



ICRA Comments on the RBI's Second Quarter Review of Monetary Policy for 2011-12 – October 2011

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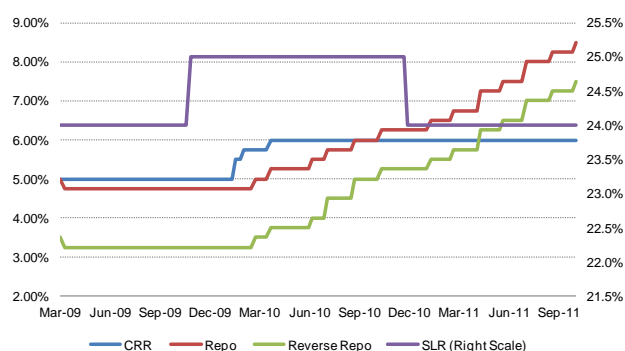
Highlights of the RBI's Second Quarter Review of Monetary Policy for 2011-12 – October 2011

- Benchmark Repo Rate increased by 25 basis points (bps) from 8.25% to 8.50% with immediate effect; Reverse Repo and Marginal Standing Facility stands revised to 7.50% and 9.50%, respectively
- Bank Rate, Cash Reserve Ratio and Statutory Liquidity Ratio unchanged at 6%, 6% and 24%
- Baseline projection for headline WPI inflation for March 2012 maintained at 7%; inflation expected to remain sticky in October-November 2011 and decline from December 2011 onwards
- Baseline projection for GDP growth for FY12 revised to 7.6%; in September 2011, the RBI had indicated downside risks to its growth projection of 8% for 2011-12 made in May 2011 and July 2011, led by moderating domestic demand and impact of weakening global growth momentum and rising uncertainty
- Monetary stance remains focussed on containing inflation and anchoring inflationary expectations, whilst aiming to balance growth concerns
- Guidance provided regarding a low likelihood of a further policy rate hike in December 2010
- Interest on savings account balances deregulated - Banks allowed to offer differential rates for savings deposits beyond Rs. 1 lakh; Deregulation could trigger increase in cost of funds for Banks
- Non-food credit and broad money growth projections retained at 18% and 15.5%, respectively

Repo rate hiked by 25 bps; RBI persists with anti-inflationary stance given high and generalised inflation

Whilst aiming to balance concerns about moderating growth impulses and persisting inflationary pressures, the RBI raised the repo rate by 25 bps to 8.50% with immediate effect, in line with ICRA's expectations. The Central Bank indicated that although the impact of past monetary actions is still unfolding, it is necessary to persist with the anti-inflationary stance. Moreover, the RBI highlighted the risks of modifying its anti-inflationary policy stance, at a time when inflation remains substantially in excess of its comfort zone, to the credibility of its commitment to low and stable inflation.

Chart 1: Movement in Key Rates



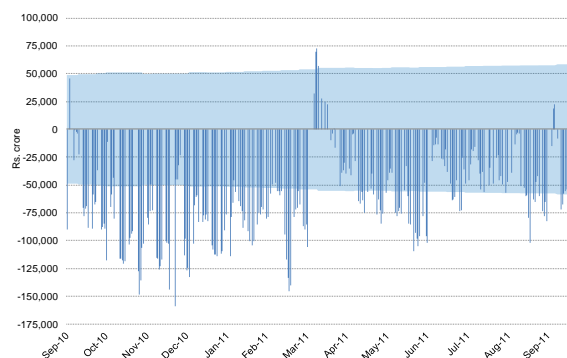
Source: RBI

With the current hike, the RBI has increased Repo rate by 375 bps since the unwinding of liquidity measures began in March 2010. The transmission of the substantial tightening began in Q3FY11 with Banks increasing their base lending rates by nearly 250-275¹ bps (modal base rate increase by 125 bps) and deposit rates by 175-250¹ bps (modal deposit rate increase by 80 bps) since March 2010, so far. The impact of the rate hikes continue to percolate into the system. Further, Banks could also pass on the likely increase in funding costs on account of deregulation of savings bank rates to borrowers. While the year-to-date credit growth is higher than RBI's indicative projections, the Central Bank has left the year-end credit growth expectation unchanged at 18%, indicating an expected moderation in credit off-take in the second half on account of lagged effect of the monetary measures taken so far.

Systemic liquidity remains within RBI comfort zone; large government borrowings in H2FY12 could exert some pressure

Systemic liquidity remained in deficit mode throughout Q2FY12, but largely remained within RBI's comfort zone of +/-1% of net demand and time liabilities, with the exception of a few days in September 2011 on account of pressures related to advance tax payments. The Marginal Standing facility (MSF) introduced by RBI in May 2011 available to Banks at 1% higher than Repo rate has been largely unutilised, as Banks were able to access adequate liquidity through the LAF.

Chart 2: Daily LAF outstanding



Note: Negative amounts indicate injection of liquidity by RBI
Note: Shaded portion indicates 1% of NDTL

Source: RBI

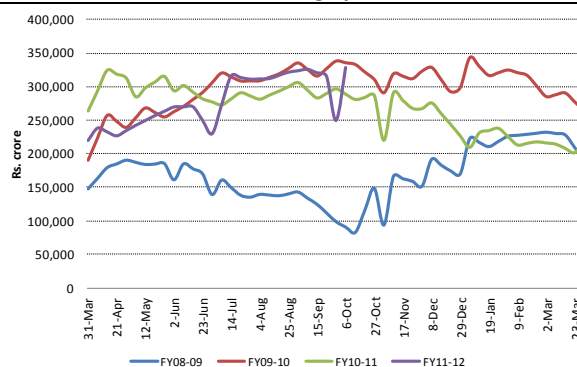
Banks maintained average excess SLR investments (including Reverse Repo) of more than Rs. 2.7 lakh-crore during H1FY12, marginally lower than 2.9 lakh-crore in H1FY11. The average SLR levels remained around 28.8% of NDTL as against the mandated 24%. Gol spending during the first half has remained high as indicated by the negative balance with RBI since April 2011 despite achieving 61% of FY12's gross market borrowings in upto October 14, 2012.

However, the full year Gol borrowing target has been revised upwards by about Rs. 53,000 crore which means the Gol's gross market borrowing in H2FY12 would be around Rs. 2.03 lakh-crore. This could exert some pressure on systemic liquidity particularly if credit demand remains benign.

¹ Relating to 5 major Banks as tracked by RBI

The call rate, which exhibited considerable volatility in FY11 owing to a substantial systemic liquidity deficit, has stabilised around the Repo rate in the current fiscal reflecting the improvement in the extent of the systemic liquidity deficit. In ICRA’s opinion, systemic liquidity is likely to remain in deficit in Q3FY12 in line with RBI’s stated policy towards the same and the considerable magnitude of borrowings to be made by the Central and State Governments in H2FY12. If credit off-take continues to grow at the current pace, while deposit growth dampens, the systemic liquidity deficit could widen in the coming months.

Chart 3: Excess SLR in the Banking System



Source: RBI

Headline inflation expected to moderate in December 2011; decline to 7% by March 2012

The Central Bank indicated that the monetary policy tightening effected so far has helped in containing inflation and anchoring inflation expectations, whilst acknowledging that both remain elevated. Headline wholesale price index (WPI) inflation has averaged 9.6% in FY12 so far and remained in excess of 9% in each month in the current fiscal year, substantially higher than the RBI’s comfort zone. Additionally, inflation has been driven by all the three groups of items, namely, primary articles, fuel & power and manufactured products, reflecting a generalisation of inflationary pressures.

The RBI expects inflation to remain sticky in October-November 2011, despite the substantial policy tightening that it has undertaken since March 2010. However, the policy review indicates a downward momentum in the de-seasonalised sequential quarterly WPI data. Additionally, WPI data for September 2011 indicates that the index levels declined or remained unchanged for six of the 11 sub-groups of non food manufactured products on a month-on-month basis, suggesting that inflationary pressures have begun to moderate in certain sectors. The Central Bank expects WPI inflation to decline significantly in December 2011 and continue to moderate in 2012-13. With the potential adverse impact of the rupee depreciation, incomplete transmission of commodity price movements, suppressed inflation related to domestic coal and electricity prices and structural rigidity of food inflation likely to be offset by the lagged impact of cumulative monetary policy actions and moderating demand, the RBI continues to expect inflation to decline to 7% by March 2012, in line with ICRA’s expectations (6.8-7%).

The RBI also highlighted that the impact of tight monetary policy has been diluted by the expansionary fiscal position, and emphasized that slippages in the fiscal deficit relative to the budget estimates would have implications for domestic inflation.

Chart 4: WPI Inflation (y-o-y, Monthly)

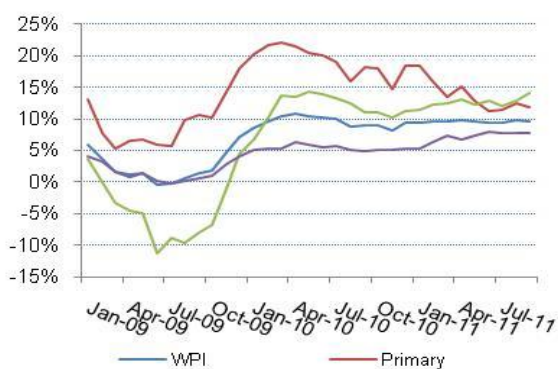
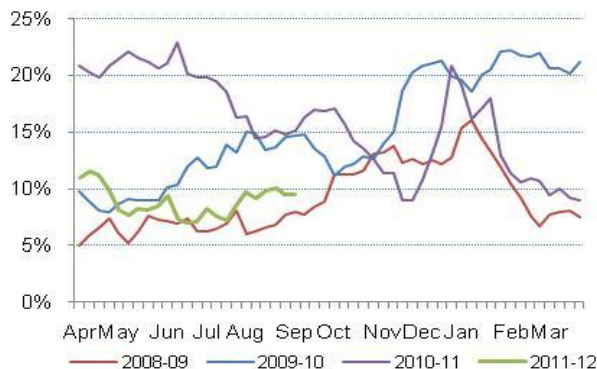


Chart 5: Food Inflation (y-o-y, Weekly)



Source: Office of the Economic Advisor, Ministry of Commerce and Industry, Government of India

The RBI emphasized that notwithstanding the persistently high inflation rate over the past two years, average inflation stood at around 5.5% in the 2000s, lower than the earlier trend rate of about 7.5%. Accordingly, the RBI indicated that conduct of monetary policy will continue to condition and contain perceptions of inflation in

the range of 4.0-4.5%, in line with the Central Bank's medium-term objective of 3.0% inflation. The RBI added that success in achieving this goal would benefit from concerted policy actions and resource allocations to address domestic bottlenecks, particularly related to food and infrastructure.

Baseline projection of real GDP growth for 2011-12 revised to 7.6%

The Central Bank revised the baseline projection for GDP growth for FY12 to 7.6%. In September 2011, the RBI had indicated downside risks to its growth projection of 8% for 2011-12 made in May 2011 and July 2011, led by moderating domestic demand and impact of weakening global growth momentum and rising uncertainty. The pace of growth of gross domestic product (GDP) at factor cost (constant prices) moderated to 7.7% in Q1FY12, from 8.8% in Q1FY11, led by a decline in the pace of industrial growth. The Central Bank indicated that capacity utilisation moderated in Q1FY12 as compared to the previous quarter while business expectations declined in Q2FY12. The Index of Industrial Production (IIP) recorded sluggish 3.9% growth in July-August 2011 relative to the same months in 2010, lower than the 6.8% growth recorded in Q1FY12. Notably, sluggish global growth is expected to dampen Indian exports and therefore its manufacturing sector, given linkages of the Indian economy with the global economy. Additionally, the RBI indicated that the services sector too may see some moderation in growth on account of inter-sectoral linkages. An increase in the sown area and a favourable monsoon rainfall in 2011 are likely to boost agricultural output in FY12, although the pace of growth is likely to be moderate given the high base effect.

The RBI indicated concerns to growth originating from the global macroeconomic environment, which may undergo a sharp deterioration in the absence of a credible solution to sovereign debt and financial problems in Europe, impacting Indian economic growth through trade, finance and confidence channels. The Central Bank also highlighted the potential crowding out of private sector investment following an increase in Government of India's borrowing programme for H2FY12.

Overall, ICRA expects the Indian economy to expand by 7.5-7.7% in FY12, similar to the baseline projection of 7.6% GDP growth for FY12 made by the RBI.

Guidance suggests low likelihood of rate change in December 2011

Given the anticipated trajectory of inflation and risks regarding growth impulses, the Central Bank provided a guidance of a relatively low likelihood of a rate action in the December 2011. Further, the RBI indicated that if the evolving inflationary trajectory is similar to its forecasts, further rate hikes may not be warranted.

The RBI indicated that the stance of monetary policy is intended to:

- Maintain an interest rate environment to contain inflation and anchor inflation expectations.
- Stimulate investment activity to support raising the trend growth.
- Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.

Notably, the Central Bank indicated in the Second Quarter Review of Monetary Policy that the monetary stance is intended to stimulate investment activity, as compared to the earlier intention to manage the risk of growth falling significantly below trend. This highlights the policy challenges facing the RBI, whose policy stance simultaneously intends to contain inflationary pressures.

The Central Bank indicated the following expected outcomes of its monetary measures and guidance:

- Continue to anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.
- Reinforce the emerging trajectory of inflation, which is expected to begin to decline in December 2011.
- Contribute to stimulating investment activity.

Deposits continue to grow faster than RBI's projection of 17%²

After moderate growth in April and May 2011, the pace of deposits growth picked up from June 2011 and aggregate deposits of the Indian Banking system stood at Rs. 56.25 lakh-crore as on October 7, 2011 after briefly peaking at Rs. 57.08 lakh-crore as on September 30, 2011. Deposits have grown by 17.5% on y-o-y basis, significantly higher than 15.1% during the same period of FY11. In absolute terms, deposits have increased by Rs. 4.20 lakh-crore since March 2011 (as compared to Rs. 3.02 lakh-crore during the same period in FY11), largely fuelled by the growth in term deposits following several rounds of interest rate hikes by Banks since Q3FY11.

The share of low-cost CASA deposits declined to 36.1% as on June 2011 from 38.7% as on March 2011 and 39.6% as on March 2010. Savings account balances remained steady at 25.1% as on June 2011 compared to 25.9% as on March 2011 and 27.5% as on September 2010. Further, we believe that Corporates have moved their part of their surplus balances to debt funds (including FMPs) given the attractive yields or used for internal working capital requirements, resulting in a sharp decline in current account balances to 11% as on September 2011 from 12.3% as on March 2011 and 13.0% as on September 2010.

Most Banks, including the larger ones, have increased their peak deposit rates by nearly 175-250 bps in the past 18 months and continue to hold rates at relatively higher levels. Incrementally, Banks may not increase deposit rates inline with lending rates given the deregulation of interest on savings accounts and we could witness an *inter-se* movement of retail deposits between term and savings deposits. However, this is unlikely to impact overall deposits growth and given that other asset classes are likely to generate moderate returns, ICRA expects the overall deposits growth to remain strong at 17-18% in FY12, stimulated by term deposits.

Credit growth remains robust despite hardening interest rates; could moderate in H2FY12

Systemic credit in the current fiscal has remained robust with incremental Bank credit of nearly Rs. 2.1 lakh-crore upto October 7, 2011, only marginally lower than Rs. 2.3 lakh-crore in the same period of FY11. The y-o-y credit growth remained strong at around 19.3% as on October 7, 2011, as compared to around 20% as on October 8, 2010, higher than the RBI's projection of 18%. However, moderating economic growth and an unyielding interest rate environment, in conjunction with a high base effect are likely to dampen the pace of growth of credit off-take in H2FY12. ICRA expects the full-year credit growth in FY12 to moderate from the current levels to around 18-19%, and remain close to the RBI's baseline projection.

Deposit Growth Trends

Chart 6: Deposits Growth (Financial year-to-date)

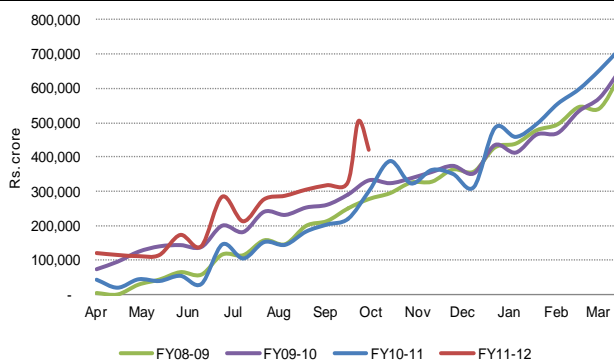
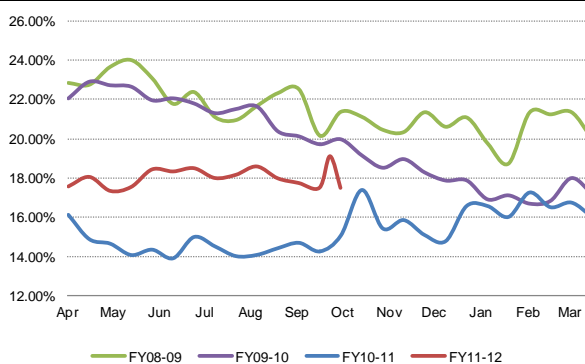


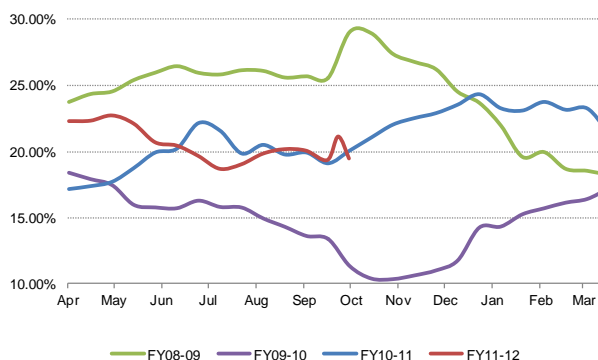
Chart 7: Deposit Growth (Year-on-year)



Source: RBI; ICRA Research

Non Food Credit Growth Trends

Chart 8: Credit Growth (Financial year-to-date)

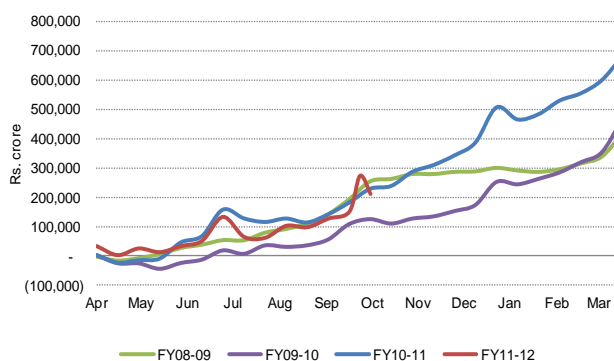


Source: RBI; ICRA Research

² RBI's indicative projection for M3 growth is 17%

Data released by the RBI regarding deployment of credit to various sectors up to August 2011 indicates that the 2.5% growth of Bank credit so far in FY12³, was primarily driven by credit to industry and retail housing, while credit to services remained flat and agricultural credit declined in the current year. Within industry, a large chunk of the incremental credit extended in the current fiscal has been absorbed by the metals sector (23%) and the infrastructure sector (36% of total incremental credit in FY12), particularly power (31%) and roads (11%) while credit to telecom shrank (11%). The medium and large industrial sectors which grew by 4.5% and 6.2%, respectively, continue to attract a greater share of Bank funding as compared to services and retail loans. While housing credit expanded by Rs. 18,060 crore between April and August 2011 (5.2% growth), data suggests incremental credit off-take for retail housing has slowed significantly.

Chart 9: Credit Growth (Year-on-year)



Source: RBI; ICRA Research

Deregulation of Savings Bank Deposit Interest Rate

In recent periods, the spread between the savings deposit and term deposit rates has widened significantly. RBI had increased the savings bank deposit interest rate from 3.5% to 4.0% in April 2011, pending deregulation. The savings bank deposit interest rate deregulated with immediate effect, subject to the following two conditions:

- Banks will have to offer a uniform interest rate on savings bank deposits up to Rs. 1 lakh, irrespective of the amount in the account within this limit.
- For savings bank deposits over Rs.1 lakh, a Bank may provide differential rates of Interest

The decision to deregulate of the bank savings deposits rate (operational guidelines awaited) is likely to benefit the deposit holders as they can get higher returns on their deposits but at the same time increase the interest rate sensitivity and the asset-liability mismatches for Banks. At the systemic level, savings accounts are estimated to account for 22%-23% of total Bank deposits as on Sep 30, 2011, the increase in saving rate could dilute the NIM by ~10-12 basis points, (assuming a broad based 50-75 bps increase in the savings bank deposit interest rate; without factoring in any rise in lending rates) while the post tax impact could be lower at 7-8 basis points, therefore return on equity could get diluted by less than 1%. The impact could be more for banks with higher savings deposits. We believe that this step would add to the profitability pressures on the Banks in light of tighter monetary stance followed by the Central Bank unless they are able to pass on the burden to the borrowers.

Introduction of new financial market products

The RBI has been taking the initiative to introduce several new financial products in the past year for the development of a secondary financial market in India. The summary of such products announced in the past and the current status of implementation is given in Annexure 1. In addition several supervisory and regulatory measures were also announced in the past year. The status of implementation of these measures is given in Annexure 2.

³ As on August 26, 2011 relative to March 25, 2011. Deposits expanded by 5.8% in FY12 upto August 26, 2011

More Supervisory and Regulatory Measures announced

The RBI has announced several supervisory measures in its monetary policy statement, a summary of which is given below:

Measure	Brief Description
Discussion paper on Dynamic provisioning	Devising a forward looking provisioning framework reflecting the credit history of Indian Banks, based on data collected from select Banks and data already available with the Reserve Bank and proposing a dynamic provisioning approach.
Overseas Investment by Core Investment Companies	Separate set of guidelines for overseas investment by CICs in both financial and nonfinancial sector companies to be issued.
Implementation of advanced measurement approaches (AMA) for operational risk under Basel II	Final guidelines for advanced measurement approach (AMA) for operational risk were issued in April 2011 . Draft guidelines on internal rating based (IRB) approach for credit risk were issued in August 2011. The final guidelines on IRB approach for credit risk to be issued by end- December 2011.
Prudential Norms for Restructuring of Advances by Banks	RBI to constitute a Working Group to review the existing prudential guidelines on restructuring of advances by Banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards.
Implementation of Next Generation RTGS (NG- RTGS)	The RBI is in the process of identifying the suitable solution under the guidance of a competent Technical Advisory Group.
Relaxation in opening new branches by SCBs	SCBs allowed to open new branches in Tier II centres without RBI permission. Earlier In December 2009, banks were permitted to open branches in Tier 3 to Tier 6 centres without prior permission. However, banks still need prior RBI permission to open branches in Tier I centres

Overall Comment

Notwithstanding its concerns regarding risks to economic growth, the stickiness of inflation prompted the RBI to raise the Repo Rate by 25 bps, in line with ICRA's expectations. With the potential adverse impact of the rupee depreciation, incomplete transmission of commodity price movements, suppressed inflation related to domestic coal and electricity prices and structural rigidity of food inflation likely to be offset by the lagged impact of cumulative monetary policy actions and moderating demand, we expect inflation to decline to 6.8-7% by March 2012. Accordingly we expect the RBI to take a pause and keep the policy rates unchanged in the rest of FY12, to balance anchoring of inflationary expectations with growth side risks, unless domestic or global economic growth displays a sharper than expected slowdown.

Annexure1: Status on introduction of new financial market products

Product	Announced in	Due Date	Actual Date	Comments
Working Group on the G-Sec and Interest Rate Derivatives Markets	Oct-2011			To set up a working group to suggest ways to suggest ways for enhancing secondary market liquidity in the G-Sec and the interest rate derivatives markets.
Committee for Review of Procedures relating to Facilities to Individuals – Residents/NRIs and PIOs	May-2011	Implementation In progress		Removal of operational impediments with respect to financial transactions of NRIs and residents, in individual and joint capacity
Review of Short Sale in Government Securities	May-2011	Dec-2011		It was proposed to extend the period of short sale from the existing five days to a maximum period of three months (May-11); detailed guidelines to be issued by Dec-11
Extension of DVP III Facility to Gilt account holders	May-2011			It is proposed to extend DVP III facility to transactions by the gilt account holders (excluding transactions between the gilt account holders of the same custodian) so that the gilt account holders get the benefit of efficient use of funds and securities. Final guidelines issued in July 2011.
Credit default swaps to be introduced	Nov-2010	Nov-2011		The final guidelines on credit default swaps (CDSs) for corporate bonds were issued in May 2011. The guidelines on CDS effective by end-November 2011.
Introduction of Interest rate Futures on 5 year and 2 year notional Coupon Bearing Securities	Nov-2010	Dec-2011		It is proposed to issue the final guidelines on the cash settled 5-year and 2-year IRFs, including the final settlement price by end-December 2011.

Annexure2: Status of key supervisory and regulatory measures

Measure	Announced in	Due Date	Actual Date	Comments
Discussion paper on Dynamic provisioning	Oct 2011	Mar-2012		Devising a forward looking provisioning framework reflecting the credit history of Indian Banks, based on data collected from select Banks and data already available with the Reserve Bank and proposing a dynamic provisioning approach.
Overseas Investment by Core Investment Companies	Oct-2011			Separate set of guidelines for overseas investment by CICs in both financial and nonfinancial sector companies to be issued.
Prudential Norms for Restructuring of Advances by Banks	Oct-2011			RBI to constitute a Working Group to review the existing prudential guidelines on restructuring of advances by Banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards.
Implementation of Next Generation RTGS (NG-RTGS)	Oct-2011			The RBI is in the process of identifying the suitable solution under the guidance of a competent Technical Advisory Group
Enhancement of Limit and Repayment Period of Housing Loan granted by Urban Co-operative Banks	Oct-2011		Oct-2011	It is proposed to increase the individual housing loan limit from Rs. 25 lakh to Rs. 30 lakh for Tier I UCBs and from `50 lakh to `70 lakh for Tier II UCBs, subject to extant prudential exposure limits; and to enhance the maximum repayment period of housing loans from the present period of 15 years to 20 years.
Review of the Existing Regulatory Framework for NBFCs	Aug-2011	The responses received till the last date (Sep 30, 2011) are under examination.		Key Recommendations were minimum asset size of more than Rs. 50 crore for registering new NBFC; 12 per cent as Tier I capital; prescription of liquidity ratio for NBFCs; asset classification and provisioning norms to be made similar to Banks.
Final Guidelines for Implementation of Advanced Approaches under Basel II Framework	Aug-2011	Dec-2011		Draft guidelines on internal rating based (IRB) approach for credit risk were issued in August 2011. Final guidelines by Dec-2011
Draft guidelines for implementing Basel III framework for SCBs operating in India	May-2011	End Dec-2011		To be issued pursuant to the RBI Monetary policy statement of May 2011 to adhere to internationally agreed phase in period (beginning 1.1.2013) for implementation of Basel III framework.
Regulatory Framework for Non-Banking Financial Company – Micro Finance Institution	May-2011	Nov-2011		A new category of NBFCs called Non-Banking Financial Company – Micro Finance Institutions (NBFC-MFIs) to be introduced, the regulatory framework of which will be broadly based on the recommendations of the Malegam Committee.

Measure	Announced in	Due Date	Actual Date	Comments
Licensing of New Banks in the Private Sector	Nov-2010	Jan-2011		Final guidelines be finalised in consultation with the Government of India, post which the process of inviting applications for setting up new Banks in private sector will be initiated.
Deregulation of Savings Bank Deposit Interest Rate	Nov-2010		Oct-2011	Savings bank deposit interest rate deregulated with immediate effect; Banks required to offer uniform interest rate on savings bank deposits up to Rs. 1 lakh; allowed to offer differential rate of interest for deposits over this amount.
Licences for Setting up new Urban Co-operative Banks	Apr-2010			Report and recommendation of the expert committee constituted for the purpose in Oct 2010 placed in public domain inviting comments till Oct 31, 2011, post which the guidelines will be issued



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