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Economy

RBI's first quarter policy review for FY07-08

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- Optimism on Indian economy continues to remain robust
- RBI expects the Indian economy to grow at about 8.5% during FY08
- Our forecast reveals that the Indian economy is likely to grow at 8.6% during FY08
- Decline in growth in housing and real estate loans

Milton Friedman rightly said, "Inflation is always and everywhere a monetary phenomenon." True to the thought and taking a cue from the current rate of inflation and surplus liquidity facing the country, Dr. Y V Reddy announced the first quarter review of its Annual Policy statement for FY08. The RBI increased CRR of scheduled banks by 50 basis points to 7%, with effect from August 4, 2007. The CRR hike is expected to drain out around Rs 160 bn from the system. The RBI also withdrew its ceiling of Rs 30 bn on reverse repo on its daily money market operations, which it holds twice a day. Going forward, the central bank has announced that it was ending the second operation, held in the afternoon, with effect from August 6, 2007. In fact this will help banks keep more funds with them under the daily liquidity adjustment facility. What is positive about the credit policy is that there aren't any changes in key policy rates, viz - bank rate (6%), repo rate (7.75%) and reverse repo rate (6%).

Optimism about the Indian economy continues to remain robust. The revised CSO estimates for real GDP growth in FY07 is at 9.4%; where agriculture, industry and service sectors' contribution was 2.7%, 11% and 11% respectively corresponding to 6%, 8% and 10.3% during FY06. RBI expects the Indian economy to grow at about 8.5% during FY08. Overall, the progress of south west monsoon has been satisfactory; sowing in kharif food grain crops, major oil seeds and cotton cultivation is higher in FY08 as against the corresponding period of FY07. Growth is visible in case of industrial production as well, with the general index of industrial production rising by 11.7% during April-May 2007 corresponding to 10.8% during the same period in FY06. Infrastructure has shown a robust growth of 8.1% during April-May 2007, mainly on account of improvement in electricity and petroleum refinery products against 7.2% achieved in April- May 2006. Our forecast reveals that the Indian economy is likely to grow at 8.6% during FY08.

The non-food credit growth of scheduled commercial banks stood at 24.4% on July 6, 2007, against 32.8% during the same period in the previous financial year. During FY07, agriculture sector recorded the highest credit growth to the tune of 32.4%, followed by service sector at 31%, personal loans at 26.5% and industry at 25.7%. There was a decline in growth in housing and real estate loans to 24.6% and 69.8% respectively. Accretion to bank deposit remained buoyant mainly driven by time deposits.

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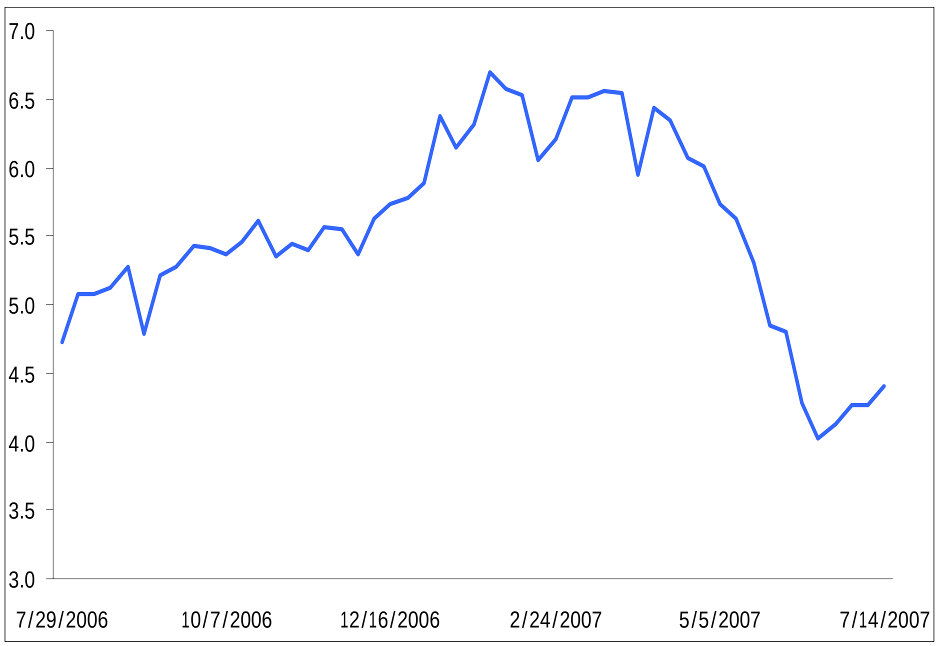
Overall, the current economic scenario seems to be quite positive and the Indian economy is expected to grow in line with RBI's expectation. Going forward, the main concerns worrying RBI Governor is inflation and growth in money supply. World over inflation remained firm during the first quarter of the current financial year, which in turn forced many central banks to tighten there monetary policy. India is no exception; in fact the monetary and fiscal policy changes made during the last quarter have paid results to an extent. Inflation based on wholesale price index has declined from 6.44% in early April to 4.41% by July 14 (refer chart 1). The RBI's annual policy has set a target to contain inflation at around 5%, considering the current rise in global crude oil prices (Brent 75.92$/BBL). With good progress of the south west monsoon and easing of supply constraints in agriculture sector, we expect inflation to hover at around 4.9% in the current financial year.

Chart 1. Inflation (%)



Source: Bloomberg

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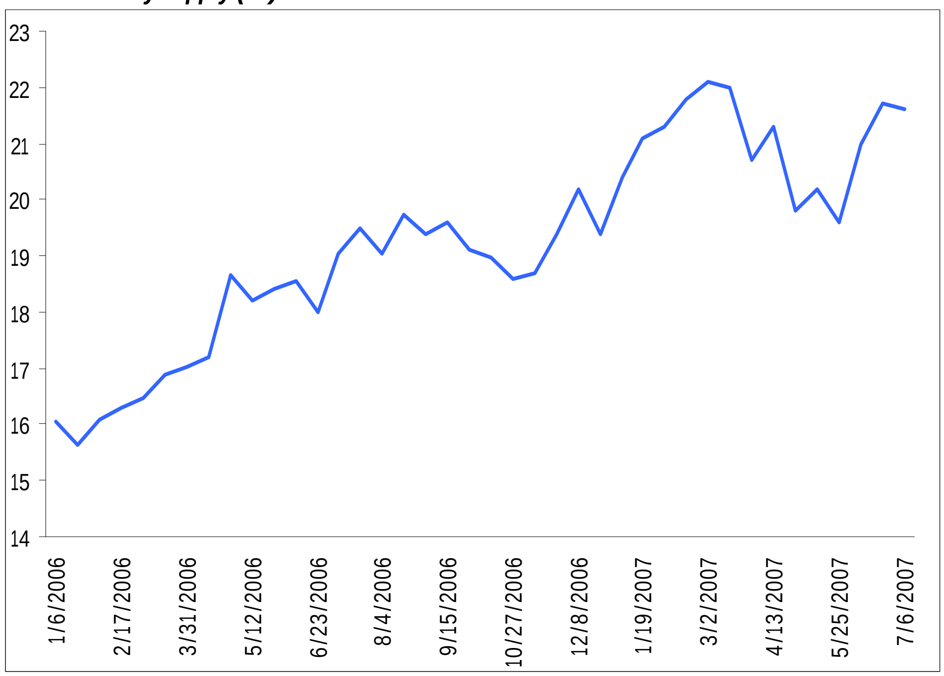
RBI's annual policy has also targeted money supply growth of about 17-17.5% for the current financial year; unfortunately money supply increased by 21.6% on YoY basis on July 6, 2007 (Refer chart 2). Reserve money increased by 29.1% YoY on July 20, 2007, while net foreign currency assets increased by Rs 296.53 bn. However, RBI is yet to attain its target. The central bank's first quarter review is in line with the current economic scenario and follows a trend adopted by various other central banks across the world. Going forward, we expect interest rates to stabilise at the current levels. We believe that the hike affected in CRR is unlikely to have a major impact on the banking sector. The incremental CD ratio of banks has dropped in Q1FY08 to 70.2 % from 96.4% a year ago. With an improvement in growth of bank deposits and slowdown in credit off-take, we expect banks to reduce deposit rates to protect NIMs.

Chart 2. Money supply (%)



Source: Bloomberg

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