Asia Economics Data Flash

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India weekly liquidity watch: Rate cut realized but credit spreads still high

Foreign exchange (FX) reserves rose by US$2 billion to US$247.7 billion in the week ending November 28. This was the first increase in reserves since mid-September this year and was mainly led by valuation changes following the USD's trade-weighted depreciation.

Broad money M3 growth continued to moderate to 19.0% yoy in the fortnight of November 21 vs. 19.9% yoy a month back, due to the continuing fall in the net FX assets of the banking sector, and falling credit to the commercial sector. Sequentially, M3 growth rose 1% mom in November, lower than the 2.3% mom growth in October (see Exhibit 1).

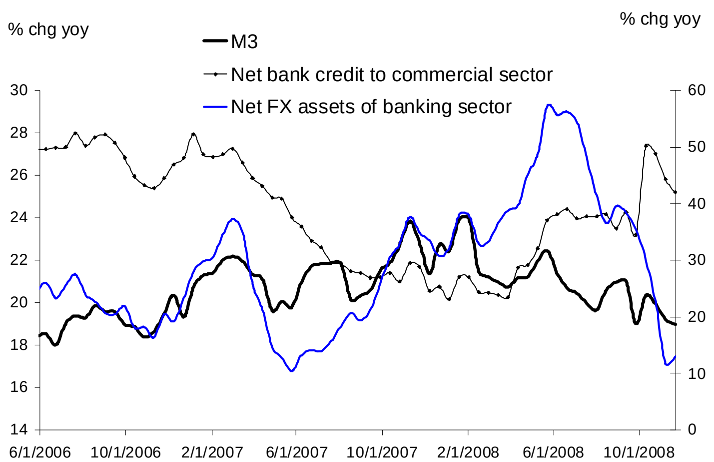
Bank credit growth slowed to 27% yoy as on November 21 compared to 29% yoy a month ago, as credit to the commercial sector continued to be difficult to obtain. Although the Prime Lending Rates (PLR) of banks have fallen to 13.25% from about 14% in September, banks have removed discounts on the PLR implying corporates are paying much higher rates now than in the last few quarters.

Liquidity conditions have eased a bit. With the deposit base remaining largely unchanged and the 350 bp cash reserve ratio cut coming into effect, free funds with banks have continued to increase and are now back at February levels after a sharp fall in October (see Exhibit 2). Banks have excess liquidity which they are parking in the reverse repo window and in government bonds.

As per our expectations, the government made an upward revision to its market borrowing plans for FY09 (see *India: Some unpleasant fiscal arithmetic*, Asia Economics Flash, October 15). It will now borrow Rs1900 billion (US$38 billion) from the market vs. its earlier estimate of Rs1450 billion (US$29 billion). We do not think this will put upward pressure on government bond yields, given that policy rates are on their way down and banks are still choosing to put free funds in government securities. Our estimate of the fiscal deficit is unchanged at 8.4% of GDP in FY09, with the increase in the fiscal stimulus announcement on December 7 being offset by the reductions in the oil and fertilizer subsidy bill due to falling commodity prices (see *Implications of the joint fiscal stimulus package and central bank rate cuts*, India Views, December 8).

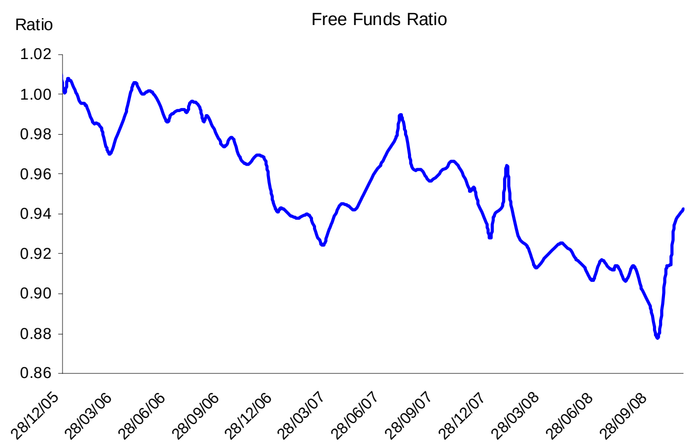
Credit spreads are still high despite expectations of more Reserve Bank of India rate cuts. Although the 3-month MIBOR and 3-month OIS spread as well as the 3-month MIBOR and 3-month treasury spread have moved down in the last fortnight in expectation of a rate cut which finally came on board on December 6, the spreads are still at very high levels, suggesting continued credit market stress (see Exhibit 3). The corporate bond spread at over 400 bp now from 250 bp in June also suggests difficult credit conditions for corporates.

Exhibit 1: Broad money M3 growth continued to moderate



Source: RBI, CEIC, Goldman Sachs Economics Research.

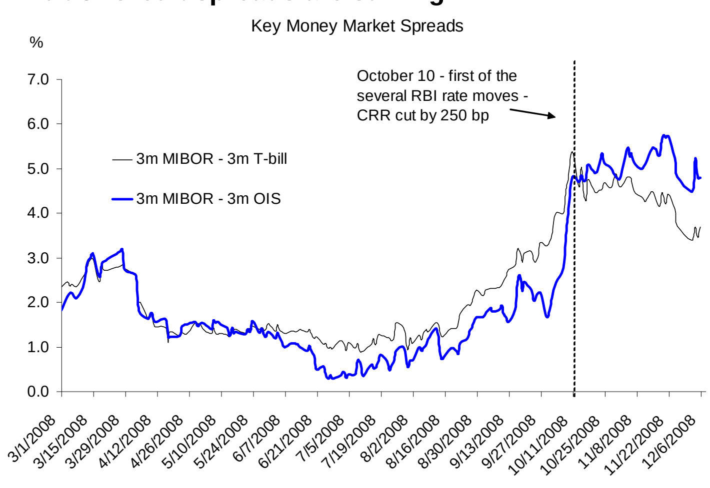
Exhibit 2: Free funds of banks are rising



Note: Free Funds ratio = (1-CRR-SLR)*bank's deposits/credit

Source: RBI, CEIC, Goldman Sachs Economics Research.

Exhibit 3: Credit spreads are still high...



Note: data till December 5, 2008.

Source: Bloomberg, Goldman Sachs Economics Research.