MID-TERM REVIEW OF ANNUAL MONETARY POLICY

Key policy rate unchanged, for now

The RBI left the key policy rate–reverse repo rate–unchanged at 6%.The repo rate was, however, raised by 25bps to 7.25%. The CRR and SLR were left unchanged as well.

October 31, 2006

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No change in reverse repo expected, surprise on repo rate

RBI's quarterly economy assessment released yesterday had indicated that the reverse repo rate may be left unchanged. This was evident from its comfort level with current inflation levels, a dip in the quarterly business expectations index, and tne mention of a come off in credit growth. However, the hike in repo rate came as a surprise. So far, during the current rate hike cycle, the repo rate and the reverse repo rate have been raised simultaneously. This current move was unusual, indicating that liquidity from RBI to banks is becoming expensive.

Headway made in opening up of the economy

The RBI has also underlined its commitment to further opening up of the economy by announcing a series of relaxations for the external sector. On current account, there is relaxation on remittances and trade-related policies. On capital account, it has announced relaxation on external commercial borrowings as well as FII investments into the country. This suggests rising confidence with respect to India's resilience to external fluctuations.

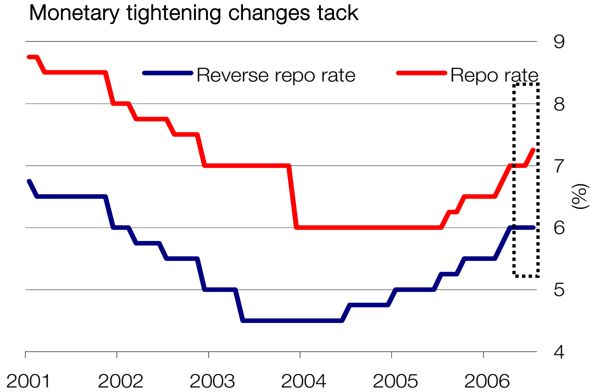
Growth forecast revised up; inflation a concern

The RBI has upped its growth forecast to about 8% Y-o-Y for FY07 from 7.5-8% Y-o-Y during the previous review. In line with this hiked forecast, it expects money supply and credit growth to breach the initial forecasts of 15% and 20% Y-o-Y, respectively. However, inflation is likely to be a potential concern going forward. The central bank has stated that inflation needs to be watched to keep it at the projected level of 5-5.5%.

More rate hikes likely

Looking ahead, we do not believe that monetary tightening is over for the economy just yet. The RBI has pointed to inflationary concerns. Our estimates suggest that inflation is likely to inch up over the course of the year. We cannot rule out a surprise rate hike before the next policy review in January 2007. At any rate, at least one hike in the reverse repo is almost a certainty, in our view.

Monetary tightening changes tack



Source: CMIE, RBI

RBI's Interest rate stance

Despite a number of economic indicators pointing to the contrary, RBI's quarterly assessment of the economy released on the eve of the monetary policy review had suggested that the reverse repo rate may not be raised. This was evident from three basic factors:

- Stance on inflation comfortable: The central bank seemed surprisingly comfortable with inflation levels, despite it currently running up to 5.26% Y-o-Y. This is evident from the remark, "In India, *headline inflation has remained largely contained* during 2006-07 so far" and "*Inflation expectations remain largely stable*, *reflecting pre-emptive monetary policy and fiscal measures*". Moreover, it had specifically mentioned that "*housing inflation*—reflecting rents on housing—*decelerated sharply* from 11.7% in August 2005 to 6.8% in August 2006."
- RBI's quarterly business expectations survey softened: The Business Expectations Index (BEI) showed a decline of 2.5% from the previous quarter. Historically, RBI has never raised rates at a time when the BEI has declined from the previous period. We looked at the period starting Q2FY05—the period when the BEI became available. The RBI has paused interest rate hikes in each of the four survey periods when the BEI declined over the previous quarter.
- Moderation in credit growth observed: On credit, the central bank observed that "Reflecting sustained credit growth of over 30% for more than a year, the incremental credit deposit ratio has remained high, though it has exhibited *some moderation in recent months.*" Also, it notes that "growth in credit is *broad based*". This is in sharp contrast with the statement during the first quarter review of the monetary and credit policy that stated, "c*redit to the housing sector continued to be strong*….. Apart from housing, strong credit demand emanated from education and other personal loans as well as from credit card holders. *Credit to commercial real estate continued to increase sharply*, constituting around three per cent of incremental non-food credit."

The increase in the repo rate, however, came as a bit of a surprise. So far during the current rate hike cycle, repo rates and reverse repo rates have been raised simultaneously. This has maintained the corridor between the two. By raising only the repo rate, RBI has increased the price at which banks can obtain liquidity from the central bank. In effect, the RBI has sent out a signal to commercial banks to decrease the level of credit offtake.

External sector initiatives

The RBI has taken forward the process of opening up of the economy. It has announced a series of measures related to relaxation on both the current account as well as capital account. On current account, notable announcements include the doubling of remittances payable and flexibility to importers/exporters with respect to forward contracts. On capital account, there are relaxations on external commercial borrowings and increase in FII limits on investments in government securities. *(See annexure).*

Steps towards further opening up of the economy are in line with the process restarted with the release of the Tarapore Committee report on fuller capital account convertibility released in August. These measures suggest that the central bank is more confident of the level of external liquidity in the system. With foreign exchange reserves exceeding USD 160 bn and India's relatively less trade dependence, the RBI is comfortable with the relaxations for the external sector.

Strong growth forecast; hawkish on inflation

Notably, the RBI has raised its forecast for GDP growth for FY07 from a range of 7.5-8% during the first quarter review of the annual monetary policy, to about 8% in the current review. In line with the increase in GDP forecast, the RBI now does not expect both money supply and credit growth to decline to initially projected levels. The forecast for money supply growth consistent with at 7.5-8% growth rate was 15% and was at 20% for credit growth. Money supply growth is, however, touching 19% Y-o-Y presently, while credit growth is at a high of 29% Y-o-Y.

The central bank has, however, maintained that inflation is likely to pose a concern going forward as well. While stating that so far inflation has been in the projected range of 5-5.5%, a watch needs to be kept on it at these levels. The RBI has pointed out to both demand and supply side pressures in keeping inflation higher than expected. Rising inflation expectations also need to be watched out for.

RBI's stance: More rate hikes expected

The RBI's stance for monetary policy over the next quarter has seen some change from the last time. The stance ahead is expected to be:

- To ensure a monetary and interest rate environment that supports export and investment demand in the economy to enable continuation of the growth momentum while reinforcing price stability with a view to anchoring inflation expectations.
- To maintain the emphasis on macro economic and, in particular, financial stability.
- To consider promptly all possible measures appropriate to the evolving global and domestic situation.

While the first two points remain largely unchanged, the third adds the term "promptly" to the stance. Our reading of this is that the central bank has not ruled out the possibility of a surprise rate hike before the next quarterly review of the annual monetary policy due on January 30, 2007. We forecast a run up in inflation during the course of the financial year—inflation is expected to rise up to 6% at most by December end. It will stay at elevated levels till the end of FY07. In this context, we expect steady rise in inflation to be a potential cause of a surprise hike before the next policy review meeting. We, therefore, expect at least one more reverse-repo rate hike before the end of FY07.

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

Monetary Measures

- Repo Rate under the LAF is increased by 25 basis points from 7.0 per cent to 7.25 percent with immediate effect.
- The Reserve Bank retains the option to conduct overnight repo or longer term repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.
- Reverse Repo Rate and Bank Rate have been kept unchanged at 6.0 per cent.
- CRR has been kept unchanged at 5.0 per cent.

Developmental and Regulatory Policies

Financial Markets

- It is proposed to extend the 'When issued' trading in the case of fresh issues of Central Government securities on a selective basis.
- It is proposed to allow scheduled commercial banks and primary dealers to cover their short positions in Central Government Securities within an extended period of five trading days and to deliver a shorted security by borrowing it through the repo market.
- Resident individuals would be free to remit up to US $ 50,000 per financial year for any current or capital account transaction or a combination of both, as against the earlier limit of US $ 25,000. The existing facilities for gifts, donations and investment by resident individuals in overseas companies would be subsumed under this revised limit.
- All categories of foreign exchange earners may retain up to 100 per cent of their foreign exchange earnings in their Exchange Earners' Foreign Currency accounts.
- Large turnkey/project exporters/service exporters with satisfactory track record may operate one foreign currency account with inter-project transferability of funds/machinery in any country, subject to specified reporting requirements.
- Large turnkey/project exporters/service exporters with good track record may deploy their temporary cash surpluses in either short-term bank deposits or AAA-rated short-term paper abroad, subject to monitoring by the authorised dealer bank(s).
- The stipulation regarding recovery of market value of machinery from the transferee project is withdrawn; however, such transfer of machinery should be reported to and monitored by the authorized dealer bank(s)/approving authority.
- Authorised dealer banks may borrow funds from their overseas branches and correspondent banks (including borrowing for export credit, external commercial borrowings (ECBs) and overdrafts from their Head Office/Nostro account) up to a limit of 50 per cent of their unimpaired Tier I capital or US $ 10 million, whichever is higher, as against the earlier overall limit of 25 per cent (excluding borrowing for export credit). Short-term borrowings up to one year or less should not exceed 20 per cent of unimpaired Tier I capital within the overall limit of 50 per cent.
- Borrowers eligible for accessing ECBs can avail of an additional US $ 250 million with average maturity of more than 10 years under the approval route, over and above the existing limit of US $ 500 million under the automatic route, during a financial year.
- Prepayment of ECB up to US $ 300 million, as against the earlier limit of US $ 200 million, will be allowed by authorised dealer banks without prior approval of the Reserve Bank subject to the stipulated minimum average maturity period as applicable to the loan.
- Authorised dealer banks may allow remittances on behalf of their customers up to 15 per cent of the average annual sales/income or turnover during the last two financial years or up to 25 per cent of their net worth, whichever is higher, for initial expenses, and allow remittances up to 10 per cent of the average annual sales/income or turnover during the last two financial years for recurring expenses. They may also permit remittances for acquisition of immovable property for the overseas office, within these limits.
- The existing limit of US $ 2 billion on investments in Government securities by foreign institutional investors (FIIs) will be enhanced in phases to US $ 2.6 billion by December 31,2006 and further to US $ 3.2 billion by March 31, 2007.

The extant ceiling of overseas investment by mutual funds of US $ 2 billion is enhanced to US $ 3 billion.

- Importers will be permitted to book forward contracts for their customs duty component of imports.
- It is proposed to allow FIIs to rebook a part, say, 25 per cent of the cancelled forward contracts, provided such contracts are supported by underlying exposure.
- Forward contracts booked by exporters and importers in excess of 50 per cent of the eligible limit (as against the earlier 25 per cent limit) have to be on deliverable basis and cannot be cancelled.
- It is proposed to permit authorised dealer banks to issue guarantees/letters of credit for import of services up to US $ 100,000 where the guarantee is intended to secure a direct contractual liability arising out of a contract between a resident and a non-resident.

- It is proposed to eliminate the lock-in period for sale proceeds of the immovable property credited to the NRO account, provided the amount being remitted in any financial year does not exceed US $ one million.
- It is proposed to dispense with the existing restrictions on the number of tie-ups by banks with exchange houses and the number of drawee branches for rupee drawing arrangements in respect of those banks having sound risk management systems.

Credit Delivery

- Consistent with the notification of the Micro, Small and Medium Enterprises Development Act, 2006, it is proposed to modify the definition of small-scale industry and micro and small enterprises engaged in providing or rendering of services for the purpose of priority sector lending.
- Banks, with approval of their boards, may formulate a transparent policy for providing One Time Settlement facility to those farmers whose accounts have been rescheduled/ restructured due to natural calamities as also those who have defaulted on account of circumstances beyond their control.
- For opening small accounts, banks need to seek only a photograph of the account holder and self-certification of address.

Prudential Measures

- Foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009.
- It is proposed to enhance the prudential limit on credit and non-credit facilities to Indian Joint Ventures/Wholly Owned Subsidiaries abroad extended by banks from the existing 10 per cent to 20 per cent of unimpaired capital funds (Tier I and Tier II capital).

Institutional Developments

- Banks are urged to harmonise their IT-based initiatives to ensure that the objective of greater financial inclusion is achieved.
- It is proposed to allow financially sound UCBs registered in States that have signed MoU with the Reserve Bank and those registered under the Multi-State Co-operative Societies Act, 2002 to convert existing extension counters into full-fledged branches.
- The Reserve Bank would place a model draft Fair Practices Code for consideration of Task Forces for UCBs (TAFCUBs) set up in the States that have signed MoUs for deliberation and adoption.
- It is proposed to allow NBFCs to issue co-branded credit cards with banks without risk sharing; and to market and distribute mutual fund products as agents of mutual funds.
- It is proposed to re-group as asset financing companies the NBFCs engaged in financing real/physical assets supporting economic activity such as automobiles and general purpose industrial machinery.
- The Committee on Financial Sector Assessment would undertake a self-assessment of financial sector stability and development.

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Sunil Jain	-	2286 4308	Alternative & Quantitative	Ravi Pilani	-	4009 4533
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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