



ICRA Comments on the RBI's First Quarter Review of Monetary Policy for FY 2010-11

Contact:

Karthik Srinivasan
karthiks@icraindia.com
+91-22-30470028

Vibha Batra
vibha@icraindia.com
+91-124-4545302

Aditi Nayar
aditin@icraindia.com
+91-124-4545385

Nikhil Rungta
nikhilr@icraindia.com
+91-22-30470020

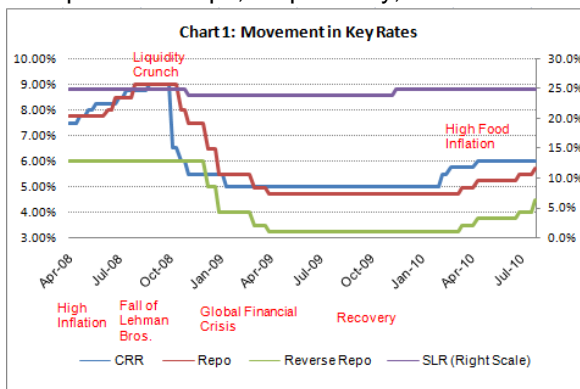
Highlights of the RBI's First Quarter Review of Monetary Policy for FY10-11 – July 2010

- Benchmark Repo rates hiked by 25 bps to 5.75% with immediate effect.
- Benchmark Reverse Repo rates hiked by 50 bps to 4.50% with immediate effect.
- The interest rate corridor between the Repo and Reverse Repo window reduced to 125 bps from 150 bps.
- CRR, SLR and Bank rate kept unchanged at 6%, 25% and 6%, respectively.
- Baseline inflation projection for March 2010 increased to 6% from 5.5%.
- Baseline estimate for GDP growth for 2010-11 revised to 8.5% from 8%.
- Bank deposit growth target of 18% maintained for FY2010-11; Bank deposit growth stood at 15.0% year-on-year as on July 2, 2010.
- Bank credit growth target of 20% maintained for FY2010-11; Bank credit growth stood at 22.3% year-on-year as on July 2, 2010.
- RBI to undertake mid-quarter policy reviews starting September 2010.

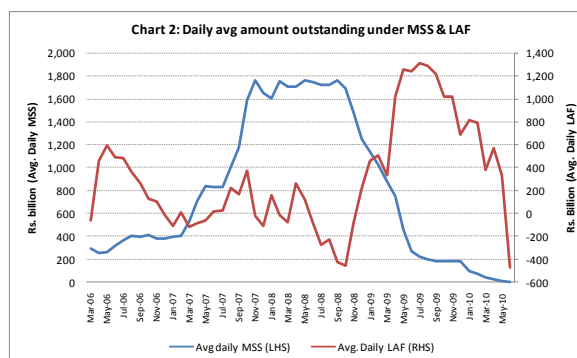
Website:
www.icra.in

RBI continues with monetary tightening: Repo hiked by 25 basis points while Reverse Repo hiked by 50 basis points

Continued concerns on the wholesale and consumer price inflation indicators prompted the RBI to increase the Repo and the Reverse Repo rates by 25 bps and 50 bps, respectively, while the Central Bank has maintained the CRR at this instance. RBI has periodically hiked rates since October 2009, cumulatively raising the CRR by 100 bps and the Repo and Reverse Repo rates under the Liquidity Adjustment Facility (LAF) by 100 and 125 basis points respectively (including the current hike). We believe that these actions reiterate RBI's stance on curbing inflation and anchoring inflationary expectations. At the same time, the corridor between the Repo and Reverse Repo rates that was at 150 bps since November 2008, has now been reduced to 125 bps, which should help in reducing the volatility in the short term interest rates.



The liquidity conditions changed significantly during the first quarter of FY 2010-11. The average daily absorption under the LAF increased to Rs. 572 billion in April 2010 from Rs. 376 billion in March 2010. However, surplus liquidity started to decline subsequent to the increase in various policy rates instituted by the RBI in the April policy. The LAF changed to injection mode from May 31, 2010 following a sharp increase in Government balances with the Reserve Bank, on account of higher than anticipated mobilisation under the 3G and broadband (3G/BWA) spectrum auctions besides the first installment of advance tax.



Policy Stance Shifted to Containing Inflation and Anchoring Inflationary Expectations

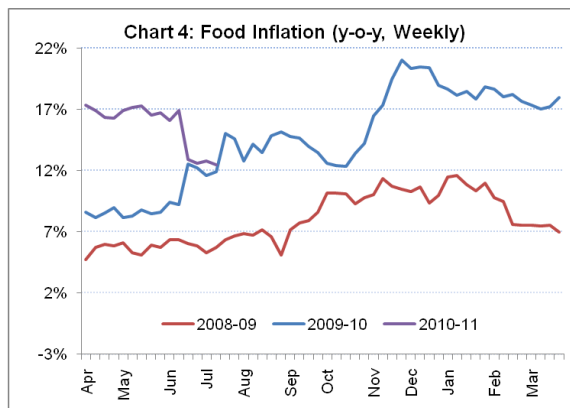
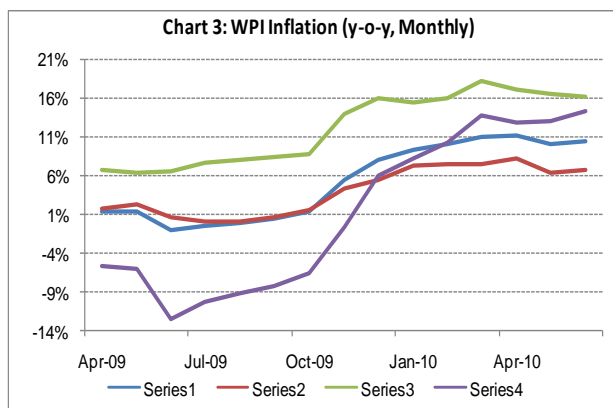
In conjunction with the sustained and strengthening domestic economic recovery and improved prospects of Indian economic growth in the ongoing fiscal, concerns raised by the persistently high wholesale and consumer price inflation have moved on to the forefront. The RBI has articulated a clear shift in its policy stance “to containing inflation and anchoring inflationary expectations” by reining in demand pressures and inflationary expectations.

Baseline Inflation Projection Revised to 6% for March 2011

The RBI has revised its baseline projection for headline wholesale price index (WPI) inflation for March 2011 to 6%, higher than the projection of 5.5% specified previously in April 2010. WPI inflation has remained in double digits for five consecutive months. In particular, non-food inflation has firmed up considerably in the last few months and emerged as a chief area of concern on the inflation front. Although food price inflation has declined somewhat in recent weeks, it still remains elevated. The second order effects of higher petroleum prices are expected to increase inflation further in the near term. The RBI has cited the emergence of demand side inflationary pressures, the return of pricing power to producers in the light of nascent capacity constraints and elevated inflationary expectations as key concerns regarding the inflationary outlook in India.

Despite monsoon rainfall so far in 2010 being below the long-period average, the volume of rainfall has exceeded that received in the preceding year and with the resultant expansion in the sown area, the RBI expects a favourable agricultural performance in 2010 to cool food price inflation. With mixed signals regarding the pace and sustainability of the global economic recovery, a decline in commodity prices and cheaper imports following idle capacity worldwide would also dampen inflationary pressures.

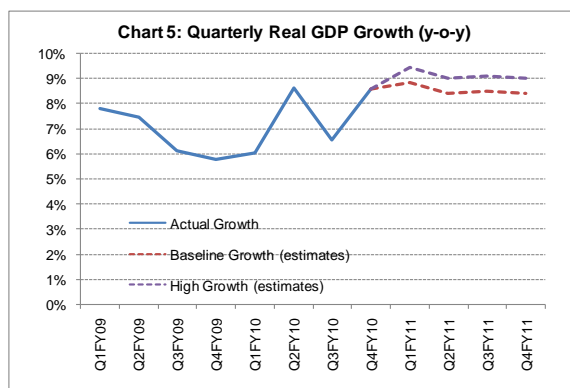
The RBI maintained its stance to condition and contain perception of inflation around 4.0-4.5% with a medium-term objective of 3.0% inflation, which would be consistent with India's integration into the global economy.



RBI's policy changes are likely to have a limited impact on food and fuel inflation, which would be determined by the *kharif* harvest and international crude oil prices, although the measured steps being taken by the RBI are expected to dampen inflationary expectations to an extent. Nevertheless, the RBI is likely to undertake further monetary tightening at regular intervals to arrest inflationary expectations.

Baseline Estimate for Real GDP Growth Revised to 8.5%

The RBI has revised its baseline estimate for real growth for the Indian economy for 2010-11 to 8.5% from 8% with an upside bias, which was indicated during April 2010, emphasising that the Indian economy is returning to the growth trajectory witnessed before the onset of the global economic crisis. The RBI's modified forecast is in line with ICRA's expectations for real economic growth for 2010-11. The Central Bank has revised its forecast principally drawing from the robust industrial production scenario as highlighted by the IIP data, and its knock-on effect on services output in the country. A favourable agricultural performance in 2010 in line with RBI's expectations, would boost rural incomes and demand and augment domestic consumer demand. In addition to the consolidation and broadening of the Indian economic recovery, the RBI has highlighted the uncertainty regarding global economic prospects, emphasising both the divergence in growth prospects of advanced and emerging economies as well as a likely slowdown in global growth momentum in the second half of the current calendar year.

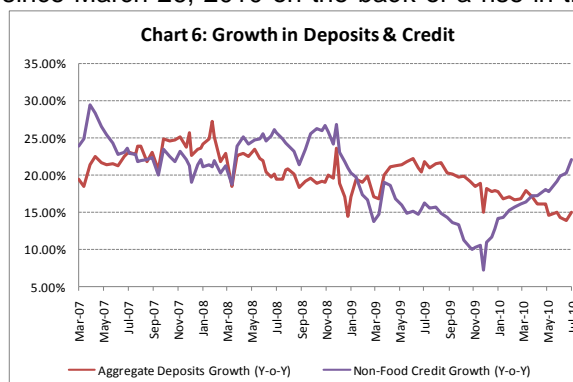


In conjunction with the upward revision in the forecast of economic growth, the RBI has articulated certain concerns regarding the strength of Indian economic growth over the course of the year through its Review of Monetary Policy and Macroeconomic and Monetary Developments for the First Quarter of 2010-11. These concerns arise on account of domestic inflationary conditions and an uncertain external growth environment. The RBI has highlighted that in addition to dampening the pace of export-led manufacturing growth, a weaker global economic outlook may raise global risk aversion which would constrict the volume of capital flows into India. Nonetheless, the RBI has also emphasised that the reverse scenario remains a possibility; considerably higher growth prospects of emerging economies may attract an enhanced magnitude of capital flows, the risks associated with which would complicate the setting of monetary policy and exchange rate management.

The RBI's modified forecast is in line with ICRA expectations for real economic growth for 2010-11. On balance, we expect that the economic recovery is likely to remain robust in the ongoing fiscal year, while some moderation in the pace of industrial growth reflecting the base effect is likely to result in a sequential moderation of the overall economic growth momentum over the coming quarters.

Credit growth picks up while deposit growth decelerates in Q1 FY10-11...

The deposit base of the Indian banking system grew by 15% on a y-o-y basis and stood at Rs. 46.33 trillion as on July 2, 2010 (3.26% growth over March 26, 2010). In absolute terms, the size of the deposit base increased by around Rs. 1.46 trillion since March 26, 2010 on the back of a rise in the term deposit base, though the low-cost CASA base has reported a decline. We believe that the decline in CASA could be on account of Corporates withdrawing their surplus Bank funds to partly meet their capex or working capital requirements. Also we believe that given the excess liquidity, the banking system did not push the mobilisation of deposits in the first quarter. Given the large volume of undisbursed sanctions, which is expected to drain any excess liquidity over the coming months, we expect Banks to increase their steps to ensure a healthy deposit growth. Consequently, we maintain our earlier estimates of a 17-19% growth in deposit base of the banking system during FY10-11 as we expect investors to continue with their preference for relatively “safe” Bank deposits, aided by higher rates on Bank deposits going forward, as more Banks raise deposit rates over the course of the year.



After the last three years of muted credit growth in the first quarter of the financial year, credit off-take has been robust in the current year till July 2, 2010. The total non-food credit extended by the Indian banking system grew by 22.14% year on year basis and stood at Rs. 33.48 trillion as on July 2, 2010 (4.89% growth over March 26, 2010 levels). Anecdotal evidence suggests that the credit growth has been largely driven by lending to infrastructure segment (primarily led to the telecom companies for 3G/BWA disbursements amounting to Rs. 1.06 trillion) and Corporate working capital requirements. While the credit growth by public sector banks led to the overall rise in the credit growth, the growth for private sector banks also improved to 21.7% y-o-y while for the foreign banks it stood at 12.8%. ICRA maintains its expectations of an 18-20% credit growth during FY10-11 on the back of a large undisbursed pipeline of sanctions and an improving macroeconomic scenario. However, in the short term, with most Banks indicating a Base Rate in the range of 6.75%-8.75%, we believe that better rated Corporates may partly move to alternate sources such as commercial paper and short term debentures for their working capital requirements, which may restrict the systemic growth in credit.

An analysis of the sectoral deployment of credit reveals that for the 12-month period ending May 21, 2010, the credit growth was driven by lending to infrastructure, food processing, paper & paper products, petroleum and iron & steel segments. Within the individual loans category, the credit card portfolio witnessed a steep decline of 27% during the aforementioned period, suggesting a reduced tolerance of Banks toward unsecured lending. Real estate loans have witnessed a marginal growth of 1.2%, while housing loans have increased by 10% during the same period. The other sectors such as Textiles, Rubber & plastics, Other metals and Construction etc. continue to report robust growth.

With a rise in credit off-take since the last quarter of FY09-10 and in first quarter of FY10-11, the Credit to Deposit (CD) ratio of the banking system improved to over 73% as on July 2, 2010 from 72% as on March 26, 2010 and from under 70% in early December 2009. The incremental CD ratio has been in excess of 106% so far during the current financial year. The excess SLR, estimated at nearly Rs. 3 trillion as on end March 2010 declined to around Rs. 2.2 trillion as on July 2, 2010, as Banks pared their investments to meet credit growth while managing their liquidity needs.

RBI to undertake mid-quarter policy reviews...

RBI has indicated that it shall undertake mid-quarter reviews at intervals of around one and half months after each quarterly review, with an intention to communicate its evaluation of the prevailing macroeconomic conditions with greater frequency to market participants. The policy document highlighted that the Central Bank has taken off-cycle policy actions a number of times in the last few years, in response to the rapidly changing global and domestic economic scenario. These mid-cycle reviews, which will take place in the months of June, September, December and March, would reduce the need for ad-hoc measures and are a welcome proposal.

Overall Comment

By raising the repo rate and simultaneously narrowing the interest corridor via a higher reverse repo, the Reserve Bank of India (RBI) has sought to address the rising concerns over inflation and better manage volatility in short-term interest rates. The unchanged cash reserve ratio (CRR) possibly points to the RBI's keenness at ensuring adequate liquidity in the economy.

While the increase in the repo rate may push up interest rates in general, such an increase may not slow down the pace of corporate investments, given that the likely increase in domestic demand would also improve corporate capacity to absorb increases in interest costs. The repo rate on its part is likely to remain the operative rate in the light of the expected tightness in liquidity, given the strong demand for funds from the commercial sector, large government borrowings, and the relatively low rate of growth in deposits.

As for the inflation trajectory, this would be influenced largely by domestic demand, the performance of the monsoons and the behaviour of fuel prices. However, the demand for funds from the commercial sector is likely to remain high, considering the high growth potential of the economy. Therefore, the RBI would have to do a tightrope walk during the rest of the year managing inflationary expectations and ensuring adequate liquidity at reasonable cost for future capacity creation.

We welcome the RBI's decision to undertake mid-quarter reviews as this reduces the need for ad hoc measures.



ICRA Limited

An Associate of Moody's Investors Service

CORPORATE OFFICE

Building No. 8, 2nd Floor, Tower A; DLF Cyber City, Phase II; Gurgaon 122 002
Tel: +91 124 4545300; Fax: +91 124 4545350
Email: info@icraindia.com, Website: www.icra.in

REGISTERED OFFICE

1105, Kailash Building, 11th Floor; 26 Kasturba Gandhi Marg; New Delhi 110001
Tel: +91 11 23357940-50; Fax: +91 11 23357014

Branches: **Mumbai:** Tel.: + (91 22) 24331046/53/62/74/86/87, Fax: + (91 22) 2433 1390 □ **Chennai:** Tel + (91 44) 2434 0043/9659/8080, 2433 0724/ 3293/3294, Fax + (91 44) 2434 3663 □ **Kolkata:** Tel + (91 33) 2287 8839 /2287 6617/ 2283 1411/ 2280 0008, Fax + (91 33) 2287 0728 □ **Bangalore:** Tel + (91 80) 2559 7401/4049 Fax + (91 80) 559 4065 □ **Ahmedabad:** Tel + (91 79) 2658 4924/5049/2008, Fax + (91 79) 2658 4924 □ **Hyderabad:** Tel +(91 40) 2373 5061/7251, Fax + (91 40) 2373 5152 □ **Pune:** Tel + (91 20) 2552 0194/95/96, Fax + (91 20) 553 9231

© Copyright, 2010, ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable. Although reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.