Monetary policy preview

We expect status quo in the annual monetary policy of the RBI

The Reserve Bank of India (RBI) is going to announce its annual monetary policy for FY2008 on April 24, 2007 and we are highlighting our expectations from the policy.

- The market is currently not expecting another 50-basis-point cash reserve ratio (CRR) hike and we also don't expect the same. The reason why we don't expect any further tightening is because we feel the RBI has already taken action on March 30, 2007, which was completely unexpected, by increasing the repo rate by 25 basis points and the CRR by 50 basis points.
- Further the inflation is expected to moderate going forward and the non-food credit and money supply growth have also shown some moderation, which favour a status quo. If the RBI goes ahead and hikes the CRR again it could be a setback for the markets.
- Liquidity management will remain high on the agenda for 2007-08, with the policy rates such as the repo rate, the reverse repo rate and the bank rate likely to remain unchanged.
- The gross domestic product (GDP) growth estimates for FY2008 could be in the range of 8-8.5% while the target zone for inflation may remain unchanged at 5-5.5%.
- A curb on foreign flows through the lowering of the NRI deposit rates to make them less attractive and lowering the external commercial borrowing limits may be undertaken to control capital inflows at least in the short term as long as the inflation is above the RBI's comfort zone.
- Some mention on the credit and fund flow to sensitive sectors like the commercial real estate may find its place in the policy, as the RBI is very concerned about the escalating real estate prices, which could lead to an asset price bubble.
- We feel the RBI should avoid excessive tightening so that concern over the economic growth potential in the next fiscal doesn't come under serious scrutiny.

The RBI has indicated that it wants to control the inflation at any cost and its recent 25-basis-point repo rate hike

Factors RBI is keeping a close watch on

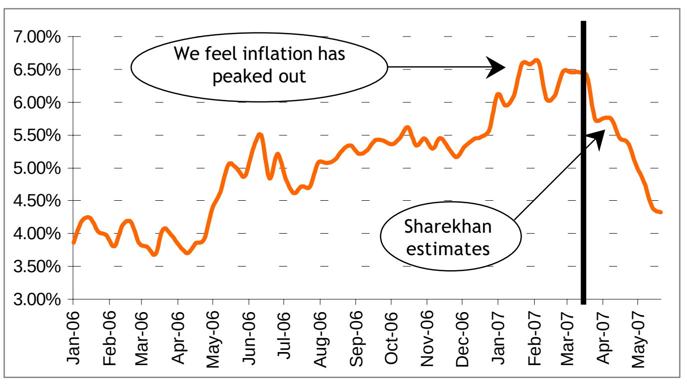
Particulars	Last policy action	Current status	Remarks
IIP numbers (%)	11	11.1	Remain strong compared to last year.
WPI numbers (%)	6.46	5.74	Expected to decline further mainly due to a higher base effect but not within the RBI's comfort range of 5-5.5% before the RBI announces the annual policy.
CPI-IW (%)	7.6	Latest data not available	Expected to have a downward bias.
Non-food credit growth (%)	29.5	27.9	Expected to track the deposit growth rates more closely as the demand shows some slowdown with a lagged effect of the policy measures and the unavailability of excess SLR holdings to fund credit by liquidating investments.
Deposit growth (%)	24.8	23	Expected to be around the 20% plus levels.
Money supply (%)	22	20.7	Moderation is visible but further policy action cannot be ruled out completely.
Forex reserves	$198 billion	$200 billion	Swelling forex kitty could call for some measures to curb NRI deposits, FDI flows into real estate and ECB by corporates in the short term to control money supply growth and maintain the stability in the rupee for export competitiveness.

and the 50-basis-point CRR hike on March 30, 2007 (when the market least expected the hikes ahead of the annual policy) goes to show that the RBI could take sudden measures to control inflation. Strong capital flows have remained the main concern of the RBI, which have contributed to the dramatic rise in the money supply and in turn raising inflationary concerns. The recent decision by the RBI to stay away from the foreign exchange (forex) market has seen the rupee appreciate significantly hurting our export competitiveness. However, uncertainty over the apex bank's monetary policy actions has also increased due to the global factors, as increased liquidity flows in emerging economies have been a major concern.

Inflation expected to moderate going forward

We expect the inflation to moderate from the current levels of 5.74% going forward as the high base effect kicks in and the inflation settles within the RBI's comfort zone by end May 2007. The Indian Meteorological Department expects the June-September 2007 rainfall for the country to be at 95% of the long period average that translates into below normal monsoon, which is not good news for agricultural growth, primary article prices and inflation going forward.

Wholesale Price Index expected to moderate going forward



Source: Office of the Economic Adivsor

Uncertainty over policy changes looms large due to global factors at play

The RBI is closely monitoring the policy stance of global central banks; as per the RBI's statements globally the process of withdrawal of accommodation in monetary policy is being actively pursued. In a meeting with the bond and foreign exchange dealers the RBI governor YV Reddy is understood to have highlighted a point that there is no concrete six-month horizon, as the global markets are in a state of flux and so the markets and bankers need to be prepared for changes. He also pointed out that all Asian countries are currently facing a task of tackling huge capital flows.

Steps taken by RBI so far to control inflation and liquidity

- The repo rate hiked by 125 basis points in 5 phases of 25 basis points each to 7.75%. The reverse repo rate hiked by 50 basis points in 2 phases of 25 basis points each to 6%.
- The CRR hiked by 150 basis points in three phases of 50 basis points each to 6.5%.
- Modified the liquidity adjustment facility (placing a Rs3,000 crore cap on the reverse repo window) and revived dated bond issuances under the market stabilisation scheme along with scheduled treasury bill auctions to mop up excess liquidity from the system on a more stable basis.
- Not injecting rupee liquidity in the system by buying dollars from the market and as a result the rupee has seen a sharp rise in the past one month.
- Increase in the risk weights and standard assets provisioning norms to discourage credit flow to certain sensitive sectors like personal loans, capital market and commercial real estate.

Foreign inflows the main cause of the high money supply growth

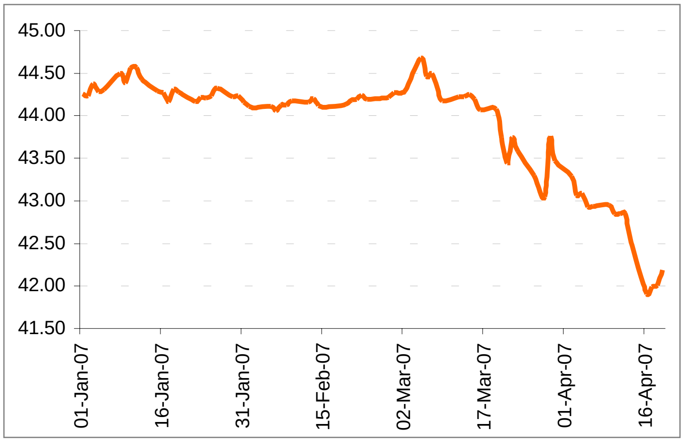
The RBI's concern on high money supply growth resulting in excess liquidity in the system, which could fuel inflation, is mainly emanating from the external commercial (ECB) borrowings by Indian corporates, FDI flows and non-resident Indian deposits. To keep the rupee from appreciating rapidly, the RBI buys dollars and in the process injects rupee liquidity into the banking system.

The money supply growth has moderated to 20.7% from 22% levels a fortnight back, due to the lagged effect of the CRR hikes and the RBI's decision to refrain itself from buying dollars. However the RBI's decision not to intervene in the forex market has led to a sharp appreciation in the rupee thus hurting the export competitiveness. Till what level the RBI would allow the rupee to appreciate before it provides some support by buying dollars remains a key question now.

NRI deposits and ECB may be discouraged

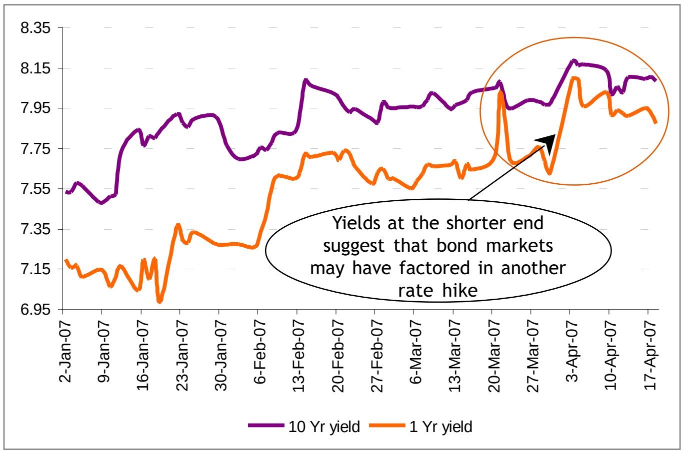
A curb on foreign flows through the lowering of the NRI deposit rates to make them less attractive and lowering the external commercial borrowing limits may be undertaken to control capital inflows at least in the short term as long as the inflation is above the RBI's comfort zone.

Rupee appreciated significantly



Source: Bloomberg

Yields rise after RBI's sudden decision to increase rates



Source: Bloomberg

What do the yields say?

The 1-year yield closed 46 basis points above its previous closing on April 4, 2007 when the bond markets reopened and reacted to the RBI's sudden announcement of a 25-basis-point repo rate hike and a 50-basis-point CRR hike. However, the yield at the shorter end has come down of late but that has been possible because of the easing of liquidity. We feel some ambiguity still remains in the market as to whether the RBI would hike the rates or maintain the status quo.

Will RBI hike rates in its upcoming policy meet?

Bloomberg estimates suggest that 36% of the market is expecting a 25-basis-point repo rate hike, around 27% expect a 25-basis-point reverse repo rate hike while less than 10% expect another 50-basis-point CRR hike.

We feel the annual policy would leave the CRR and other policy rates unchanged as we have witnessed an unexpected tightening at end-March 2007. Further the inflation is expected to moderate going forward and the non-food credit growth and money supply have shown some moderation. The RBI should avoid excessive tightening so that concern over the economic growth potential in the next fiscal doesn't come under serious scrutiny.