Will the RBI cut rates tomorrow?
January 28, 2008

The FACTS:

On January 29, the RBI announces its third quarter review of annual monetary policy 2007-08, with the following background:

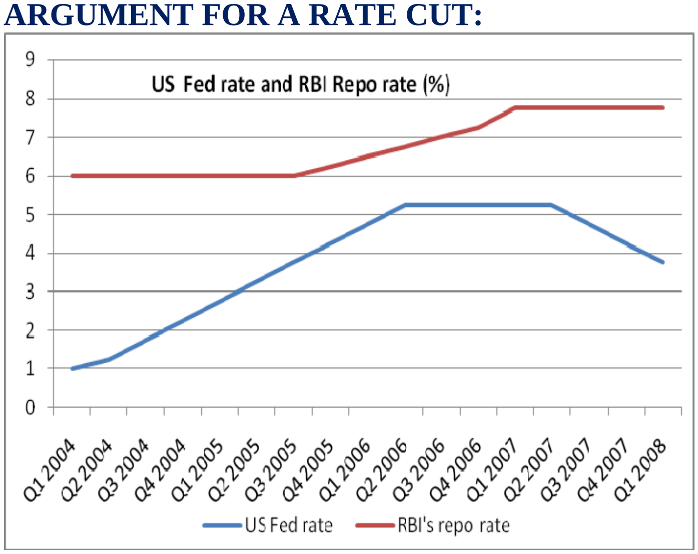
1) Last monetary policy action was a CRR hike of 50bps (bring CRR to 7.5%), in October 2007.
2) US Fed Funds rate at 3.5%, RBI repo rate at 7.75%
3) Latest WPI inflation is 3.83% (Jan 12), credit growth 21.5% (Jan 4), money supply growth 22.4% (Jan 4).
4) IIP growth (Apr-Nov 07) is 9.2%; compared to 10.9% in Apr-Nov 06.
5) Forex reserves increased by US$76.38 bn Apr-Dec 07, compared to US$25.63bn in Apr-Nov 06.

THE VIEW: Outcome of January 29th RBI's Meeting

Organisation	View on Repo Rate	Reason
Merrill Lynch	Cut by 25 bps	To neutralize a rising interest rate differential
Citigroup	Cut by 25 bps	1). Fed to cut extensively by another 100 bps to 2.5%. 2). Slowing credit and consumption growth 3). To avoid huge capital inflows.
HSBC	Cut by 25 bps	Growth concerns
JP Morgan	Status quo (Expect cut in July meeting)	Relatively strong growth momentum High money supply growth.
Yes bank	Status quo (Expect cut if required between Jan 29 and April Meeting)	Depending upon the resurgence in capital inflows and incoming data on growth and inflation in interim time.

The latest Reuter and Bloomberg surveys indicate 54% and 33% of their respondents respectively expect the rate cut of 25 bps.

ARGUMENT FOR A RATE CUT:



- Interest rate differential (now at 4%) with US would result in the record capital inflows, putting further pressure on the rupee.
- Majority expect the US Fed to cut the benchmark rate extensively (with 50 bps cut expected on Jan 30 itself).
- US, Europe and Japan to drag down global growth, with negative growth implications for India.
- Interest rate sensitive sectors showing a slowdown.
- Concern about 'overheating'/inflation in India has receded.

ARGUMENTS AGAINST A CUT

- Wider interest rate differential should logically result in renewed strength in capital inflows (a pattern that was observed post September FOMC decision. But with intensively uncertain and volatile global financial markets, the decisive direction of capital flows would take time to evolve. Further risk aversion has increased substantially now.
- Although the inflation is under control, risks persist. In run-up to election, the inflation would be topmost priority of the Indian policymakers. Also the money supply (M3) growth (at 22.8% in Dec'07) intensifies the fear of inflation. Globally the policymakers are concerns about the inflation.
- There is additional room for the RBI to absorb excess inflows through MSS. (The ceiling for the MSS stands at Rs.2.5 trillion, while the RBI has absorbed only Rs.930 bn in April-Dec 07).