FIRST QUARTER REVIEW OF ANNUAL POLICY

Edelweiss
Ideas create, values protect

Strong tightening; broadly as expected

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Siddhartha Sanyal
+91-22-4040 7505
siddhartha.sanyal@edelcap.com

Smita Pattnaik
+91-22-6620 3029
smita.pattnaik@edelcap.com

Monetary measures

In its first quarter review of the Annual Policy Statement today, the Reserve Bank of India (RBI) hiked the repo rate by 50bps, to 9.0%. CRR has also been increased by 25bps, to 9.00%. The reverse repo rate has been left unchanged at 6.00%.

Rate	Prior	Edelweiss estimate	Current	Highest since
CRR	8.75	9.00#	9.00*	Nov-99
Repo rate	8.50	8.75	9.00	Oct-00
Reverse repo rate	6.00	6.00	6.00	-

** Effective August 30 # Effective August 16*

CRR hike announcement, as expected

Currently, the liquidity situation is tight, and during July the system borrowed sizeable amounts (INR 183 bn as on July 29) from RBI under liquidity adjustment facility (LAF). However, during August and the first half of September, sizeable inflows are expected to come into the system through the transfer of RBI's annual surplus (~INR 130 bn) to the government, and sizeable redemptions and coupon receipts. The CRR hike has broadly been in expected lines, and has been an attempt to mop up the fresh infusion of liquidity.

Repo rate hike is stronger than expected

Growth rates of bank credit and M3 have been far higher than RBI's comfort zone. At this juncture, thus, RBI was expected to signal higher interest rates. However, the 50bps hike (with immediate effect) in the repo rate has been stronger than our expectation of a 25bps hike.

The dual hike in CRR and repo rate can also be seen as a strong move to contain inflationary expectation.

No further RBI action expected until October policy

With likely absorption of liquidity through the enhanced CRR in the first fortnight of September, followed by advance tax outflows thereafter, RBI expects to get rid of excess liquidity from the system effectively till end-September. The 50bps repo rate hike also suggests RBI's preference for front-loading of pre-emptive monetary action rather than a gradual approach at this juncture. We believe that RBI will refrain from any further tightening till the October policy (October 24), barring further unanticipated adverse developments, either domestic or external.

Concerns aggravate for industrial sector

This sharp hike in the repo rate will push up bank lending rates. We expect the PLRs to move up by ~50bps. Higher interest rates will further aggravate the concerns related to the industrial sector in the near term which is suffering from subdued business confidence indices, expectations of modest export demand, and higher wage and input costs. Real GDP growth may be ~7.8% for FY09, backed by relatively better performance of the services sector.

Inflation concerns override growth slowdown

The slowdown in real activity against the backdrop of a shooting inflation poses difficulties for policymakers. However, at this juncture, as expected, RBI reiterated its priorities to curb inflation even at the cost of sacrificing growth.

Why hike in CRR?

Fresh liquidity inflow in August and September

(INR bn)

For the week ending	1-Aug	8-Aug	15-Aug	22-Aug	29-Aug	5-Sep	12-Sep	19-Sep	26-Sep
Outflow									
Auction G-Sec	0	100	0	60	0	0	80	0	0
Auction 91day T-bill*	5	5	5	5	5	5	5	5	5
Auction 182day T-bill*	0	5	0	5	0	5	0	5	
Auction 364day T-bill*	10	0	10	0	10	0	10	0	10
MSS auction	?	?	?	?	?	?	?	?	?
Advance tax	0	0	0	0	0	0	0	450	0
Total outflow	15	110	15	70	15	10	95	460	15
Inflow									
Redemption G-Sec	0	0	0	0	0	100	0	0	0
Redemption 91day T-bill	30	30	30	30	5	30	30	20	5
Redemption 182day T-bill		5		5		5		5	0
Redemption 364day T-bill	10	0	10	0	10	0	10	0	10
Rdmp TB MSS	10	10	15	0	10		20		20
Interest- Gsec	28	11	19	11	24	28	28	0	9
Interest- Others	5	1	4	5	35	0	4	5	4
RBI profit	0	0	0	130	0	0	0	0	0
Total inflow	83	56	78	181	84	163	92	30	48
Net inflow	68	(54)	63	111	69	153	(3)	(430)	33
Cumulative net inflow	26	(27)	36	147	216	369	366	(64)	(31)

Source:Bloomberg, RBI, Edelweiss research

Note: Figures in parentheses are negative values. **-Minimum amount*

Figures in the table do not include the proposed CRR hike effective August 30, MSS auction, state development loans, government balances with RBI, and possible flows from abroad.

Currently, the liquidity situation is tight and the system has consistently borrowed sizeable amount during July from RBI under LAF (INR 183 bn as on July 29).

However, during August and the first half of September, sizeable inflows are expected to come into the system. A key component of such flows is the transfer of RBI's annual surplus (~INR 130 bn) to the government in mid-August. The government is likely to spend this amount, which will infuse liquidity into the system. There are also sizeable redemptions and coupon receipts over the next couple of months. The combined net inflows may not necessarily be sufficient to consistently waive off the current spell of liquidity shortage. However, given RBI's clear stance of according priority to liquidity management, it was expected that the central bank will remain vigilant over fresh inflows coming into the system over the next few weeks.

Additionally, there can be inflows from foreign sources as well as infusion of liquidity, if the government unwinds its surplus balance held with RBI (~INR 197 bn as on July 18).

Accordingly, our expectation had been that RBI would announce a CRR hike of 25bps, but will make it applicable only at a later date. The announcement of hike in the CRR by 25bps, to 9%, is in line with our expectation. The enhanced CRR requirement has been made effective from the fortnight beginning August 30 (our expectation was August 16). The hike will lead to liquidity absorption of ~INR 85 bn.

With the likely absorption of liquidity through the enhanced CRR in the first fortnight of September, followed by advance tax outflows from September 15, RBI expects to get rid of excess liquidity in the system effectively till end-September.

Why repo rate?

Given the already stretched fiscal situation, the brunt of the burden of tackling inflation will have to be borne by the monetary policy in the near term. The current level of inflation is way above RBI's comfort zone, and has not shown any definite sign of peaking out.

Off late, bank credit has been growing at 25.7% Y-o-Y. Even if we take the possibility of a sizeable credit demand from the oil marketing companies, credit growth is substantially higher than RBI's target zone of 20% Y-o-Y. Money supply growth has continuously been above 20% (again above RBI's target zone of 16.5-17.0%). Thus, at this juncture, we expected RBI to signal interest rates to move up further.

The 50bps hike (with immediate effect) in the repo rate has been stronger than our expectation of 25bps hike. This demonstrates RBI's preference for strong pre-emptive action and front-loading of policy action rather than gradualism at this juncture.

Containing inflationary expectations

At the moment, with inflation at a 13-year high and exhibiting no definite sign of peaking out, it is extremely important for the central bank to contain inflationary expectations. The dual hike in CRR and repo rate can also be seen as a strong move to contain inflationary expectation, and broadly in expected lines.

Why not reverse repo rate?

Raising the reverse repo rate from the current level of 6% will mean taking it beyond the level of the bank rate. Though bank rate is largely not in use at present, it refers to the rate of borrowing money by banks from RBI. Reverse repo rate, on the other hand, is the rate that the banks get while parking their funds temporarily with RBI. Thus, taking reverse repo rate beyond 6%, without hiking or dismantling the bank rate can be an anomaly, which RBI understandably avoided at this juncture.

RBI expects inflation to moderate in Q4FY09

RBI expects the inflation to stay at the current elevated levels for the current quarter and bulk of the next quarter, and anticipates a significant reduction in inflation only in Q4FY09.
The policy aims at bringing down inflation to a level close to 7.0% by end-March 2009 and "below 5.0% as soon as possible". RBI's medium-term target of inflation ~3.0% remains unchanged.

GDP growth likely at ~8%

RBI had set the real GDP growth projection for FY09 in the range of 8.0-8.5% in the Annual Policy Statement in April 2008. At this juncture, RBI feels that a projection of ~8.0% appears more realistic, barring domestic or external shocks.

Concerns aggravate for industrial sector

This sharp hike in the repo rate will push up bank lending rates. We expect bank PLRs to move up by ~50bps. Higher interest rates will further aggravate the concerns related to the industrial sector in the near term which is suffering from subdued business confidence indices, expectations of modest export demand, and higher wage and input costs. Real GDP growth may be ~7.8% for FY09 (Edelweiss estimate), backed by relatively better performance of the services sector.

Policy stance retains flexibility

RBI's stance for monetary policy remains unchanged from what it had announced in the Annual Policy Statement in April 2008. The stance of the policy reiterates preference for the following:

- To ensure a monetary and interest rate environment that accords high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to continuation of the growth momentum.
- To respond swiftly on a continuing basis to the evolving constellation of adverse international developments and to the domestic situation impinging on inflation expectations, financial stability and growth momentum, with both conventional and unconventional measures, as appropriate.
- To emphasise credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

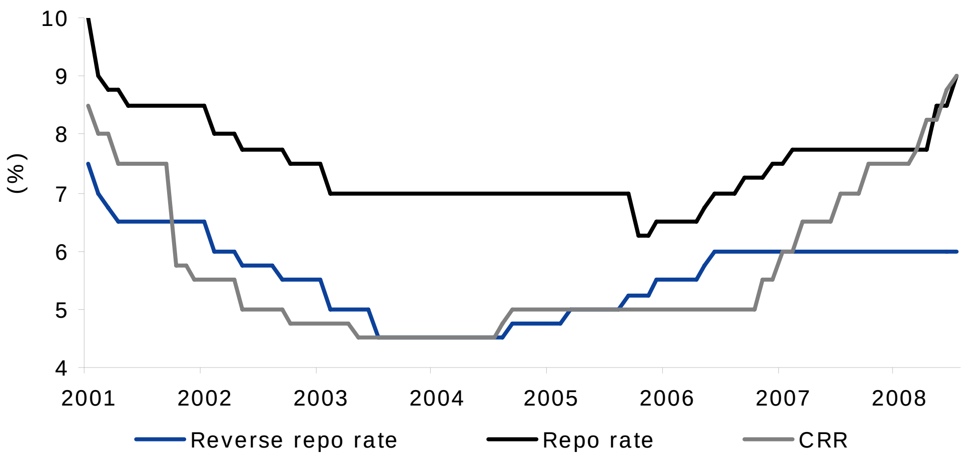
In brief, RBI continues to emphasise to rein in prices, anchor inflationary expectations, and ensure orderly conditions in the financial market. Bringing down inflation from the current high levels and stabilising inflation expectations currently assume the highest priority in the stance of monetary policy. RBI maintains its strong hawkish stance and keeps its option open for reacting to international and domestic developments swiftly and on a continuous basis.

No RBI action expected until October policy

With the likely absorption of liquidity through the enhanced CRR in the first fortnight of September, followed by advance tax outflows thereafter, RBI expects to get rid of excess liquidity from the system effectively till end-September. Any small and temporary mismatch in liquidity can be modulated with use of market operations, including LAF or issuance of additional short-term treasury bills under the Market Stabilisation Scheme (MSS).

The sharp hike in repo rate also suggests RBI's preference for front-loading of pre-emptive monetary measures rather than a gradual approach. Although RBI keeps its options open for monetary measures on a continuing basis, we believe that the central bank will prefer to refrain from any further tightening till the October policy (October 24), barring further unanticipated adverse developments, either domestic or external.

Monetary tightening continues



Source: RBI

Naresh Kothari	Co-Head Institutional Equities	naresh.kothari@edelcap.com	+91 22 2286 4246
Vikas Khemani	Co-Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Shriram Iyer	Head Research	shriram.iyer@edelcap.com	+91 22 2286 4256

Recent Research

Date	Company	Title
29-Jul-08	**Macro Meter**	Inflation, oil, monsoon remain in focus
25-Jul-08	**Monsoon Update**	Is it raining?
24-Jul-08	**RBI Policy Preview**	Tightening to continue
17-Jul-08	**Inflation**	A pleasant surprise
11-Jul-08	**IIP**	IIP sinks

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	101	62	14	2	188

* 8 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	77	70	41

Rating Interpretation

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