Monetary Policy Review 2009-10 – Q3 FY10

After a prolonged period of accommodative monetary policy stance, RBI today in its third quarter monetary policy review increased the CRR ratio by 75bps (against our and street expectations of 50bps) to 5.75%. It, however, left the key policy rates unchanged - Repo rate (4.75%), reverse repo rate (3.25%) and bank rate (6%). With rising risk of high inflation and anemic credit demand, the central bank has now shifted its stance from 'managing the crisis' to 'managing the recovery'. Despite huge sanctions, the credit growth has remained at low 14% yoy until mid-January. The apex bank, has thereby, reduced its non-food credit growth target to 16% yoy (previously 18% yoy). The deposit growth projection too has been scaled down to 17% from 18% earlier. Further, money supply (M3) growth rate has been lowered to 16.5% (previously 17%). With both WPI and CPI ruling pretty high, the central bank has raised its annual inflation outlook to 8.5% (previously 6.5%). The reserve bank has completed over 98% of its hefty net market borrowing programme of the central government for FY10, largely being front-loaded. Even after factoring in zero growth in agricultural sector, the central bank has projected a GDP growth of 7.5% for 2009-10 (earlier 6%+ with upward bias), implying meaningful growth in coming quarters.

Main policy highlights

- With improving economic environment as reflected in higher industrial production, infrastructure and yoy growth in exports, the central bank revised its real GDP growth target to 7.5% from earlier 6%+ with an upward bias. The growth in real GDP during Q2 at 7.9% was driven by revival in industrial growth and pick-up in service sector and arrears of payment from Sixth pay commission. The growth in Q3 GDP, however, is expected to come in lower than the previous quarter (Q2) largely due impact of deficient monsoon dragging the agricultural output. This, however, would more likely be off-set by better prospectus of rabi crop. Even after factoring zero growth in agricultural sector for the current year, the central bank has projected a GDP growth of 7.5%, implying meaningful growth in coming quarters.

- Further, IMF too has reduced its projected rate of economic contraction from 1.1% earlier to 0.8% now. It has also revised its GDP estimates for the world economy upward; and now expects it to expand by 3.9% in 2010, from earlier 3.1%. It expects the India GDP to grow by 5.6% in 2009, (earlier 5.4%) and by higher 7.7% (6.4% in 2010).

- WPI inflation continues to remain at elevated levels and was up 7.3% for the month of December, 2009. While the current rise in inflation has largely been a supply-side constrain, the reserve bank expects, inflation to moderate by July,2010. As against projected inflation target of 6.5% (with upward bias) until the second quarter monetary policy review, the reserve bank today increased its outlook to 8.5% largely on expectations of increase in commodity prices and demand-supply mismatch. However, the apex, needs to ensure price stability and anchor inflation expectations.

- With tepid credit demand, the central bank comfortably completed over 98% of its hefty net market borrowing programme. The front-loading of the borrowing programme had a minimal impact on credit growth and with excess liquidity in the system; we expect credit growth to remain healthy in coming period. Accordingly, money supply (M3) growth target has been reduced to 16.5% (previously 17%).

- The easy availability of non-bank source of funds, delay in capex plans by the corporates, stimulus package and muted demand from OMC, have all contributed towards lower credit demand. The system credit growth which had attained a peak of ~29% yoy as at October 2008 has now moderated to ~14% levels. The system credit as at mid-January remained at low 14% yoy levels. Following this, the central bank since the beginning of the year, has been lowering its credit growth target. During the third quarter monetary policy, the apex bank toned down its non-food credit growth target to 16% as against previous 18% levels. Deposit growth target too has been reduced to 17% levels.

- While the central bank refrained from withdrawing its accommodative monetary policy, it increased the cash reserve ratio (CRR) by 75bps to 5.75% (much ahead of our expectations of 50bps). The increase would be implemented in two stages. 50bps reduction w.e.f 13th Feb, 2010 and another 25bps effective from 27th Feb, 2010. While the increase in CRR is expected to anchor inflation expectations, this increase will drain away over Rs360bn of funds from the system. Bankers expect minimal impact of this rate hike, as they have been parking surplus funds under the reverse repo window. According to data available, banks have been parking an average of over Rs1,090bn under LAF window during the year. In our view, bankers are unlikely to increase their lending rate in near future, although an increase in deposit rate cannot be ruled out. The apex bank, however, left its key policy rates unchanged with repo rate at 4.75%, reverse repo rate at 3.25% and bank rate to 6%.

The third quarter monetary policy stance broadly highlighted:

- Anchor inflation expectations and keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments as warranted.

- Actively manage liquidity to ensure that credit demands of productive sectors are adequately met consistent with price stability.

- Maintain an interest rate environment consistent with price stability and financial stability, and in support of the growth process.

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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