Monetary policy preview

RBI will find it difficult to choose between one more interest rate hike and a pause in the rate hike exercise

RBI's dilemma: to hike or not to hike

We believe the Reserve Bank of India (RBI) will find it difficult to choose between *one more interest rate hike* and *a pause in the rate hike exercise* when it meets on October 31, 2006 for the mid-term review of its Annual Monetary Policy 2006-07. It would be a tough call for the apex bank for several reasons.

While the softening oil prices, the pause by the US Federal Reserve (Fed) in its interest rate hike exercise and India's wish to move to a higher growth trajectory demand a pause, the country's strong economic growth and higher inflation rate make out a case for another rate rise. Besides, with the next quarterly review of the monetary policy scheduled very close to the state elections in Uttar Pradesh and Punjab, it makes more sense for the RBI to act now rather than then.

The opinion on the streets also seems divided with the recent polls conducted amongst the capital market players and bankers showing that while some favour a pause, the others prefer a hike.

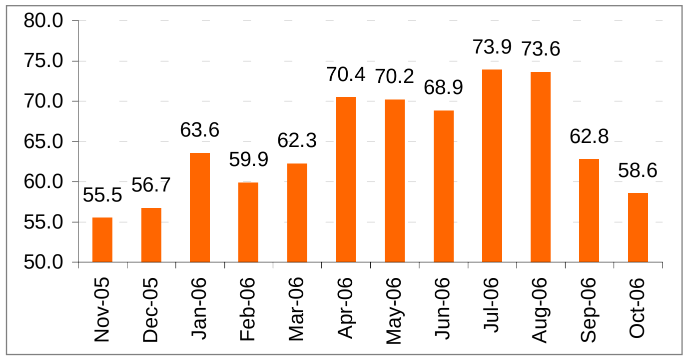
We believe that if the RBI resorts to a rate hike on October 31, it will be slightly negative for the equity markets in general and for the banking sector in particular in the short term. The short-term interest rates have already tightened over the last few weeks. In the near term, liquidity shall face more pressure, what with the October-December quarter being a festive season, when credit disbursals are high. As the longer-term yields have not moved in tandem with the short-term yields, we believe that the possibility of another rate hike has been only partly factored in by the bond market.

Global factors favour a pause

Softening oil prices

The crude oil prices have come down by 25% from their peak levels of $78.63 per barrel (bbl) in August 2006. The average Brent crude oil price for October 2006 is at $58.6 per bbl compared with that of $62.8 per bbl for September 2006 and $70+ per bbl for July and August 2006.

Brent crude oil price ($/bbl)



The RBI has recognised rising crude oil prices as one of the major threats to global as well as domestic economic growth, and the softening crude oil prices make out a case for a pause.

Fed stops its rate hike exercise

CY2006 has seen central bankers across the world tightening their interest rates and this was one of the reasons why our own apex bank went for an unexpected interest rate hike in June 2006 (see our note "RBI raises repo rates unexpectedly" dated June 09, 2006).

However, the world's largest and perhaps most influential central bank, the Fed, took a pause from its interest rate increase exercise on August 09, 2006. It has kept the target Fed fund rate unchanged at 5.25% since then.

India's wish to move to higher growth trajectory

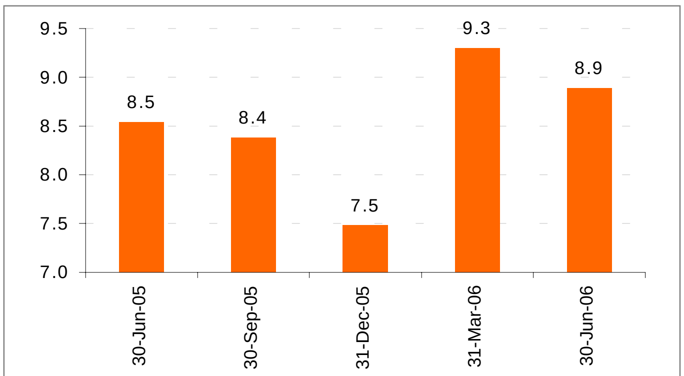
After achieving a 7.5% growth in its gross domestic product (GDP) over the last three years, India appears hungry for more. The same is evident from the Planning Commission's proposal to set the target GDP growth rate at 10% for the 11th Five-Year Plan. While the target looks ambitious, the same would require heavy investments in infrastructure (like undertaken in China) and higher interest rates would sure be an impediment to growth.

Domestic factors favour a hike

Domestic growth on a higher plane

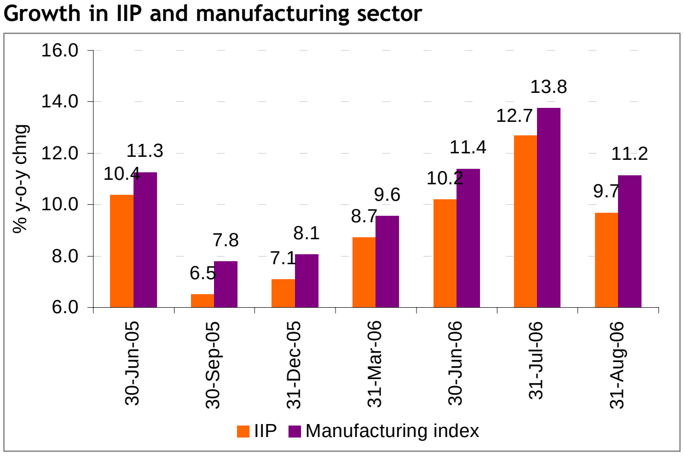
The growth in the economy is just getting better each quarter and each month. The growth in India's GDP continued unabated at 8.9% year on year (yoy) for Q1FY2007 after a robust growth of 7.9% for FY2006. The Index of Industrial Production (IIP) has seen a rise of 10.7% till August 2006 compared with an 8.7% growth in the same period last year. Amazingly, despite the floods in several parts of the country during August 2006, the IIP grew by a strong 9.7% yoy and the manufacturing sector grew at a faster clip of 11.2%.

GDP growth (% y-o-y change)



Source: MOSPI

Growth in IIP and manufacturing sector



Source: MOSPI

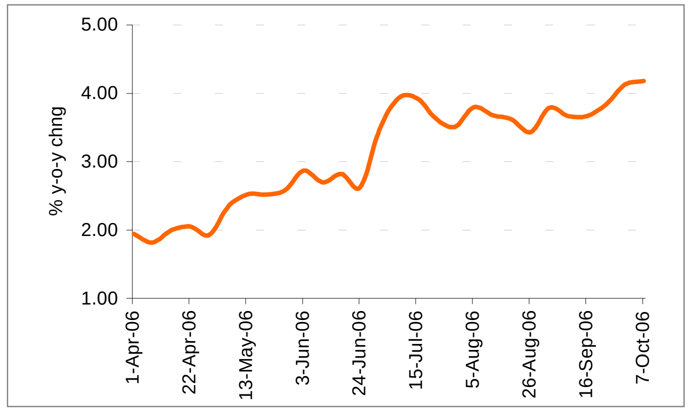
Inflation on its way up

For much part of FY2007, inflation has remained benign. However, over the past few weeks the same has moved up. All the three main components of the commodity baskets, primary articles, fuel, oil and lubricants and manufactured articles have seen an upward bias. The resulting concern is visible in the statements of the governor of the RBI:

"We are most concerned about the inflationary expectations. Unless there is a convincing reason that oil prices are easing off on a sustained basis, the inflationary expectations will not be significantly altered"

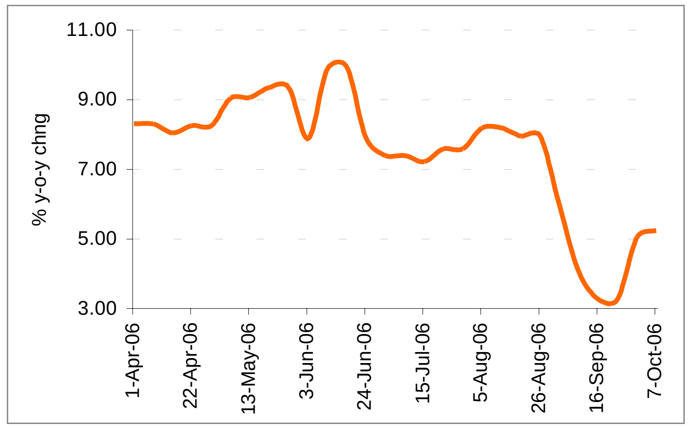
- YV Reddy, Governor, RBI

Inflation ups ante—manufactured articles



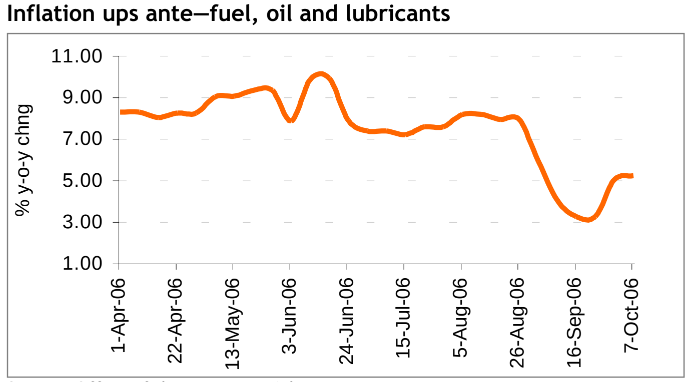
Source: Office of the Economic Adviser

Inflation ups ante—primary articles



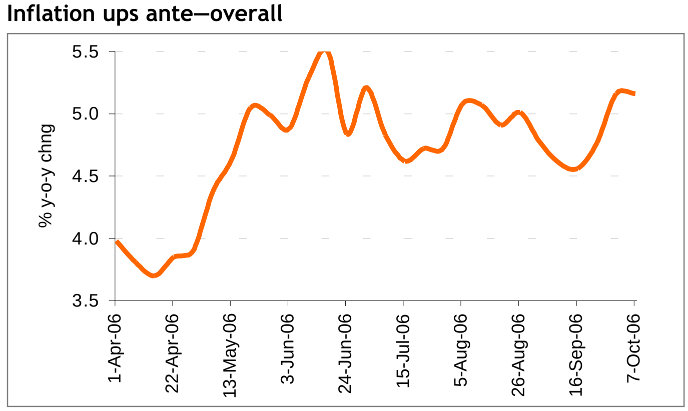
Source: Office of the Economic Adviser

Inflation ups ante—fuel, oil and lubricants



Source: Office of the Economic Adviser

Inflation ups ante—overall

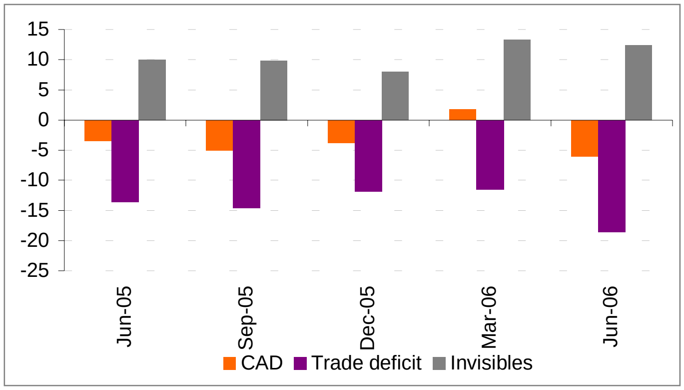


Source: Office of the Economic Adviser

Current account deficit has moved up

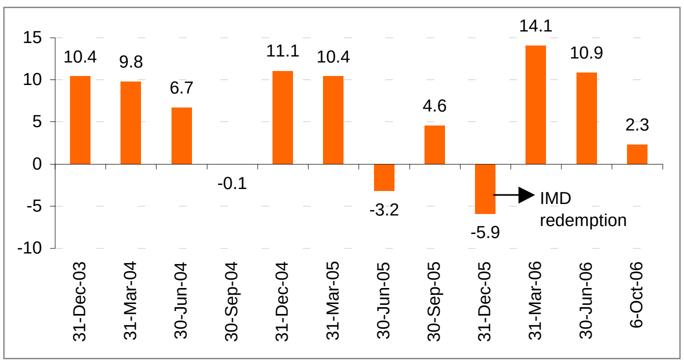
India's current account deficit widened to $6.1 billion in Q1FY2007 from $3.5 billion in Q1FY2006, far ahead of our and consensus expectations. The deterioration of the current account has more than offset the gains made on the capital account front, thereby slowing down the accretion to the foreign exchange (forex) reserves of the country.

Current account deficit widens for Q1FY2007 (US$ billion)



Source: RBI

Accretion to forex reserves slowing down (US$ bn)



Source: RBI

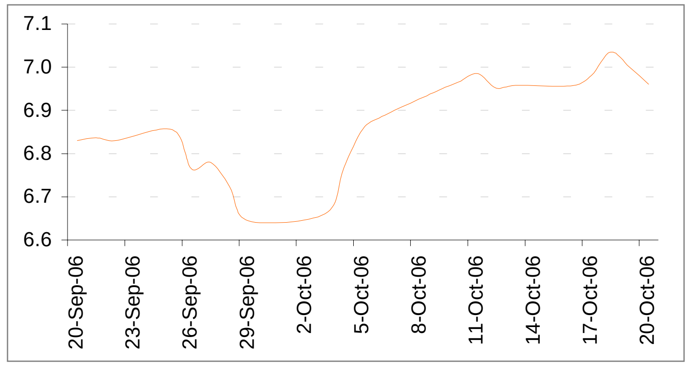
State elections may prompt a move now

State elections are lined up in several states like Uttar Pradesh, Punjab and Uttaranchal in early CY2007. The RBI's next quarterly review of the Annual Monetary Policy 2006-07 is scheduled on January 30, 2007 which would be very near to the election dates. For obvious reasons the central government would want the RBI to make a move now rather than during the elections.

Yields up but rise may be seasonal

The short-term bond yields have already moved up by 31 basis points from their recent bottom of 6.645% on September 29, 2006.

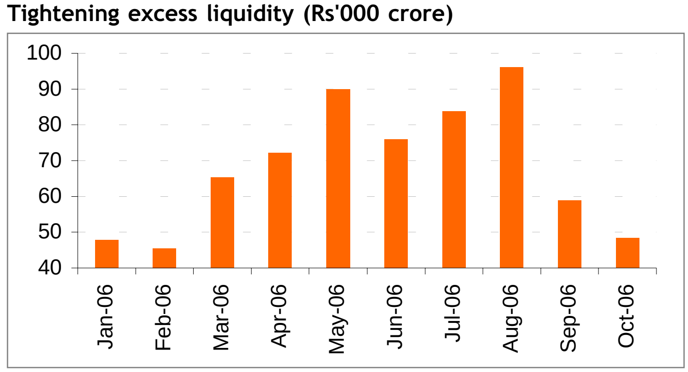
Short-term yields moving up—one-yr bond yield (%)



Source: Bloomberg

The yields may have increased partly because the bond market participants are likely to have started factoring in another rate hike. However the other reason could be that traditionally yields tend to tighten during festive seasons like *Diwali* and Christmas when loan disbursals are higher and liquidity tight. The excess liquidity in the system has come down dramatically, thereby exerting pressure on the short-term interest rates. As the longer-term interest rates haven't moved up much in tandem, another rate hike seems to have been factored in by the bond market only in part.

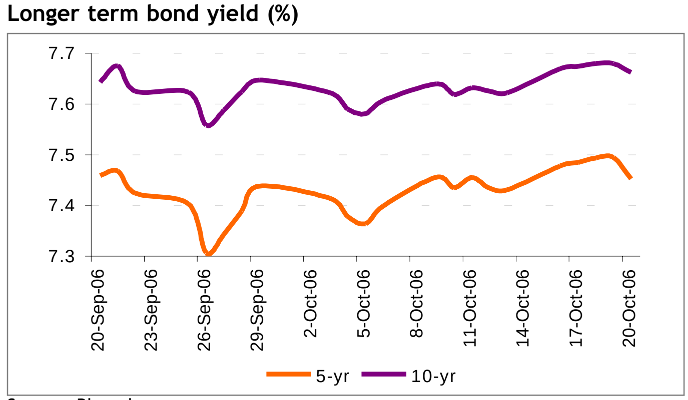
Tightening excess liquidity (Rs'000 crore)



Source: RBI

Note: Excess liquidity includes the central government balances, market stabilisation bonds and balances under liquidity adjustment facility.

Longer term bond yield (%)



Source: Bloomberg

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