sharekhan special

Monetary policy preview

We feel a 25-basis-point hike in the repo and reverse repo rates may be on the cards

Another rate hike looks imminent

We feel a 25-basis-point hike in the repo and reverse repo rates may be on the cards. All the current indicators, which the Reserve Bank of India (RBI) normally considers, are above their target zone or rate. This increases the likelihood of another rate hike. In a recent poll conducted by Reuters among the top Indian banks and investment companies, almost all voted for a hike in both the repo and the reverse repo rate in the forthcoming policy review meet on January 31, 2007. The market looks to be ready for a 25-basis-point hike in the key rates. However any higher measure of hike could come as a surprise and affect market sentiments.

Bank rate may not be raised

We feel the bank rate may not be raised currently as it is the RBI's medium-term policy rate and nothing seems to have drastically changed on that front. The inflation rate has breached the 6% level all right but we feel the same may come down in the medium term due to the recent measures taken by the government, such as the customs duty cut and the import of food grains. Only two respondents out of the fifteen voted for a 25-basis-point hike in the bank rate in the Reuters poll.

Particulars	RBI's target range (%)	Current yoy growth rates (%)	Measures taken so far in FY2007
Inflation	5 - 5.5	5.95	Reverse repo rate hiked twice in June and July 2006 by 25 basis points each; currently at 6%.
M3 growth	15.5	20.00	Repo rate hiked thrice in June, July and October 2006 by 25 basis points each; currently at 7.25%. CRR hiked by 50 basis points in two phases during December 2006.
Credit growth	20.0	30.00	

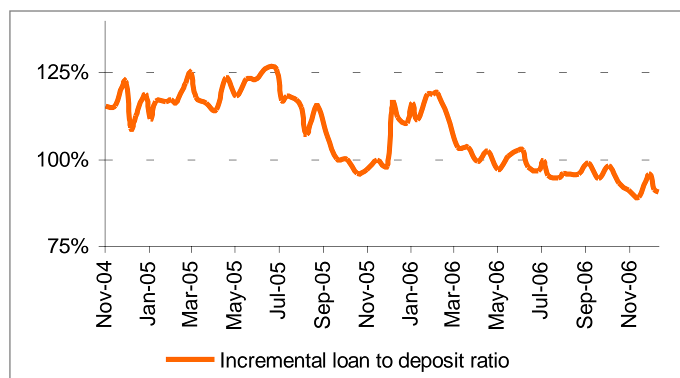
Factors to influence domestic interest rates in the near term

Particulars	Outlook for next three months
Global interest rates and inflation	Look benign with US Fed not raising rates and Japan adopting a wait-and-watch policy.
India's current account and BOP policy	Current account deficit may widen on higher imports, but capital account flows should be able to finance the deficit.
Money supply and nominal GDP growth	Money supply continues to be above RBI's target rate which remains a cause for concern.
Incremental loan/deposit ratio	Expected to continue its decline, as banks run out of excess SLR.
Government finances	Robust tax collections have helped to improve the fiscal performance; going forward lower government borrowings would help in freeing more funds for private investments.
Existing system liquidity	Currently liquidity in the system has improved but the same still remains low from the July levels. It is expected to improve with government spending and foreign inflows.
Inflation	Continues to be above RBI's target zone. With state elections round the corner, inflation management may become a key issue for the government. We have seen some measures like customs and import duty cuts. Expect some more duty cuts in the budget.

Credit growth continues unabated

Despite RBI's move to hike the key policy rates and raise the cash reserve ratio (CRR) by 50 basis points year on year, the credit growth continues to be ~30%. The credit/deposit ratio is around 74% while the investment/deposit ratio has come down to 30% levels from the highs of 35% in the last couple of years. Most of the banks' statutory liquidity ratio (SLR) is at 26-27%, which is very close to their threshold level of 25% SLR requirement. Banks have been reducing their investment holdings to fund credit growth. The incremental loan/deposit ratio has been steadily coming down with banks running out of excess SLR securities.

Incremental loan/deposit ratio

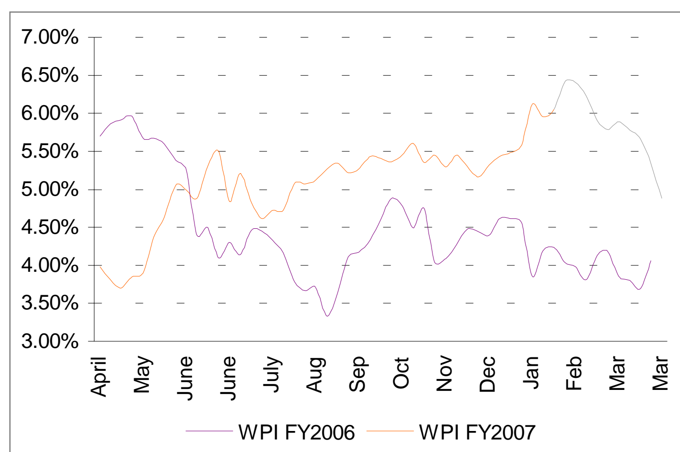


Source: RBI

Inflation above the comfort zone

The current inflation rate at 6.12% is much above the comfort zone (5-5.5%) of the RBI. The inflation rate has touched the 6% level mainly due to the rise in the price of primary articles owing to higher food article prices. A lower base in the corresponding period of the previous year has also played its part. We expect the inflation rates to moderate in the medium term, however the rates may persist above the 6% level in the near term.

Wholesale Price Index y-o-y change



Source: Office of the economic advisor

Customs duty cut would help moderate inflationary pressures

With the state elections round the corner, the government has its hands full to curb inflation. The recent reduction announced in customs duties would help curb inflationary pressures going forward. Primary articles and manufactured products have been the key drivers of the recent spurt in inflation. The reduction in customs duty in select raw materials would provide a broad-based approach to tame the rising inflationary pressures. This fiscal measure will help cap the ability of the domestic producers to hike the prices of these goods and ultimately lead to moderation in the manufactured products group, which has recently seen a rise in its pricing power.

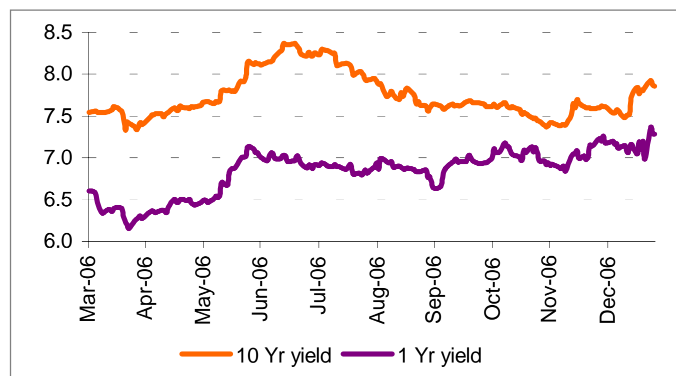
RBI to have SLR flexibility

Although the year-on-year credit growth remains robust at 30%, the deposit growth at 20% is lagging behind. Currently banks need to hold 25% of their deposits in government and other approved securities. Currently the RBI does not have the power to lower the SLR requirement from 25%. But the government has been working on a proposal to empower the central bank to set the SLR requirement floor below 25% and it is in the final stages of getting the President's assent. We feel even if the RBI is granted the power to lower the SLR during the policy review meet, the apex bank may not choose to exercise it. Nevertheless, the move would provide the RBI greater flexibility in the future to manage system liquidity.

Bond market appears to have factored in the rate hike

After the latest inflation data of 6.12% was released on January 19, 2007, the one-year benchmark yield closed almost 36 basis points above its previous close. The sharp rise in the bond yield indicates that the market feels the RBI would further hike the rates. The yields had earlier firmed up after the 50-basis-point hike in the CRR announced in December 2006. Overall, the bond market seems to have factored in another rate hike.

10-year and 1-year benchmark yields

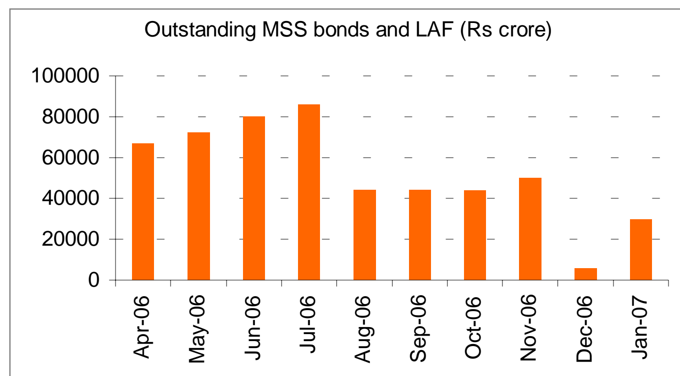


Source: Bloomberg

Liquidity in the system has shrunk

The system liquidity has shrunk to some extent; the advance tax outflows and the CRR hike had drastically lowered the liquidity in December 2006. Although the situation has improved since then, yet liquidity remains lower than the earlier levels.

Trend in banking system liquidity



Source: RBI

Deposit rates on the rise

State Bank of India and ICICI Bank have hiked their deposit rates once again by 50-100 basis points each after the rate hikes announced in December 2006 in the wake of the CRR hike. The demand for credit is not slowing down significantly and banks are required to offer much higher rates to attract deposits. Mid-sized banks like Union Bank of India have also announced a rate hike and we expect the other banks to follow suit. HDFC has said that if the RBI raises rates, then it would need to hike its lending rates again. Banks may also consider revising their lending rates to protect their margins.

The author doesn't hold any investment in any of the companies mentioned in the article.

Disclaimer

"This document has been prepared by Sharekhan Ltd. This Document is subject to changes without prior notice and is intended only for the person or entity to which it is addressed to and may contain confidential and/or privileged material and is not for any type of circulation. Any review, retransmission, or any other use is prohibited. Kindly note that this document does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction.

Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. SHAREKHAN will not treat recipients as customers by virtue of their receiving this report.

The information contained herein is from publicly available data or other sources believed to be reliable. While we would endeavour to update the information herein on reasonable basis, SHAREKHAN, its subsidiaries and associated companies, their directors and employees ("SHAREKHAN and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent SHAREKHAN and affiliates from doing so. We do not represent that information contained herein is accurate or complete and it should not be relied upon as such. This document is prepared for assistance only and is not intended to be and must not alone betaken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. We do not undertake to advise you as to any change of our views. Affiliates of Sharekhan may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject SHAREKHAN and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

SHAREKHAN & affiliates may have used the information set forth herein before publication and may have positions in, may from time to time purchase or sell or may be materially interested in any of the securities mentioned or related securities. SHAREKHAN may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall SHAREKHAN, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. Any comments or statements made herein are those of the analyst and do not necessarily reflect those of SHAREKHAN."