Key highlights

- Repo rate increased by 50 bps to 9%.
- Reverse Repo rate kept unchanged at 6%.
- Bank rate kept unchanged at 6%
- Cash Reserve Ratio (CRR) increased by 25bps to 9.00% w.e.f. from August 30, 2008.
- Year end inflation target revised higher to 7% for 2008-09.
- Money supply is targeted to grow around 17%.
- Deposits projected to increase by around 17.5 per cent or around Rs.6,00,000 crore
- Aggregate credit is targeted to grow around 20%.
- GDP estimates for the year 2008-09 revised to 8%.
- To emphasize credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

The RBI increased LAF Repo rate by 50 bps to 9% with immediate effect. The Cash reserve ratio (CRR) was increased by 25bps to 9.00% with effect from August 30, 2008. The use of CRR serves as a constraint on the banks ability to expand lending beyond a point. In this sense, it is likely to be an effective defense against a potential overheating scenario; while the measures that have been taken to contain supply-side inflation take effect.

The monetary stance was a double whammy for the entire corporate and the financial markets. The 50 bps hike in the repo rate was unexpected by the markets and hence responded negatively with the stock markets falling by 500 points and the bond yields spiked by nearly 50 bps (lost Rs 3 in one day). The message is clear that the Reserve Bank of India would prioritize inflation over growth. The hike in CRR by 25 bps was imminent, as inflows in the wake of Sixth Pay Commission, loan waiver and redemptions in the second quarter would enhance systemic liquidity. However, a 50bps hike in the repo rate as against market expectations of 25bps was a shocker.

Policy Stance

The overall stance of Monetary Policy was very hawkish as the concerns mainly emanated from uncertain inflation outlook. The RBI stated that the "inflation risks have increased sharply and appear to be persistent at this juncture". Hence "bringing down inflation from current high levels and stabilizing inflationary expectations" has been accorded highest priority to price stability.

Indeed, the stance taken at this juncture was much expected. The policy has ward-off lingering uncertainty in context of interest rate scenario and inflationary expectations. The governor also alluded that it would maintain constant vigil on the target set, in order to monitor price and macro-economic developments at intervals and intervene if, necessary depending on the economic conditions.

Inflation an overriding concern

"Bringing down inflation from the current high levels and stabilizing inflation expectations assumes the highest priority in the stance of monetary policy".

Indian experience of Inflation is not proportionately different from the global inflationary fears. The central bank emphasized that inflation in the last few months has grown in magnitude and is driven by supply side pressures in the context of limited spare capacity and mounting demand and there no clear signs of moderation in the near term. The pressures on global inflation emanate from prices of food-grains, crude oil and metals, which are not only acute in nature but will also, prolong for sometime to come. The domestic prices for food-grains may soften in the medium-term taking indications from improvement in crop conditions in some of the major crop producing countries. By far the monsoons in India augur fair-weather conditions for domestic food prices. International crude and metals prices on the other hand will continue to remain at elevated levels. In a recent survey by IMF whereby global activity is expected to come down to 1% will subsequently temper demand and speculative activity in the commodities market and finally pull down prices. This apart, sustained expansion in money supply. However, an early sign of moderation in the money supply and deposit growth was noted, still use of instruments would be required on an ongoing basis for active liquidity management.

Impact on the Banking and Industrial sector:

In the first quarter monetary policy RBI vocalized deep concerns over strong credit growth, the significantly overdrawn state of the banking system to sustain the credit disbursement, mismatches between sources and uses of funds and implications for interest rates, liquidity conditions and credit quality. Currently, credit growth is noted at 25% way above RBI's trajectory. The excerpt from the policy, given as under, indicates RBI intent to take disciplinary action to check banking industry extravagance. To this extent the RBI pronounced strict adherence of prudential norms to credit quality while greater credit availability across labour-intensive industries. The stance is intended at reducing consumption expenditure but at the same time promoting investments in employment intensive sectors.

"Banks should focus on stricter credit appraisals on a sectoral basis, monitor loan to value ratios and generally ensure the health of credit portfolios on a durable basis without encountering undue asset-liability mismatches. If necessary, the Reserve Bank would consider undertaking supervisory review of those select banks which are over extended in terms of their credit portfolios relative to their sources of funds."

The industrial performance has moderated during April-May 2008, recording year-on-year expansion of 5.0 per cent as against 10.9 per cent in April-May 2007. According to Macroeconomic and Monetary developments many industrial sectors are currently operating at near or full capacity and are planning further capacity expansions. In this context investment momentum would be adversely impacted as corporates may shelve existing projects for fear of surge in financing costs.

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