IndiaInfoline

Event Update - RBI hikes CRR, LAF Repo rate

April 02, 2007

Major highlights

√ CRR hiked by 50 bps in 2 stages effective from 14th and 28th April 2007
√ Cut in interest paid on excess CRR above 3% to 0.5% from 1% earlier
√ Repo rate hiked by 25bps to 7.75% widening interest rate corridor to 175bps

RBI continues monetary tightening- Hikes CRR and LAF Repo rate

India's Central Bank once again hiked policy rates to contain inflationary pressures in the economy. This is sighting high credit growth of 29.4% and inflation, which has sustained over 6% for 11 weeks in a row (currently at 6.46%). While the hike in CRR (by 50bps in 2 stages) and Repo rate (by 25bps with immediate effect) is not unwarranted, the timing of the move certainly is; as the Monetary Policy Review is scheduled on April 24, 2007. RBI has also reduced the rate of interest paid on excess CRR (above 3%) maintained with itself from 1% to 0.5%. While inflation is expected to come down from May 2007 due to the high base effect and impact of monetary measures, sustainable drop is likely with structural changes through capacity additions and better food grain supplies.

All the monetary measures are expected to make money dearer and we expect Banks to once again increase lending and deposit rates. The drop in interest rate on CRR is likely to impact margins marginally by around 2bps, which we expect this to be recovered through lending rates. Sharp rise in interest rates over the past 12 months has seen affordability reduce and could impact asset quality in the future. We maintain our neutral stance on the sector. PNB, BOI and BOB are our top picks, while Canara Bank is our top SELL in our coverage. We are in the process of updating our ratings and will realease it soon.

Top BUY- PNB, BOI
Top SELL- Canara Bank

Analyst
Ashutosh Narkar
anarkar@indiainfoline.com
91-22-6749 1767

Head of Research
Sachin Neema
sachin.neema@indiainfoline.com
91-22-6749 1750

Institutional Sales
Sandeepa Arora
sandeepa@indiainfoline.com
91-22-6749 1776

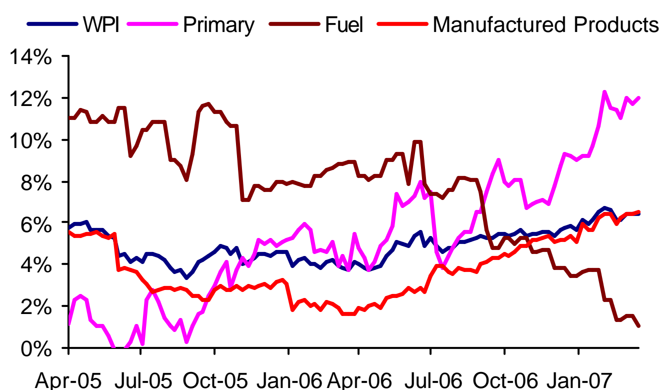
IndiaInfoline

RBI's recent monetary action is based on sustained high inflation and credit growth. Inflation has been driven by shortage of food grain supplies and lack of new capacities in the manufacturing sector, both keeping product prices high. Credit growth has also remained at around 30% and RBI's monetary measures have yet to make an impact on the same. While we expect inflation to taper down from May 2007 due to the high base effect, stable inflation environment can be envisioned post new capacities (expected in FY08-10) get operational and supply shortages solved. We expect RBI to maintain a tight monetary policy and observe impact of its actions before making any further move.

Inflation has been above 6% for the past 11 weeks

Manufacturing products and primary articles have been the major contributors towards rise in the WPI index. While shortage of food grains has pushed up primary articles index, absence of new capacities in major manufacturing sectors (capacity utilization is around 85%-95%) has contributed to higher prices. Food grain shortage is being increasingly solved through imports, much due to the adverse political implications on vote banks as elections draw close. However, manufacturing inflation is unlikely to come down in a hurry as capacity utilization in the current year has increased further and is hovering around the upper limit and most new capacities are expected to become operational in FY08-10.

Chart: WPI index trend



Source: Bloomberg, India Infoline research

Table: Capacity utilization trend

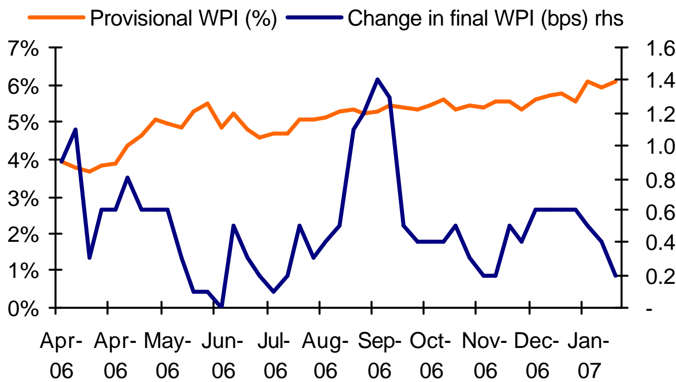
Capacity utilization %	FY00	FY03	FY06
Aluminium	86	82	75
Auto Ancillaries	68	69	77
Cars & UVs	59	59	84
Cement	86	80	85
Commercial vehicles	48	55	88
Fertilizers	93	78	86
Paper	76	84	89
Petrochemicals	77	99	98
Refining	77	96	96
Steel	67	76	90
Tractors	74	45	58
Tyres	67	73	88

Source: ICRA, India Infoline research

As explained earlier, lack of new capacities has seen commodity prices rise far quicker than the index has managed to capture. While paucity of comparable data is a hindrance, the same is visible in cement, where the index despite a high growth has not been able to track actual commodity price movement. Revisions to provisional figures have also been consistently higher than provisional figures reflecting our view.

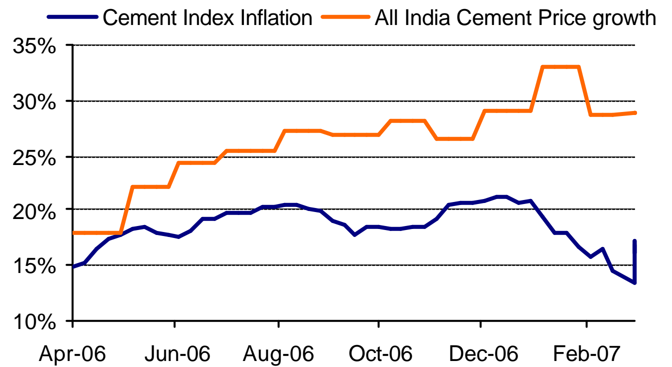
IndiaInfoline

Chart: Prov. WPI index and change in prov figures



Source: Bloomberg, India Infoline research

Chart: Cement prices and Cement inflation index



Source: Ministry of industry and Commerce, India Infoline research

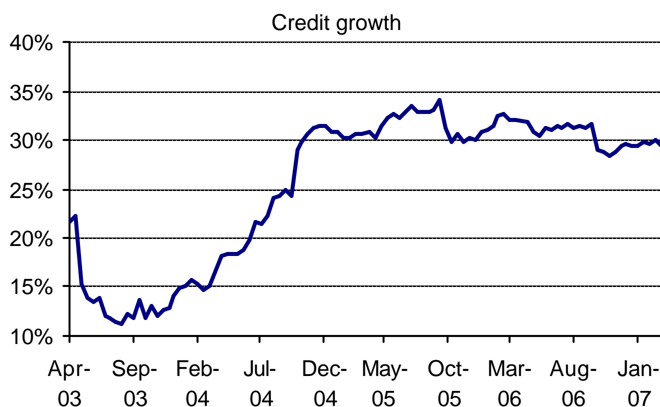
Base effect to pull down inflation from May 07, though manufacturing sector key to stable inflation

Despite our apprehensions on the ground level situation, we expect inflation to moderate from May 2007 as high base effect of last year and impact of monetary measures kick in. This is not to say that inflation could remain benign as structural changes like capacity additions take time to play out and sustained manufacturing growth could keep inflation high.

Credit growth- No signs of slow down yet

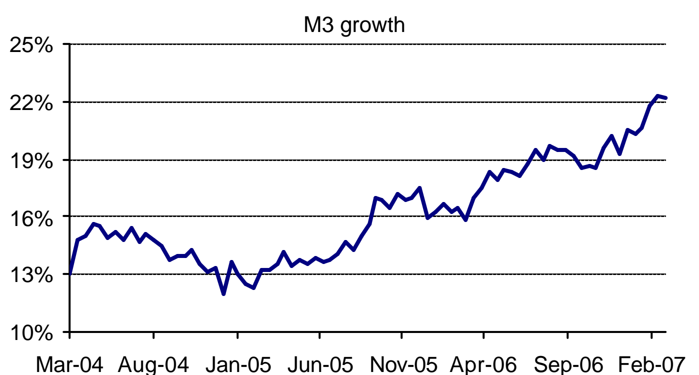
Last 12 months have seen Banks hiking their PLR three times out of which the last two have come in the fourth quarter. To put things in perspective, mortgage loan rates have increased by 250-300bps on the existing loans and around 200bps on new home loans. Corporate borrowing rate has also increased by 250bps in the past 12 months. Despite this, credit growth has remained high at 29.4% (yoy) as on 16th March 2007 and money supply has grown by 22% yoy.

Chart: Credit growth trend



Source: RBI, India Infoline research

Chart: Money supply trend

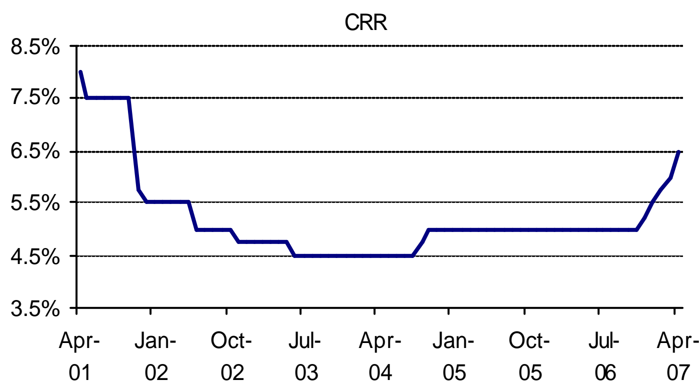


Source: RBI, India Infoline research

IndiaInfoline

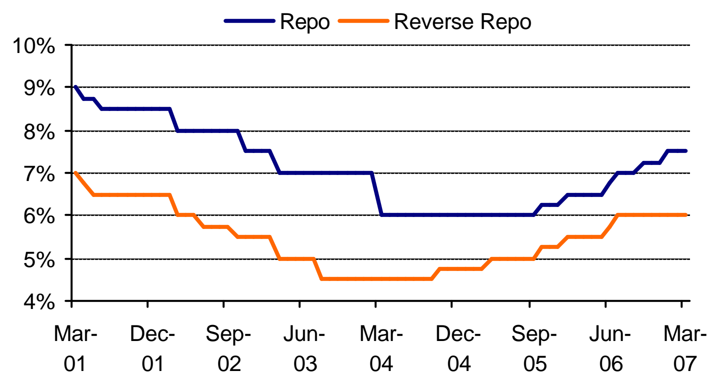
The Central Bank has been vigilant of the situation and taken many policy initiatives to curb liquidity and inflation pressures. While the initial response to the situation came through increased risk weights and standard provisioning on select asset classes like capital market exposures and commercial real estate financing, actions became stern through hike in CRR (150bps since October 2006), increase in the repo rate by 125bps and expanding the interest rate corridor to now at 175bps from 100bps a year earlier.

Chart: Cash reserve ratio trend



Source: RBI, India Infoline research

Chart: LAF repo and reverse repo trend



Source: RBI, India Infoline research

RBI could be done with raising policy rates, though tight monetary policy to continue. Lending rates set to rise further.

150bps rise in CRR and 125bps rise in repo rate has taken us back to the 2002 levels in a far lesser time than it took to come down. We think the RBI is done with most of the hike in policy rates with a bias towards one more up move. Our assumption is based on the fact that monetary policy changes take some time to percolate to the ground level and the sharp rise in lending rates has reduced affordability for borrowers. This is likely to get further accentuated by an increase in lending rates post this current policy rate and CRR hike. However, we expect RBI to continue its tight monetary policy during FY08 till credit growth slows down to a sustainable 18-20%.

Low sterilization cost- RBI frequently using CRR to manage liquidity

RBI in the past has used Market stabilization Scheme (MSS) and Liquidity Adjustment Facility (LAF) to sterilize liquidity in the market. However, it has increasingly started using CRR as a tool to sterilize liquidity from the market. Use of CRR has two advantages to the RBI. First, it sends out a strong signal that the Central Bank intends to pursue a tight monetary policy and second sterilization cost through CRR is almost negligible compared to the other instruments. Current effective interest rate paid on CRR balances stands at 1% (reduced to 0.5% from FY08), while the interest paid on a LAF operations is 6% (no change in rates in the latest announcement) and around 7.5-8% on the MSS bonds depending on tenure whether it is a treasury bill or dated security. This way the government is saving around 5.5-7% on the cost of liquidity sterilization. In addition CRR hike compresses Net interest Margin (NIM) further adding to RBI's objective.

The drop in interest rate on excess CRR balances above 3% to compress banks margins marginally by 2bps. However, we expect the same to be recovered by through lending rate hikes. Banks with higher CASA and excess SLR better placed to face funding cost rise post the recent policy rate and CRR hike.

Margins to suffer marginally by around 2 bps in the short term due to cut in interest rate on CRR, should be passed on in the medium term.

We estimate the impact of drop in CRR interest rate from 1% to 0.5% effective from the new fiscal FY08 to be around 2bps on Banks NIMs. However, we expect this to be passed on to the borrower in the medium to long term.

Banks with higher CASA ratio and excess SLR better placed

We estimate Banks with higher CASA and excess SLR will have a higher cushion on margins to manage rising funding cost and drop in yield on CRR balances. 500bps higher CASA at similar deposits costs, reduces funding cost by 20bps and equivalent rise in NIMs. Cushion on NIMs would provide banks with higher provisioning capacity to maintain asset quality. This is especially important in the current situation where fast rise in interest rates could deteriorate asset quality.

Table: CASA sensitivity

	CASA @ 35%	CASA @ 40%
Advances yield	9.00%	9.00%
Other earning assets yield	6.80%	6.80%
Blended asset yield	8.10%	8.10%
Cost of funds	5.38%	5.18%
NIM	2.72%	2.92%
Other Income	1.30%	1.30%
Operations cost	2.20%	2.20%
Pre Provisioning cost	1.82%	2.02%
Provisioning cost	0.80%	1.00%
ROA	1.02%	1.02%

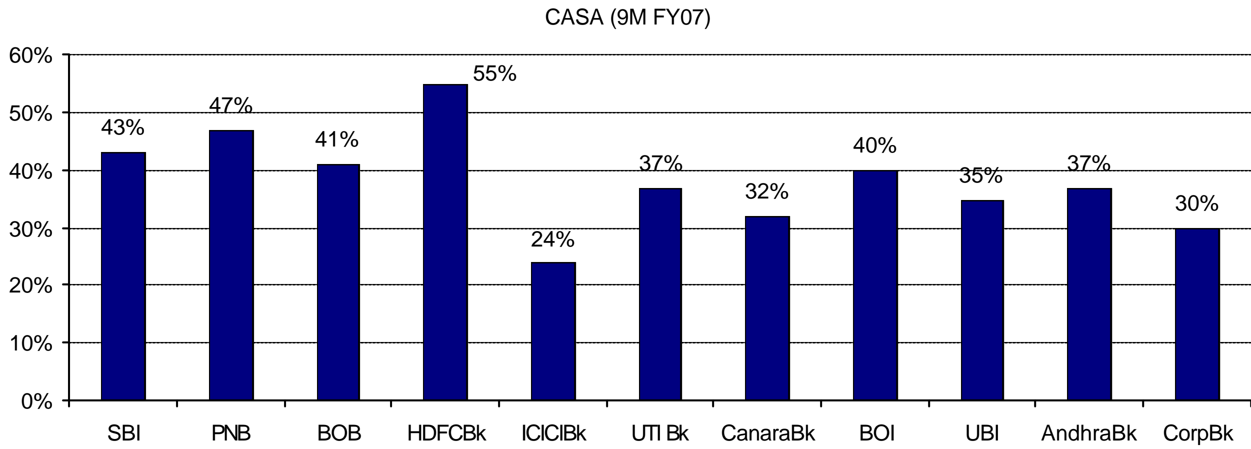
Source: India Infoline research

5% higher CASA expands margins by 19bps and allows for 20bps higher provisioning to maintain asset quality.

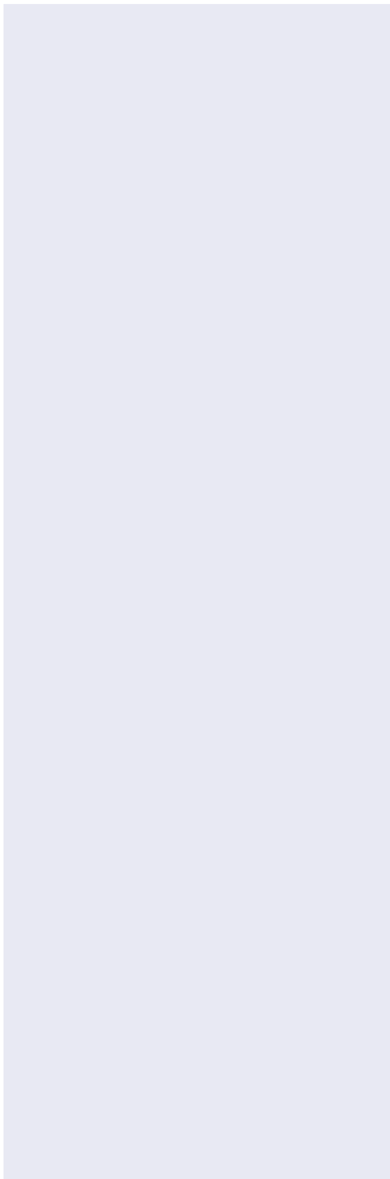
PNB, SBI, BOB and HDFC Bank have built up a strong CASA franchisee, which should help them contain deposit cost escalation. SBI, PNB and HDFC Bank hold sizeable excess SLR while most other within our coverage hold very low excess SLR which cannot cushion lower deposit growth. The impact of rising deposit cost would be felt more for ICICI Bank, UTI Bank, Canara Bank and Corporation Bank as they have to mop up funds to deploy for high advances growth and a SLR requirement.

IndiaInfoline

Chart: CASA ratio comparison



Source: RBI, India Infoline estimates



Our Recent Publications

Indian Transformer Industry: Capitalizing on changing current - February 07, 2007

Usha Martin (Q3 FY07) - February 05, 2007

Nagarjuna Construction Company Ltd (Q3 FY07) - February 02, 2007

Indraprastha Gas Ltd (Q3 FY07) - January 31, 2007

Allsec Technologies Ltd (Q3 FY07) - January 31, 2007

Published in April 2007. All rights reserved. © India Infoline Ltd 2006-07
This report is for information purposes only and does not construe to be any investment, legal or taxation advice. It is not intended as an offer or solicitation for the purchase and sale of any financial instrument. Any action taken by you on the basis of the information contained herein is your responsibility alone and India Infoline Ltd (hereinafter referred as IIL) and its subsidiaries or its employees or directors, associates will not be liable in any manner for the consequences of such action taken by you.

We have exercised due diligence in checking the correctness and authenticity of the information contained herein, but do not represent that it is accurate or complete. IIL or any of its subsidiaries or associates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this publication. The recipients of this report should rely on their own investigations. IIL and/or its subsidiaries and/or directors, employees or associates may have interests or positions, financial or otherwise in the securities mentioned in this report.

India Infoline Ltd, 15th Floor, P.J.Tower, Dalal Street, Mumbai -01. Tel 91-22-67491700.

India Infoline Research can be also accessed on Bloomberg (Code IILL), Thomson First Call and ISI Emerging markets.

it's all about money, honey!