Monetary policy review

RBI tightens monetary noose further

In line with its objective of controlling inflation, the Reserve Bank of India (RBI) has raised the repo rate by 50 basis points and the cash reserve ratio (CRR) by 25 basis points as against our expectations of a 25-basis-point hike in each. Following the rate hikes, both the repo rate and the CRR stand at 9%.

Key policy highlights

- The repo rate has been hiked by 50 basis points to 9% from 8.5% earlier.
- The CRR, the ratio of cash balances to be maintained by banks with the central bank, has been increased by 25 basis points to 9% (effective from August 30, 2008).
- The bank rate (the rate at which the RBI lends to commercial banks) and the reverse repo rate under the liquidity adjustment facility have been kept unchanged.
- The gross domestic product (GDP) growth forecast for FY2009 has been revised downwards from 8-8.5% to around 8.0%, barring domestic or global shocks.
- Inflation to be contained around 7% by March 2009, with a medium-term objective of a 3% inflation rate.
- Though the growth in money supply, credit offtake and deposits has moderated, the same remains well above the central bank's target levels.
- "Price stability" (anchoring inflation) remains the top priority of the RBI and the Central Bank has kept its options open to respond to any adverse development, globally and domestically, that can have a bearing on inflation and inflationary expectations.

Surveys indicate lower business confidence

The RBI's survey of manufacturing companies, carried out in June 2008, indicates some moderation in business optimism with business expectation indices (for July-September 2008) declining by 0.9% compared with the readings of the previous round of the survey. Business confidence surveys conducted by the other agencies convey a similar picture.

Organisation	Period	Index	yoy (%)	% chg since previous survey
NCAER	Apr-Sep'08	Business confidence	-1.7	-3.4
CII	Apr-Sep'08	Business confidence	-2.9	-5.3
RBI	Jul-Sep'08	Business expectations	0.8	-0.9
Dun & Bradstreet	Jul-Sep'08	Business optimism	-18	-11.2

Concerns expressed by RBI

Soaring domestic inflation

The concerns related to inflation in the domestic economy are:

- Strong evidence of pressure on the domestic aggregate demand which coupled with the slack in the supply response is exacerbating the inflation situation. Inflationary pressures in crude oil and movement in international prices of key commodities pose significant upside pressures for the domestic prices of a number of commodities.
- Though there are some signs of moderation in the key monetary and banking aggregates (money supply, deposits) in response to the RBI's ongoing monetary tightening, credit expansion continues to be buoyant and may warrant supervisory review of banks' "over-extending" credit.

Slowdown in economic growth

The intensifying financial turmoil in major financial centres of the world threatens to worsen the global macro-economic outlook as consumer and business sentiments take a beating. This along with the heightened risk averseness has increased the likelihood of a credit squeeze worldwide. Though the impact of the recent global developments on the emerging economies has been limited due to a strong local demand in these economies, the slowing of the import demand from the developed economies poses further downside risk. For India, despite the growing concerns of a slowdown, the central bank is confident of achieving an 8% growth in the GDP during FY2009 on the back of the strength in the domestic investments and consumption.

Potential external shocks

Various risks to global economic growth have either become reality or have intensified in recent months. For financial systems worldwide, though a potential crisis seems to have been averted, the current outlook remains characterised by heightened uncertainty. Consequently, the situation calls for close monitoring of the future developments in the financial markets globally and increased preparedness to combat the same.

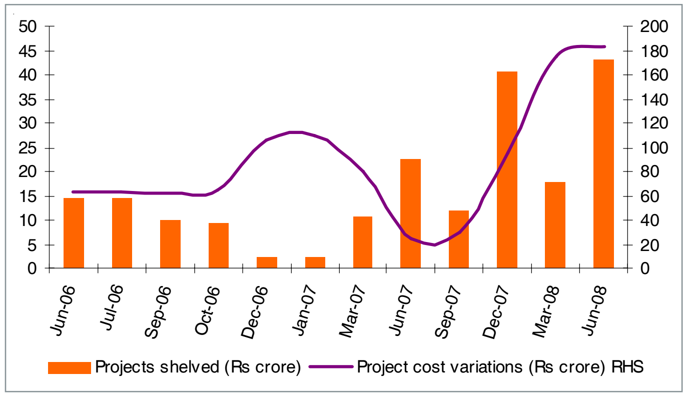
RBI's action to prompt banks to raise rates

Though the Q1FY2009 credit growth reported by major banks has been encouraging, the outlook for their future profitability and business growth remains under cloud. The banks have not been able to fully pass on the increased cost of funds to consumers which has affected their margins. The rate hikes announced today would further pressurise their margins as well as moderate their business growth. We might see some of the banks increasing their lending rates to avoid erosion of profits; however such banks would run the risk of witnessing an uptick in delinquencies. Overall, the higher than expected repo rate hike coupled with the continued "hawkishness" in the central bank's monetary stance bodes ill for the banking sector.

Higher capital costs to hurt corporate India

Considering the anticipations of more rate hikes as well as the recent hikes in the lending rates, funding capital expenditure is likely to become more expensive for corporate India. Already, the business sentiment has taken a beating owing to fears of an economic slowdown, higher working capital cost and increasing input cost. As is evident from the chart below, there has been a notable increase in projects getting shelved (in value terms), which coincides with the reported variations in project investment costs (including financing costs). Considering these factors, in FY2009, the earnings growth (for Sensex companies) is likely to be lower than the widely expected 20% and in line with our estimate of around an 18% growth.

Trend in projects shelved



Conclusion

The RBI's policy will continue to put emphasis on price stability (read *inflation control*) while ensuring an interest rate environment conducive to the maintenance of the economy's growth momentum. In specifics, the central bank expects the inflation rate to remain high at around 12% well through November 2008 and later taper off towards the targeted 7% level by March 2009. This is in line with our expectations that inflation would move down from December 2008 onwards, primarily due to the high base effect of the last year. Though the current real interest rates indicate expectations of around 100- to 125-basis-point hike in the repo rate, we anticipate additional hike of around 50-75 basis points in a phased manner by the end of CY2008.