Monetary policy review

Rate hike was expected, but banks need to make higher provisions

The Reserve Bank of India (RBI) has raised the repo rate by 25 basis points to 7.5% in the third quarter review of its Monetary Policy for 2006-07 in line with the market expectations. The RBI has maintained its inflation target stating that the current high inflation levels may be transitional. Overall the RBI continues to remain vigilant. While the rate hike was on expected lines the prudential measures on standard assets provisioning announced by the RBI reaffirms its focus on the quality of assets in the system.

The salient features of the third quarter review are as follows.

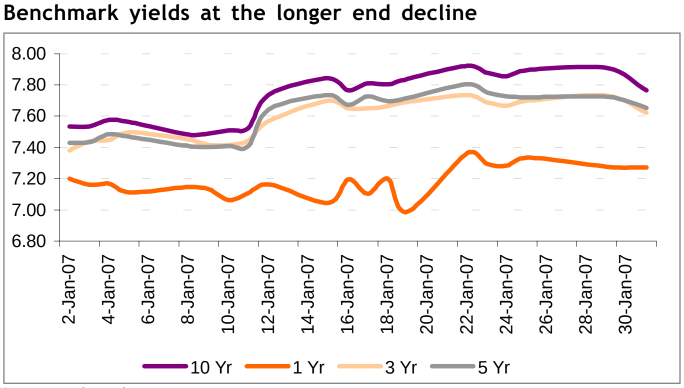
Particulars	Measure	Prevailing/new rate
Repo rate	25 basis points hike	From 7.25% to 7.5%
Reverse repo rate, bank rate and CRR*	Kept unchanged	6%, 6% and 5.5% respectively
FY2007 GDP	Revised upwards	to 8.5-9% compared to 8% projected in the Mid-Term Review of October 2006 and 7.5-8% in the annual policy review of April 2006
Inflation	Target range remains unchanged	5-5.5%

* Hiked in December 2006 by 50 basis points in two phases.

Bond yields drop after policy announcement

The 10-year bond yield closed at 7.76%, which is 15 basis points down from its previous close of 7.91%. However, the 1-year yield ended almost flat at 7.27% compared to its previous closing of 7.28%. The bond yield showing a dip reflects that the market expects the inflation to moderate going forward and believes in the RBI's approach to keep the inflation within the targeted levels.

Benchmark yields at the longer end decline



Source: Bloomberg

The RBI expects the overheating to be transitional...

Improvement in supply side visible: The improvement in the aggregate supply conditions have been driven by the double-digit growth in manufacturing and services. The industrial activity has gathered momentum on the back of the manufacturing activity, supported by mining and electricity generation. The lead indicators point to the sustained strength of the growth in the services sector. Agricultural performance, however, remains weak. But below trend agricultural production has created supply side pressures particularly in the commodities due to the decline in the production of rice, coarse cereals, oilseeds, pulses etc.

Demand side firming up: The pick-up in the investment intentions and the high growth of the capital goods production and capital goods imports suggest that the investment demand is strengthening further. The corporates are also reporting sustained business optimism and raising capital expenditure. Second, there is buoyancy in the consumer demand. Third, the demand for bank credit remains high with concerns on the asset quality and growth in the money supply. Fourth, there is a widening trade deficit. Fifth, there are infrastructure bottlenecks. Sixth, there are also wage cost pressures. And lastly there are the elevated asset prices.

There is evidence of substantial investment taking place, accompanied by the overall productivity increases, which should add to the potential output. Furthermore, there has been an upward shift in the gross domestic saving and investment rates, which could provide the base for a higher level of the structural component of growth. Thus, it becomes important to recognise that the signs of overheating could be transitional in nature as the capacity additions are underway but the realisation could be constrained over the next two years.

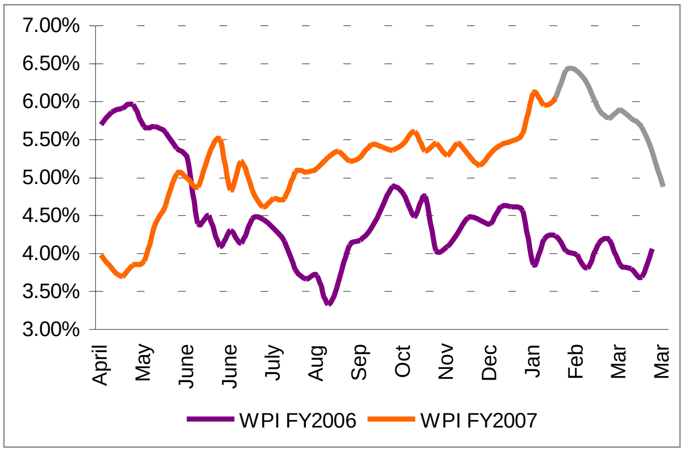
Maintains target inflation range of 5-5.5%

The RBI hopes that the policy measures being undertaken at the current juncture would curb inflation as close as possible to the targeted levels of 5% to 5.5% at the earliest, while continuing to pursue the medium term goal of a ceiling on the inflation at 5%.

Inflation expected to moderate by end-March 2007

The RBI has been mentioning that it's a transitional phase caused due to the lagged supply and demand side effects. Currently the demand is firming up and the supply is expected to catch up once the capacity additions start contributing. The *rabi* season is also expected to be better and ease the pressure on the commodity prices. We expect that the impact of recent duty cuts, absence of a lower base effect and an improved supply side would help inflation moderate to below the RBI's comfort zone by end-March 2007. Again the bond yields coming down also indicate the market factoring in lower inflation going forward.

Inflation expected to moderate from end-March



GDP growth revised upwards to 8.5-9%

The real gross domestic product (GDP) growth originating from the agricultural and allied activities has been somewhat lower-than-expected in the first half of 2006-07, based on the likely production in the *kharif* season. However, a clearer assessment of the *kharif* crop performance is pending and a revision in the growth rates may happen. Again taking into account the favourable water storage conditions that should augur well for the *rabi* season, the RBI feels it is reasonable to expect that agriculture will maintain its trend growth of 3% as anticipated in the Annual Policy Statement of April 2006 and the Mid-Term Review of October 2006. On the other hand, the momentum of growth has been sustained in the industrial and services sectors and the outlook remains bright. Accordingly, the real GDP growth for 2006-07 is currently expected to be in the range of 8.5-9% compared to 8% projected in the Mid-Term Review of October 2006 and 7.5-8% in the Annual Policy Statement of April 2006.

Overall growth outlook remains upbeat

The RBI's outlook survey points to optimism on the growth outlook. The business expectations index for October-December, 2006 was higher than in the preceding quarter but marginally lower than in the corresponding quarter a year ago. The expectations index for January-March, 2007 is higher than in the preceding quarter as also in the corresponding quarter a year ago. A positive outlook for the demand conditions continues with the increased optimism reflected in the order books, production, employment and profit margins. The assessment about the growth of exports and imports indicates a marginally lower level of confidence. Expectations of an increase in the selling prices have moderated somewhat in relation to the preceding quarter.

Standard asset provisioning norms increased

The RBI is concerned with the high credit growth in the real estate sector, outstanding credit card receivables, loans and advances qualifying as capital market exposure and personal loans. Furthermore, the data reveals higher default rates in regard to the credit card receivables and personal loans. Thus the RBI feels it is imperative to increase the provisioning norms in respect of the standard assets in the aforesaid four categories of loans and advances (excluding residential housing loans).

Provision for standard assets	Earlier (%)	Revised (%)
Real estate sector, outstanding credit card receivables, loans and advances qualifying as capital market exposure and personal loans	1	2
Banks exposure to NBFCs*	0.40	2

*Further risk weights also increased from 100% to 125%, not applicable to asset finance companies. Source: RBI

Impact of increased standard asset provisioning

The increased provisioning norms would reduce the banks' profits at the current lending rates for these products. Hence, the lending rates may see an upward revision in these categories. The private banks like HDFC Bank and ICICI Bank will be impacted most, which we feel should pass on the increased cost to the borrowers by increasing their lending rates in these categories. Non-banking finance companies (NBFCs) not involved in asset finance, could also see their borrowing costs moving up as the dual impact of the higher provisioning norms and higher risk weights does make it inevitable for the banks to hike the lending rates for NBFCs not engaged in the asset finance business. Normally, the RBI releases detailed guidelines on the items mentioned in its policy review in due course of time, and the same is expected on the increased standard asset provisioning norms.

NRI deposit rates revised

A sizeable increase in non-resident (external) rupee account [NR(E)RA] and foreign currency non-resident (banks) [FCNR(B)] deposits has been observed in 2006-07 so far.

The RBI has felt it appropriate to reduce the interest rate ceilings on [NR(E)RA] and [FCNR(B)] deposits by 50 basis points and 25 basis points, respectively to discourage NRI deposits and curb asset price inflation. A lot of money is routed through the NRE deposits into the country and finds its way into real estate and capital markets.

Policy stance expected going forward

The liquidity management will receive priority in the policy hierarchy for the remaining part of the year. The RBI would use all policy instruments, including the CRR, to ensure the appropriate modulation of the liquidity in responding to the evolving situation. This would make the market more vigilant to capital flows and the overall liquidity conditions.

The RBI has reinforced the emphasis on price stability while continuing to ensure an environment to maintain the growth momentum. Overall the RBI continues to remain vigilant on the domestic and global developments. It has kept its options open to respond swiftly with all possible measures appropriate to the evolving global and domestic situation impinging on the inflation expectations and the growth momentum. However, if the inflation moderates on expected lines, money supply and the credit growth slows down to a comfortable zone then we may not see further rate hikes. However other prudential measures are expected from time to time to keep the quality of assets in the system healthy.