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## First quarter review of Monetary Policy 2006-07

### Highlights

- RBI increases reverse repo rate to 6.0 per cent and repo rate to 7.0 per cent.
- Bank rate and Cash Reserve Ratio kept unchanged at 6 per cent and 5 per cent, respectively.
- GDP growth projection for 2006-07 retained at 7.5-8.0 per cent.
- Inflation projection for 2005-06 unchanged at 5.0-5.5 per cent. Money supply, deposit and credit growth above the indicative projections, warranting caution.
- Monetary aggregates, non-food credit continues to expand at high rates on a year-to-year basis.
- Looking ahead, the overall stance of the policy will be:
  - To ensure a monetary and interest rate environment that enables continuation of the growth momentum, while emphasising price stability with a view to anchoring inflation expectations.
  - To reinforce the focus on credit quality and financial market conditions in order to support export as well as investment demand in the economy for maintaining macroeconomic and, in particular, financial stability.
  - To consider measures as appropriate to the evolving global and domestic circumstances impinging on inflation expectations and the growth momentum.

## In search of the neutral rate

For the last few quarters, the Reserve Bank of India (RBI) has maintained a growth outlook of 7.5-8.0 per cent and an inflation outlook of 5.0-5.5 per cent. In the said period, it has increased the benchmark reverse repo rate a number of times. One way to interpret this is that it believed that the rate that prevailed before the policy announcement was inconsistent with the growth and inflation outlook that it had. Obviously, the fact that the rate was raised each time implied that the RBI thought it was too low and could push either growth, or inflation, or both outside the upper bound of the range. Persistent increases suggest that it did not believe it had found the “right” rate.

The “right” rate is what we refer to as the neutral rate. It is best defined as the rate that is most consistent with an acceptable and sustainable combination of growth and inflation. Is 6 per cent the neutral rate? The RBI’s announcement suggests that it just might be. The announcement indicates that there should be no further expectation of unidirectional changes in the reverse repo rate. That does not, of course, imply that it will not change in the October announcement, or, for that matter, between now and then. What it does mean is that, from now on, the change can be in either direction of the neutral rate, if circumstances so warrant.

What circumstances would warrant a change? In the growth-inflation framework, clearly, a reduction in the growth rate below 7.5 per cent or a fall in the inflation rate below 5 per cent could induce a reduction in the reverse repo rate. Conversely, an increase beyond the upper bounds of the ranges, as has consistently happened over the last few quarters, could provoke further increases. By October, besides the weekly inflation numbers until then, we shall have the quick estimates for first quarter GDP and the April-August numbers for the Index of Industrial Production. Their magnitudes will determine whether the RBI stays put or moves, either up or down.

Over the last few quarters, we have been consistently arguing against a rate hike. Posed in the context of the neutral rate benchmark, this argument was essentially founded on the perception that a sustainable growth-inflation configuration could have been achieved at a higher rate of growth, which would be consistent with a lower interest rate. Both the range of sustainability and the neutral rate that is consistent with that range are, of course, matters of judgment. That apart, the position of the RBI in its latest announcement brings a welcome dose of transparency to its decisions and the rationale underlying them. Even though it has not explicitly committed to either the notion or the level of a neutral rate, we do interpret the announcement as, first, reflecting a neutral rate approach and second, making the judgment that 6 per cent is the neutral reverse repo rate. Less time and effort will hopefully be spent in the future on guessing what the RBI will do.

*Dr Subir Gokarn*

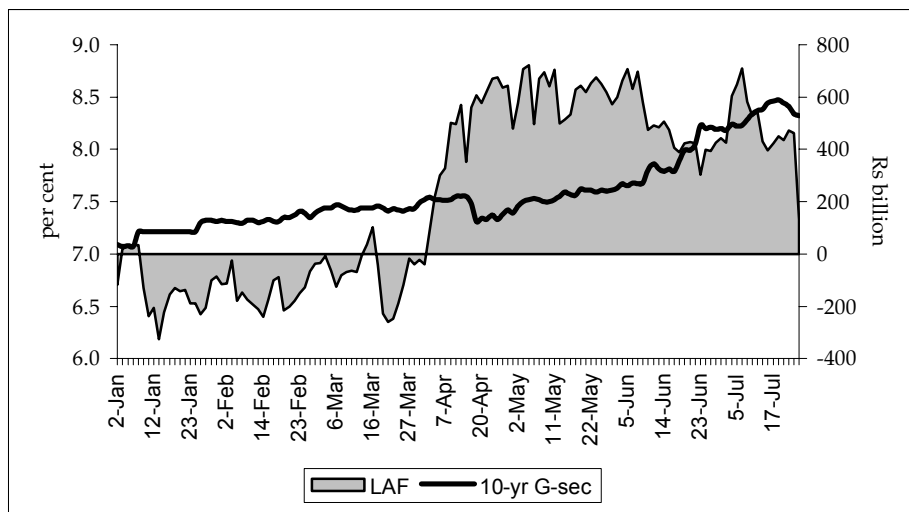
## I. Macro context

RBI raised the reverse repo/ repo rate by 25 bps in its first quarter review of the Monetary Policy 2006-07. While targeting inflation remained the primary objective of RBI, other macro developments such as slowdown in FII inflow and global monetary tightening also weighed heavily on the decision making process. In the following lines, we discuss some key macroeconomic indicators that guided the RBI's current stance.

Inflation rate based on WPI began to firm up during June 2006. The rate crossed the 5.0 per cent mark, touching 5.44 per cent week ending June 17. The rate, however, moderated down to 4.68 per cent during week ending July 8, primarily on account of a high base. While rising international crude oil prices continued to put pressure on domestic inflationary expectations, inflation in primary food articles also exerted considerable upward pressure on the overall domestic inflation. Inflation in vegetables went up from negative 2.7 per cent during May 2006 to 13.2 per cent during June 2006. For the same period, pulses witnessed an inflation of about 34 per cent.

Besides pressure on select agricultural commodities, even the corporate sector is under pressure to raise prices, as its margins are strained due to a sustained rise in the raw material costs. Inflation in manufactured products rose from 2.87 per cent during week ending June 17 to 3.63 per cent week ending July 8. While normal monsoons may keep prices of primary articles under control, inflation in manufactured products will continue to face cost-push pressures. A monetary intervention will thus have little impact on curbing increased inflationary pressure arising from high costs. Also, the recent increase in the prices of petroleum and diesel is expected to provide further impetus to inflation.

### Liquidity and interest rates

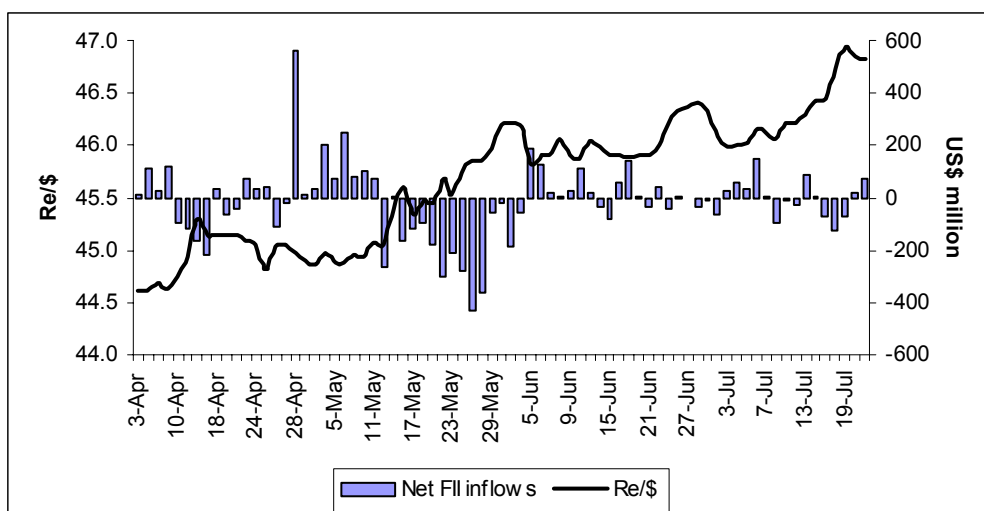


Source: RBI

An unexpected move by the Central bank to hike key interest rates by a quarter basis points (bps) last month saw yields on government dated securities climb to four-and-a-half year highs. The yield on the 10-year G-sec gained almost 60 bps during June 9 to July 24, 2006, while the yield on the 1-year G-sec increased by 33 bps, pulling up the spread from 106 bps to 141 bps.

Liquidity within the banking system increased substantially as the average net outstanding repo balance under the liquidity adjustment facility of the Central bank increased from negative Rs 119 billion in the fourth quarter of 2005-06 to Rs 539 billion during the first quarter of 2006-07. The central bank infused a total of Rs 7,229 billion in the system during January-March, 2006, while it consistently absorbed a total of Rs 32,841 billion during first quarter of the current fiscal.

#### Exchange rate and net FII inflow



Source: RBI, SEBI

From the beginning of the current fiscal, the rupee has witnessed significant depreciation. From an average of 44.95 to the dollar in April, rupee touched a 3-year low of 47 in July. The exchange rate for the month of July (till 24 July) averaged 46.35 against the dollar. The rupee has been weakening on the back of continuous interest rate hikes in US, which have strengthened the dollar sentiment and have led to foreign investors moving away from the emerging markets. The net FII inflow during February and March was around \$1,659 million and \$1,450 million, respectively. After registering a net sales of \$1,473 million in April, the net inflow failed to bounce back to previous levels. Net inflow during June and July (till 20 July) was at low levels of \$193 million and \$45 million, respectively.

## II. Global scenario

### Global Monetary Policy stance

| Country                         | Policy rate                       | Increase (+) /Decrease (-)<br>in Policy rate<br>(in basis points) |             |                         | Current<br>rate<br>(%) |
|---------------------------------|-----------------------------------|---|-------------|-------------------------|------------------------|
|                                 |                                   | 2004  | 2005        | 2006*                   |                        |
| <b>Developed economies</b>      |                                   |   |             |                         |                        |
| Australia                       | Cash rate                         | No change   | +25         | +25                     | 5.75                   |
| European Union                  | Marginal lending facility         | No change   | +25         | +50                     | 3.75                   |
| Japan                           | Overnight collateralised rate     | No change   | No change   | +25                     | 0.25                   |
| UK                              | Bank rate                         | +100  | -25         | No change               | 4.50                   |
| USA                             | Fed fund rate                     | +125  | +200        | +100                    | 5.25                   |
| <b>Emerging Asian economies</b> |                                   |   |             |                         |                        |
| India                           | Repo rate                         | +25   | +50         | +50                     | 5.75                   |
| Indonesia                       | BI rate                           | Not applicable  | +425        | -50                     | 12.25                  |
| Korea                           | Uncollateralised overnight rate   | -50   | +50         | +50                     | 4.25                   |
| Malaysia                        | Overnight policy rate             | No change   | +30         | +50                     | 3.50                   |
| Philippines                     | Overnight reverse repurchase rate | No change   | +50         | No change               | 7.50                   |
| Thailand                        | 14-day Repurchase rate            | +100  | +200        | +100                    | 5.00                   |
| <b>Average oil price</b>        |                                   | <b>2004</b>   | <b>2005</b> | <b>2006<sup>^</sup></b> |                        |
| WTI Cushing Ok                  |                                   | 41.5  | 56.6        | 66.8                    |                        |
| European Brent                  |                                   | 38.3  | 54.6        | 66.2                    |                        |

\* Rate hikes during the period January –July 2006

<sup>^</sup> Average oil prices during the period January-June

Source: Respective Central Banks

Rising oil prices has had a major influence on the monetary policy stance adopted in major economies worldwide. The Federal Reserve Open Market Committee raised the interest rates for the 17th consecutive time on June 28 to 5.25 per cent. The current monetary policy stance in US continues to remain biased towards tightening as all the major indicators of inflation—consumer price inflation, core consumer price inflation and the personal consumption deflator—have been above the upper limit of 2 per cent. Expectation of a slowdown in growth in the short term however, may not prevent another 25 basis point rate hike in August.

Europe and Asia also witnessed monetary tightening in the recent past. Bank of Japan raised its interest rates for the first time in last 6 years. In China as well, the one-year benchmark rate was raised by 27 bps to 5.31 per cent, but with the aim of controlling domestic overheating.

## III. Impact on economy

### Inflation

Taking a cue from rising inflationary pressures, RBI has taken a “pre-emptive” measure of raising the interest rates. There is buoyant growth and hence, demand pressures both from within and outside the economy. High interest rates will keep the inflationary pressures

from demand side under check. But, inflation in manufactured products is cost-push in nature and monetary intervention is not very effective in controlling inflation arising from high costs. Also, if the monsoons turn out to be normal, it will keep prices of primary articles under control to some extent. Overall, we maintain our earlier outlook of 5.0-5.5 per cent average inflation rate during 2006-07.

### **Interest rate**

The immediate impact of the widely expected 25 bps rise in the reverse repo/repo rate saw the yield on the 10-year G-sec rise by 4 bps from 8.21 per cent to 8.25 per cent as the rate hike had already been factored in by the market. The move, which came as a pre-emptive hike to control global and domestic inflationary pressures, is likely to push bond prices down in the short term. However, markets are expected to gain considerable support in the medium run because of the efforts by the central bank to contain inflationary pressures. Retail lending and deposit rates are likely to see some pass-through, as interest rates settle at a higher equilibrium. On balance, we expect the yield on the benchmark 10-year G-sec to lie between 7.8-8.0 per cent by the fiscal end.

Following is the impact of the rate hike on bond yields according to tenor:

#### **Increase in bond yields according to tenor (%)**

| <b>Tenor</b> | <b>Average yields (%), July</b> | <b>Expected average yields (%), August</b> |
|--------------|---------------------------------|--|
| 1            | 7.00                            | 7.16                                       |
| 2            | 7.21                            | 7.34                                       |
| 3            | 7.45                            | 7.61                                       |
| 4            | 7.70                            | 7.81                                       |
| 5            | 7.79                            | 7.93                                       |
| 6            | 7.96                            | 8.09                                       |
| 7            | 8.10                            | 8.29                                       |
| 8            | 8.17                            | 8.30                                       |
| 9            | 8.21                            | 8.35                                       |
| 10           | 8.34                            | 8.48                                       |

Source: CRISIL estimates, [www.debtonnet.com](http://www.debtonnet.com)

### **Exchange rate**

The weakened rupee will draw significant support from the rate hike, as it will improve the existing interest rate differential between the US and domestic interest rate. Appreciation of rupee from the current levels will also guard RBI's objective of keeping inflationary expectations under check. While the current economic momentum will strengthen the rupee sentiment, dollar strength overseas will continue to be the crucial determinant of rupee strength. In the near term, while the rupee is expected to draw support from an expected revival of foreign inflow, US Federal Reserve's decision in early August on continuation of monetary tightening will determine the future course of action. Going forward, we expect the rupee to trade around 45-46 to the dollar by the fiscal end.

## IV. Impact on financial services

### Deposits

#### **RBI's assessment of developments**

Bank deposits recorded a strong growth during the first quarter of 2006-07. RBI noted that the growth in demand deposits at 26.2 per cent (y-o-y) as on July 7, 2006, was higher than the previous year. This growth has been attributed to a sharp rise in non-food credit, higher resource mobilisation through the primary capital market, and through domestic mutual funds. Such funds get temporarily parked in demand deposits prior to utilisation, thus fuelling growth in the same.

Time deposits recorded a y-o-y growth of 19.3 per cent as on July 7, 2006, higher than that recorded a year ago. RBI attributes the high growth to both the higher interest paid on time deposits by scheduled commercial banks (SCBs) and the base effect. Interest rates on time deposits of 1-3 year maturity have increased by 25 bps and 100 bps over the past quarter in the case of public sector banks and private sector banks, respectively. Interest rates were increased primarily to mobilise deposits, in order to meet increased credit demand. The banks were able to pass on this rate increase to the borrowers.

#### **CRISIL Research opinion**

CRISIL Research's analysis reveals that only growth in term deposits (forms around 60 per cent of total deposit base of banks) is interest rate sensitive, while growth in current and savings deposits shows no sensitivity to the same. According to our analysis, for every 100 bps increase in term deposit rates, the term deposit growth would increase by 88 bps. In our Banking Annual Review dated April 2006, we had stated that we expect term deposits to grow at 15.72 per cent in 2006-07. However, given that banks have increased deposit rates by around 25 to 100 bps between March 2006 and July 2006, we believe that the growth in term deposits will be marginally higher than our estimates.

### Advances

#### **RBI's assessment of developments**

Bank credit recorded strong growth between March 31, 2006 and July 7, 2006. Non-food credit, on a y-o-y basis, registered a growth of 32.9 per cent as on July 7, 2006, on top of a high base of 31.0 per cent, a year ago. According to the RBI, the industrial sector, housing sector; and agriculture and allied activities accounted for almost 30 per cent, 14 per cent and 12 per cent of the incremental non-food credit, respectively.

The increase in industrial credit was mainly fuelled by infrastructure, which accounted for nearly one-fourth of the incremental credit of the industry.

Agricultural credit recorded a robust growth, reflecting the impact of the various policy initiatives taken to improve the same.

Credit to the housing sector continued to be strong. Apart from housing, healthy credit demand emanated from education, other personal loans and credit card holders. Credit to the commercial real estate sector continued to increase sharply, constituting around 3 per cent of the incremental non-food credit.

### *CRISIL Research opinion*

#### **Industrial credit**

Since there is no significant change in our outlook on industrial GDP, we do not expect any change in the demand for industrial credit.

#### **Retail credit**

Assuming a full pass-through of the rate hike, CRISIL Research's analysis reveals that for every 100 bps increase in interest rates, the car demand would slow down by 86 bps, however, the demand for CVs and two-wheelers is not very sensitive to the rise in interest rates. While, we expect the new car finance disbursements to slow down by 22 bps, we do not expect any impact on new CV and two-wheeler finance disbursements. Consequently, the growth in the outstanding portfolio of auto finance is expected to slow down by 10 bps.

#### **Overall credit**

We believe that there will be no major change in the overall credit growth, since the retail finance portfolio constitutes a mere 15.7 per cent of the overall advances portfolio of a bank. In view of these factors, we expect the credit-deposit ratio to be marginally lower than our estimates.