Monetary policy preview

RBI expected to maintain the status quo

We expect the Reserve Bank of India (RBI) to keep the policy rates unchanged during its upcoming second quarter credit policy review meet. With inflation around 3% and annual credit growth moderating to 22%, the RBI is much more comfortably placed than it was in the previous couple of quarters. Although the Wholesale Price Index (WPI) has steadily declined mainly due to a base effect, yet the Consumer Price Index (CPI) rules above 7%. This, and high crude and other international commodity prices would decrease the odds of a rate cut due to persisting inflationary pressures. The challenge for the RBI will remain the management of domestic liquidity and currency, which is also expected to be the priority and focus area of the policy. Thus, with a slowdown in some of the lead indicators (credit growth, exports and consumer demand), the central bank's stance is expected to moderate to neutral from hawkish while the policy rates are likely to remain steady. The market also seems to be unanimously agreeing that the status quo on the policy rates (reverse repo and repo) would be preserved. However, there exists a 33% chance that the cash reserve ratio (CRR) may be increased by 50 basis points in the upcoming policy review, as per market estimates.

Focus likely to remain on liquidity and currency management

Currently, liquidity in the system remains high and with strong foreign inflows the market expects a 33% chance of another 50-basis-point hike in the CRR. We expect the RBI to hold the CRR steady and wait to see how the Securities and Exchange Board of India's (Sebi) latest move to curb the issue of new participatory notes (PNs) controls the incremental capital inflows. If the desired results are achieved and the money supply growth starts to moderate, then the RBI may consider a reduction in the CRR going forward, so that adequate liquidity prevails to meet the credit demand.

Other routes for capital inflows could be targeted

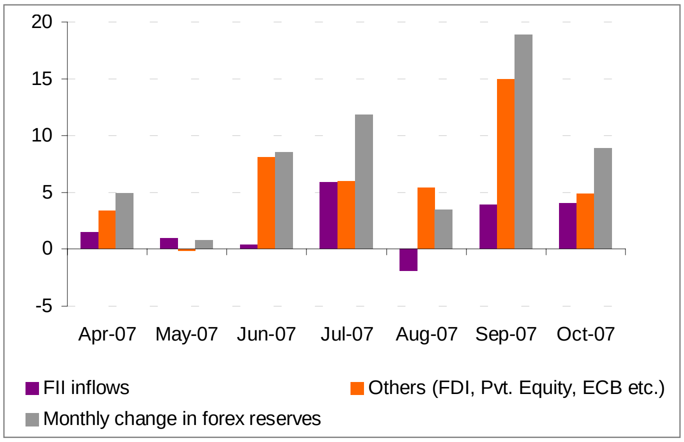
The finance minister has said that the rupee is not in a comfort zone and adequate measures would be taken to control the sharp appreciation in the rupee. In this regard we have seen the RBI curbing the amount of external commercial borrowings (ECBs) made by Indian companies. Recently, Sebi has put restrictions on foreign inflows via the PN route. Our foreign exchange (forex) reserves have

RBI's dilemma not made easy with contrasting signals from various factors

Factors	Status of various factors and likely influence on RBI's policy decision
Inflation	WPI has steadily declined to 3% mainly due to a high base effect, but CPI is above 7%, hence rate cuts may not be on the cards.
Crude oil prices and other international commodity prices	Continues to rule firm above $90 barrel, a serious concern highlighted by RBI time and again. A significant risk for higher inflation.
Credit growth	Moderated from above 31% to 22%, hence bias for a softer interest rate regime is building up.
Production growth (IIP)	Has moderated from highs of 15% to 10%, could be affected further if interest rates don't soften.
Liquidity	High liquidity available in the domestic market continues to be a concern, likely to remain the focus area of policy review.
Money supply	Continues to remain at 21% plus, much above RBI's comfort zone of 17.5%, could witness further liberalisation in capital outflows.
Global cues	Fed futures indicate another possible 25-basis-point cut in the meeting scheduled on October 31, 2007. Other global central banks have also held rates steady. Thus RBI cannot keep raising the domestic interest rates and sooner or later we need to realign our rates with global interest rates.

jumped from $200 billion to $257 billion in a span of almost seven months (April to October 2007). However, the foreign institutional investor (FII) inflows during this period amounted to almost $15 billion. The remaining $42 billion comprises mainly foreign direct investments (FDIs), private equity inflows and ECBs. With the ECB and FII routes already witnessing some restrictions, it could be the other segments like FDI and private equity that could be under the scanner, especially the FDI in the real estate sector.

Monthly trend in forex reserves ($ billion)



Source: SEBI, Bloomberg, RBI & Sharekhan Research

Further liberalisation in capital outflows could also be on the cards

The RBI has been recently encouraging more capital outflows by all entities, be it individuals, mutual funds or Indian corporates. We could expect some more liberalisation on these fronts so that the pressure on the appreciation in the rupee is tackled from all fronts.

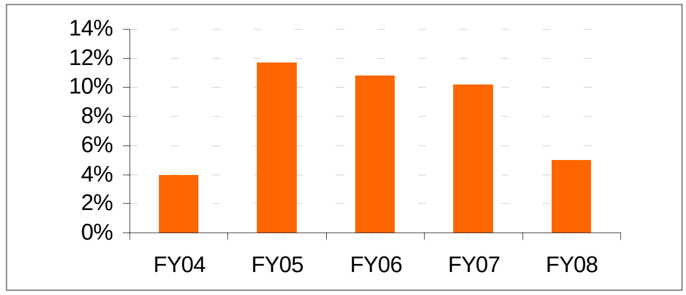
High crude and asset prices remain a key risk to inflation

We expect the RBI to stress on the current high prices of crude and other commodity globally, which continue to remain a key risk for higher inflation. Crude prices have breached the $90-per-barrel mark. If fuel prices are revised upwards, the same could significantly alter the WPI numbers going forward, once the high base effect starts to wane. This, we feel, is one of the main concerns for the RBI.

RBI likely to take cognisance of a possibility of a slowdown

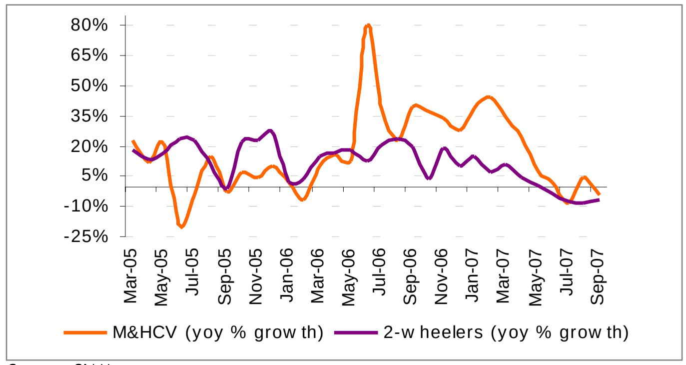
Our domestic interest rate cycle has peaked and globally major central banks are either withholding policy rate hikes (European Central Bank and Bank of England) or beginning to cut rates (US Federal Reserve [Fed]). Fed futures are pointing to a further 25-basis-point rate cut. With inflation around 3%, we feel that the RBI would now take cognisance of the fact that due to its strict monetary tightening measures, domestic growth could have been jeopardised.

Year-to-date credit growth remains low



Source: RBI

Auto sales have slowed down considerably



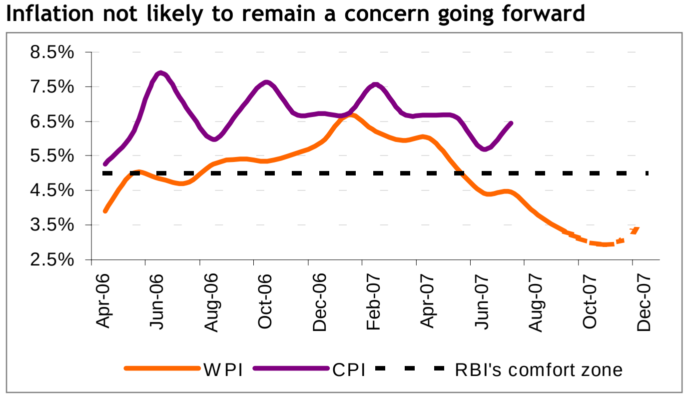
Source: SIAM

Is RBI likely to cut rates?

We feel that the interest rates have peaked out, however the chances of a rate cut immediately look dim due to the following reasons.

1. *Inflation:* Even though the WPI is around 3% and well below the RBI's comfort zone of 5%, the CPI is at 7.3%. The RBI would also like to bring down the CPI before it starts cutting the interest rates. Oil prices are hovering above $90 per barrel which remains a cause for concern, as a pass-through of the higher oil prices would increase inflation, which has only come down due to the higher base effect of the last year. The week-on-week inflation is still on the uptrend. We don't expect inflation numbers to be a concern for the RBI in the medium term, if we strictly go by the weekly numbers reported by the authorities.

Inflation not likely to remain a concern going forward



Source: MOSPI

2. *Money supply:* Money supply is still growing at 21% year on year (above the RBI's target of 17.5%) and continues to remain a concern with the possibility of foreign inflows remaining strong.

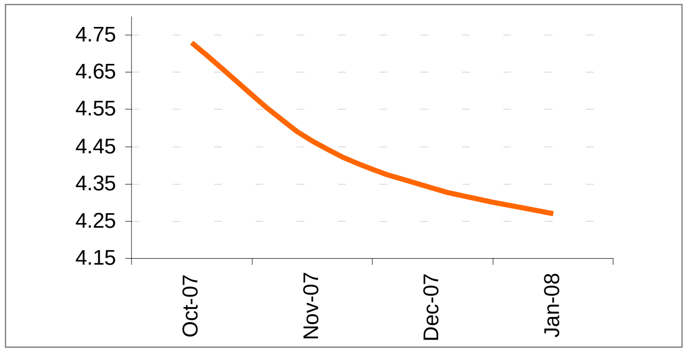
Monetary stance likely to shift to a neutral mode

Hence, we feel the RBI is likely to change its much hawkish stance to a more neutral stance and then start to focus on growth once again in its upcoming policy review meet scheduled at end October 2007. With regard to interest rates, we feel the market rates could soften (despite no change in policy rates or reserve requirements) once the banking industry gains comfort from (1) the RBI's neutral stance; (2) the high cost deposits run off the banks books; and (3) deposit growth remains above credit growth. In such a scenario bankers may consider to reduce rates and provide a boost to credit growth, which should also help banks to protect their margins, as a falling credit/deposit ratio is not margin accretive for banks.

Global interest rate scenario makes case for a neutral stance

Our domestic interest rate cycle has peaked and globally major central banks are either withholding policy rate hikes (European Central Bank and Bank of England) or beginning to cut rates (Fed). The Fed has cut rates by 50 basis points in mid September and Fed futures indicate another possible 25-basis-point cut in the meeting scheduled on October 31, 2007. Thus the RBI cannot keep raising the domestic interest rates and sooner or later it needs to realign our rates with global interest rates. Otherwise, the arbitrage possibilities will exist and the rupee would continue to appreciate, making liquidity management more difficult for the RBI.

Fed futures indicate rate cuts ahead



Source: Bloomberg

Conclusion

We expect the key takeaway of the policy meet to be the RBI's stance on liquidity and currency management going forward, as policy rates are expected to be held steady. The RBI is likely to sound cautious notes on various global factors and risks to domestic inflation. The policy stance is likely to shift from hawkish to neutral. We could also see further liberalisation in capital outflows to ease the pressure on the rupee. However, curbs on FDI or private equity in real estate cannot be ruled out. We don't expect another CRR hike (market estimates suggest a 33% chance of a further 50-basis-point hike in CRR). We don't expect such a hike because currently the RBI has around Rs48,000 crore of headroom left under the Market Stabilisation Scheme. The credit demand is normally high in the second half and after Sebi's latest curbs on PNs we feel the RBI would definitely take some time to see the trend in the incremental FII money before it chooses to take any step to control domestic liquidity. Hence, the status quo on the CRR front could be a mild positive for the markets.