Monetary policy Review

RBI maintains status quo for all key rates

Belying our expectations of a 25-basis-point rate cut, the Reserve Bank of India (RBI) maintained the status quo for all key rates. A 75-basis-point cut in the interest rates by the US Federal Reserve (Fed) had renewed expectations that the RBI would follow suit. However, these expectations were not met due to continuing inflation concerns on the domestic front and an increasingly worsening international situation.

Key policy highlights

- Bank rate (rate at which RBI lends to commercial banks) kept unchanged at 6%.
- The repo rate and the reverse repo rate kept unchanged at 7.75% and 6% respectively.
- The cash reserve ratio (CRR), the ratio of cash balances to be maintained by banks with the central bank, kept unchanged at 7.5%.
- Gross Domestic Product (GDP) growth forecast retained at 8.5% for FY2008, assuming no further escalation in international crude prices and barring domestic and external shocks.
- Inflation to be contained around 5% in FY2008, with a medium-term objective of 4-4.5% rate of inflation.

RBI survey indicates lower business confidence

RBI's survey of manufacturing companies indicates some moderation in the business optimism with the business confidence reporting a fall of 4.7% from Q2FY2008 and 6.2% from the corresponding quarter a year ago. Business confidence surveys conducted by other agencies convey a mixed though an overall positive picture for the near term.

Concerns expressed by RBI

Continuing domestic inflation

The domestic inflation concerns are:

- During FY2008 (April 2007 to December 2007) the money supply (M3) increased by 22.4%, which was higher than the 20.8% increase in the corresponding period last year and was well above the projected trajectory of 17-17.5%. We believe M3 increasing at the start of the busy season was considered inflationary by the RBI.
- The headline WPI (wholesale price index) inflation has been edging up moderately since early December 2007 largely due to the base effect. The RBI added that there are indications of upside inflationary risks going ahead.
- The domestic prices of petrol and diesel were last changed in February 2007. Since then the price of the Indian crude basket has gone up by 39% (till December 2007).

Turbulence in international financial markets

The RBI said that the turmoil in the international financial markets since July 2007 (triggered by the payment defaults in the US subprime markets) has deepened in subsequent months. These unusual developments have heightened uncertainties for the emerging markets. This has also made the international markets considerably volatile having an impact (at least sentimental) on India.

Conclusion

The RBI has concluded that the outlook towards all the three components of GDP (agriculture, industry and services) continue to be positive. The domestic factors (which are dominating) are better-balanced, stable and positive compared with the international factors, which are becoming uncertain. RBI's policy will be to continue to emphasise price stability (read controlling inflation) while ensuing an interest rate environment conducive for the continuation of the growth momentum.

Fundamentally, the decision to leave the rates unchanged does not have any material impact on the bond yiends and the net interest margin of the banks. However, it is a sentimental negative for financial (banks and non banking financial companies), auto, and real estate stocks.