Putting things in perspective...

This is precisely what the Reserve Bank of India (RBI) has managed to do through its Annual Credit and Monetary Policy issued earlier today. Amidst expectations that the central bank would combat inflationary pressures more aggressively in this policy, there was a clear risk that growth concerns could be compromised for the time being. However, there are enough pointers in the policy document to believe that RBI would try and maintain a fine balance between inflationary concerns (a short-term phenomenon) and growth issues (longer term in nature). We believe that the stance suits the current scenario perfectly and the policy indeed puts things in the right perspective rather than taking knee-jerk actions to problems that seems extremely complex to be solved with a token interest rate hike.

Increase in CRR by 25 bps while keeping Bank Rate, Repo Rate and Reverse Repo Rate - have been left unchanged

RBI has hiked the Cash Reserve Ratio (CRR) by 25bps to 8.25% in the policy. This move comes after a 50bps increase in CRR on April 17th. All other benchmark rates - Bank Rate, Repo Rate and Reverse Repo Rate - have been left unchanged. The consensus had expected a 25bps hike in Repo Rate.

Policy stance

RBI seems reluctant to give away the run in growth momentum that the economy has sustained over the last few years. Indeed, since there are hardly any signs of strong demand side activity resulting in higher inflation, the central bank rightly believes that the inflation management, without compromising on growth could well be achieved, albeit over a period of time. The stance of the policy sets out the hierarchy of issues that the economy faces at this point in time. The official stance of the policy is as follows (emphasis added by us):

- To ensure a monetary and interest rate environment that accords high priority to **price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to continuation of the growth momentum.** - *(The stance clearly assigns the priority for the coming months)*
- To respond swiftly on a continuing basis to the evolving constellation of adverse international developments and to the domestic situation impinging on inflation expectations, financial
- stability and growth momentum, with both conventional and unconventional measures, as appropriate.
- To emphasize credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

Inflation management, without compromising on growth could well be achieved

The reason why we believe that inflation management might not be at the cost of growth, as RBI views it, is clearly laid down in para. 95 of the policy document. We reproduce an extract from the paragraph here:

Calibrated monetary policy actions undertaken since September 2004 thus continue to have some stabilizing influence on the economy. ***Further, the very recent initiatives in regard to supply-management by the Government of India and measures relating to the cash reserve ratio by the Reserve Bank are in the process of impacting the economy, while a more reliable assessment of crop prospects is underway.*** *Fourth, critical to the setting of monetary policy is the importance of anchoring expectations relating to both global and domestic developments. Accordingly,* ***policy responses for managing expectations should consider the evolving global and domestic uncertainties surrounding the slowing down of global output growth and also the potential for exaggerated bearishness in the Indian context. Fifth, while monetary policy has to respond proactively to immediate concerns, it cannot afford to ignore considerations over a relatively longer term perspective of, say, one to two years, with respect to overall macroeconomic prospects. At the same time, it is critical at this juncture to demonstrate on a continuing basis a determination to act decisively, effectively and swiftly to curb any signs of adverse developments in regard to inflation expectations. In view of the above unprecedented uncertainties and dilemmas, it is important to take informed judgements with regard to the timing and magnitude of policy actions; and such judgements need to have the benefit of evaluation of incoming information on a continuous basis.***

The gist of the stance is accurate, the way we read it. Fiscal policy measures initiated during the previous few months are yet to show up on prices and the central bank is willing to wait for the results.

Moreover, in pursuit of combating inflationary pressures that are largely supply side and probably a near term issue, we should not ignore the impact of any harsh measures on longer term growth. We need to protect our domestic consumption dynamics when the major economies globally are slowing down sharply.

Inflation & Growth dynamics

We view the overall policy stance as less hawkish than expected and indeed relatively pro-growth.

The central bank assesses that the rise in underlying prices in the economy since the beginning of 2008 is largely supply side and a global phenomenon. The policy points to all time low food stock levels in many economies for essential food articles and commodities and the resultant impact on prices in international markets. Conventional economics suggest that supply side factors impacting prices cannot be moderated significantly through increasing interest rates. What the economy faces currently is dis-similar from the situation seen during early part of 2007. Back then, supply side factors prevailed along with high demand growth. Credit growth in the banking system was at 30% levels during the period and there were clear signs of excesses in the demand side of the economy. As a result, the central bank acted aggressively in hiking both the reserve requirements and interest rates in the system. The result was that of moderation in prices and headline inflation cooling off from 7% levels to as low as 3%. A part of the moderation could also be attributed to positive base effect.

This time around, inflation seems purely supply side. Also, the latest figures relating to industrial production imply that growth could be slowing. Credit growth in the banking system has moderated to 21% levels. Resultantly, the central bank has not resorted to aggressive interest rate tightening/hawkish stance on the inflation front. More importantly, the inflation projection for FY2008-09 has been set at 5%-5.50%, which is higher than current projections. The medium term 'target' has been kept intact at 3%. However it seems a distant scenario the way things stand now.

Keeping the inflation projection higher could suggest that the central bank does not intend to curb it down to 4% at the cost of lower growth. The growth estimate of close to 8.5% is fairly aggressive considering the early signs of moderation in growth. Our own estimate of GDP growth for 2008-09 is 8.2%, assuming some interest rate stimulus during the latter part of the year. RBI has also pointed towards the slowing business confidence reflected by the surveys

that are conducted in the economy. By clearly stating that the past actions are still working on the system and that one should also look at a longer term horizon while setting policy, RBI seems to tread an optimum balance between growth and inflation. Given the political hues and cries surrounding the issue of inflation, market observers had feared that the central bank might give in to the pressures. It has not been the case this time.

Other estimates

RBI's estimates on deposit & credit growth have been lowered to 17% and 20% respectively for FY2009. Money supply is expected to grow by 16.5%-17%, a target that has not been achieved over the last few years. Lowering of credit growth target to 20% does not look in line with a GDP growth of 8.5%. Our sense is that the credit off-take has to be stronger than just 20% to be able to sustain 8.5% economic growth. RBI's estimate of 20% is probably based on its assessment of the past monetary actions.

Liquidity management to be the focus

System liquidity would remain optimum enough to support growth in investment activity and productive growth in the economy

Active management of liquidity and capital account would continue to remain the focus of the central bank going forward. The idea is to ensure that there is no spillover of excess liquidity on the demand side thereby resulting in acceleration in inflationary pressures. RBI would use all possible measures to ensure that system liquidity is not in the excess mode. The 75bps hike in CRR over the last couple of weeks should be viewed in this context and not from a rate view perspective. Cumulatively, the CRR hikes is expected to drain out about Rs.27,000 crores from the system over the next month or so. Given the current overhang of liquidity and expected unwinding of MSS bonds, system might not be very constrained on the liquidity front even after this CRR hike. System liquidity would remain optimum enough to support growth in investment activity and productive growth in the economy.

Impact of CRR hike

The impact of CRR hike is expected to be muted and benign. The 0.75% hike in CRR would translate into about 0.1% hit on the profitability of banks given the current deposit base of the banking system. This is not very significant and banks would take the hit without passing on the costs to the borrowers. Indeed, with incremental credit-deposit ratio below 75% for the first time since 2004, passing on the costs look infeasible at the current juncture. At best, some banks could adjust their deposit rates downwards to reduce their costs.

10-year yield could trade in a range of 8% to 8.30% over the next few weeks

Again, the impact of this move on bond yields would be insignificant. The markets would read positives in the policy from interest rate perspective. Having said that, bond yields could rise over the next couple of months owing to significant amount of auction supply that would hit the market in the coming weeks. 10-year yield could trade in a range of 8% to 8.30% over the next few weeks. Also, weekly headline inflation readings would be monitored minutely by the market participants to get early cues on possible RBI actions.

While it is too early to suggest that interest rates would come off relatively soon, we still believe that the broad system interest rates might have peaked. Barring probable hikes in reserve requirements, we do not assign a high probability to hike in key interest rates in the economy.

Overall assessment

The global interest rates and financial markets still under stress

With global interest rates and consumer confidence on decline and financial markets still under considerable stress, it looks unlikely that domestic rates would rise from the current levels. Moreover, the domestic consumption seems to be slowing down enough to prevent banks from passing on the higher costs to the borrowers. It would need a significant change in the global growth dynamics to make RBI shift its policy stance considerably from the current levels.

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