data Company Limited, Bloomberg, Reuters, and CIRA

Data Calendar

Figure 12. Data calendar for the week of 5-9 July

Date	Day	Local Time	Country	Indicator	For	Citi Fcst	Mkt Fcst	Prev.
5-Jul	Mon	14:00	Indonesia	BI Policy Rate (% p.a.)	5-Jul	6.50	6.50	6.50
		16:00	Taiwan	CPI (%YoY)	Jun	1.1	0.7	0.7
				WPI (%YoY)		7.6	—	9.4
6-Jul	Tue	08.30	US	ISM Non Manufacturing Index	Jun	53.5	55.4	55.4
			Australia	Cash Target Rate (%)		4.5	4.5	4.5
		9:00	Philippines	CPI (%YoY)	Jun	4.1	4.3	4.3
7-Jul	Wed	16:00	Taiwan	Exports (%YoY)	Jun	47.5	46.2	57.9
				Imports (%YoY)		48.1	48.0	71.4
				Trade Balance (US$ bn)		2.50	2.60	3.25
8-Jul	Thu		UK	BOE Policy Rate (%)		0.5	0.5	0.5
		08.30	US	Initial Jobless Claims (‘000)	3-Jul	460.0	460.0	472.0
		12:01	Malaysia	IP (%YoY)	May	9.8	—	10.1
		18:00		O/N Rate (% p.a.)	8-Jul	2.75	2.63	2.50
9-Jul	Fri	10:00	Korea	BOK Policy Rate (% p.a.)	Jul	2.00	—	2.00
10-Jul	Sat		China	Exports (%YoY)	Jun	36.7	37.0	48.5
				Imports (%YoY)		29.8	35.8	48.3
				Trade Balance (US$ bn)		17.4	15.9	19.5

Source: Bloomberg, CEIC Data Company Ltd and CIRA estimates

Monsoon Monitor

Monsoon Update

- Rainfall continued to remain in the red, with trends 25% below normal for the w/e 30th June. On a cumulative basis, rainfall during 1 Jun-30 June was 16% below normal.

- However, crop sowing data available until Jul 2nd indicates that acreage under crops such as rice, oilseeds, sugarcane and cotton is higher this year, on a y-o-y basis.

- A quick recap, following its 1st stage forecast for the summer rains (June-Sept) released in April, which predicted that rainfall would be 98% of the Long Period Average of 89cm; the IMD released a 2nd revised forecast later in June. (see https://www.citigroupgeo.com/pdf/SAP37646.pdf)

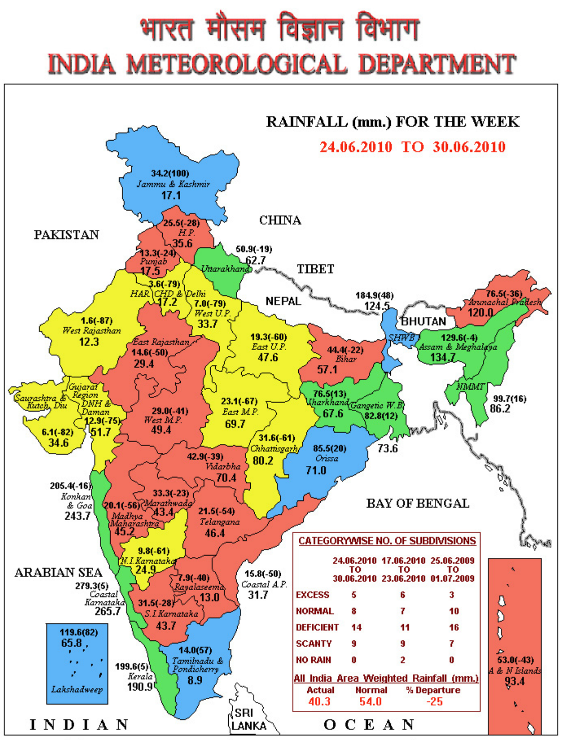
- New forecasts estimate rainfall at 102% of the LPA (this falls within the 'normal' category of 96-104% of the LPA). Rainfall in July and August is estimated to be at 98% and 101% of LPA respectively. For an update on the monsoons, pls see http://www.imd.gov.in/section/nhac/dynamic/Monsoon_frame.htm

Figure 13. Progress of the Monsoons

No of Subdivisions	29-Jun-05	28-Jun-06	27-Jun-07	02-Jul-08	01-Jul-09	30-Jun-10
Excess	3	7	13	18	2	7
Normal	14	16	17	10	4	16
Total	17	23	30	28	6	23
Deficient	17	10	6	8	22	10
Scanty	2	3	0	0	8	3
No rain	0	0	0	0	0	0
Total	19	13	6	8	30	13
TOTAL	**36**	**36**	**36**	**36**	**36**	**36**

	Actual Rainfall (mm)		% Departure from LPA	
	1-24 June	1 June -1 July	1-24 June	1 June -1 July
Country as a whole	103.2	145.4	-11	-16
Northwest India	38.9	56.3	-6	-20
Central India	86.1	130.9	-18	-24
South Peninsula	137.7	173.1	16	5
North East India	221.1	313.6	-22	-17

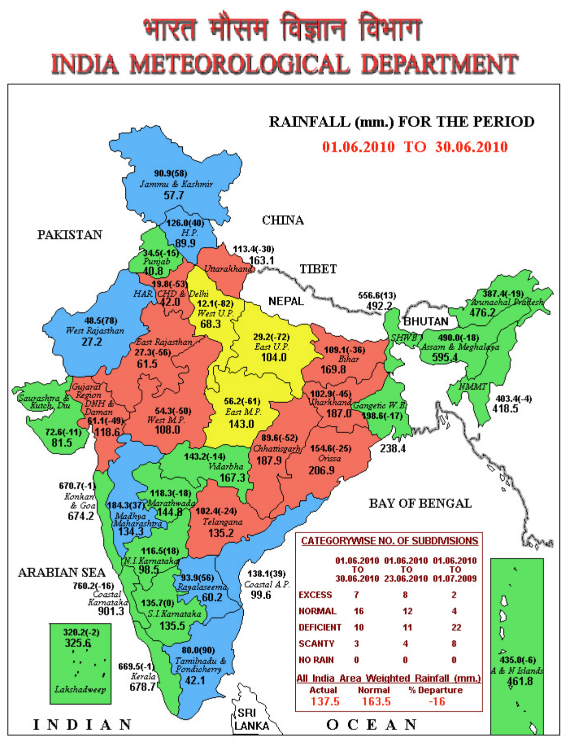
Figure 14. Weekly Rainfall: Week Ended 30 June : 25% BELOW Normal



LEGEND: EXCESS (+20% OR MORE) NORMAL (+19% TO -19%) DEFICIENT (-20% TO -59%) SCANTY (-60% TO -99%) NO RAIN (-100%) NO DATA

NOTES:
(a) Rainfall figures are based on operational data.
(b) Small figures indicate actual rainfall (mm.), while bold figures indicate Normal rainfall (mm.)
Percentage Departures of Rainfall are shown in Brackets.

Figure 15. Seasonal Rainfall : 1 June -30 June: 16% BELOW Normal



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Percentage Departures of Rainfall are shown in Brackets.

Source: IMD

Appendix A-1

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