

FIRST QUARTER REVIEW OF ANNUAL POLICY

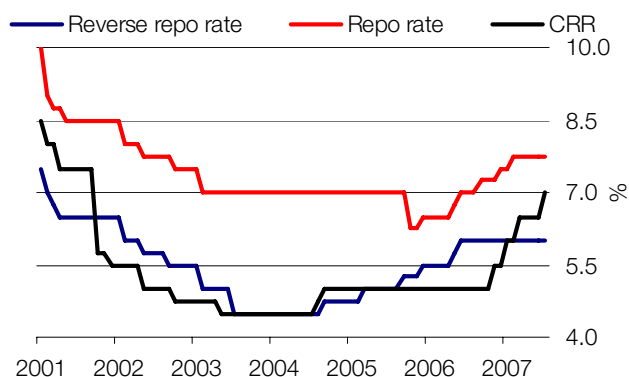
Hawkish stance

- * **Major policy announcements – surprise tightening:** (i) The central bank increased the CRR by 0.5% to 7% (with effect from the fortnight beginning August 4), while keeping other key interest rates unchanged. The CRR hike was not expected either by us or as a consensus. We had pointed to an inter-meeting hike in the CRR after the April policy meeting, but had expected it to take place sooner. (ii) The ceiling of INR 30 bn on daily suction under the reverse repo auctions has been withdrawn with effect from August 6, 2007.
- * **Reasons for the moves -Liquidity:** Liquidity withdrawal is to be topmost priority for the RBI at present. So far in the current monetary tightening cycle, the RBI has used the CRR as an inter-meeting tool. The fact that it has waited for the policy to hike rates this time around suggests that the need for a hike (while existing) was not as pressing as it has been in the past.
- * **RBI's tone- Inflation and financial markets risks:** The RBI sounds surprisingly hawkish in the latest policy document. It has pointed to commodity price pressures and the re-pricing of risks in global financial markets as the risk factors. It also needs to be noted, that the RBI has sent out a clear message that it does not expect interest rates to come off anytime soon.
- * **Looking ahead - More monetary tightening likely:** Given (i) the withdrawal of ceiling on the reverse-repo auctions (ii) the RBI's focus on liquidity management and (iii) the fact that the CRR is a blunt instrument of liquidity withdrawal, the RBI could raise the reverse-repo rate from its current 6% level. Additionally, the possibility of yet another CRR hike (depending on the extent of liquidity in the system) cannot be ruled out at this stage.

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Monetary tightening



Source: RBI, CMIE

* **Policy announcements: Surprise tightening**

- ♦ The central bank increased the CRR by 0.5% to 7% (with effect from the fortnight beginning August 4), while keeping other key interest rates unchanged. The CRR hike in the policy review was not expected either by us or as per consensus estimates. We had pointed to an inter-meeting hike in the CRR after the April policy meeting, but had expected it to take place before the end of Q1 FY-08.
- ♦ The ceiling of INR 30 bn on daily suction under the reverse repo auctions has been withdrawn with effect from August 6, 2007.
- ♦ At present, two liquidity adjustment facility (LAF) auctions are conducted. The second LAF (conducted everyday between 3pm and 3:45pm) has been withdrawn, with effect from August 6, 2007.

* **Reasons for the move: Liquidity**

Liquidity withdrawal is to be topmost priority for the RBI at present. Liquidity in the system has been abundant as is evident from:

- i. Strong M3 growth, above 20% in FY-08 so far. This contrasts with the RBI's indicative target of 17%-17.5% for M3 growth.
- ii. The average bids under reverse repo auctions have risen to INR 870 bn in July, up from INR 411 bn in June.
- iii. Call money rates have been on the decline. In July, call rates were on an average between 1.08-0.79%, in comparison with April, when they stood between 10.38%-5.28%.

So far in the current monetary tightening cycle RBI has used the CRR as an inter-meeting tool. The fact that it has waited for the policy to hike rates this time around suggests that the need for a hike (while existing) was not as pressing as it has been in the past. It started hiking the CRR in December 2006, when credit growth was over 30% and inflation was beginning to harden. The context of high credit growth and inflationary threat was persistent till the last hike in March. However, in the current scenario, credit growth is at sustainable levels of 24% Y-o-Y and inflation is below the RBI target level of 5% (the latest release puts it at 4.41% Y-o-Y).

* **RBI's tone: Inflation and financial markets risks**

The RBI sounds surprisingly hawkish in the latest policy document. While inflation has been a key concern since the beginning of the tightening cycle, there is increased concern with respect to financial market risks.

- i. Commodity and asset price pressures – The central bank has pointed out to global commodity prices, particularly crude oil as a source of concern. It has also highlighted that the outlook on agricultural production is unclear and would depend on the progress of south-west monsoon.

- ii. Re-pricing of risks – The RBI notes that the financial markets have been aggressively re-pricing risks and that there is now ‘considerable’ uncertainty around them. It has highlighted that, “...contextually, financial stability may assume greater importance in the months to come”.

It also needs to be noted, that the RBI has sent out a clear message that it does not expect interest rates to come off anytime soon. We can expect, at the very least, that interest rates in the economy will continue to stay at the current levels.

*** Looking ahead: More monetary tightening likely**

In context of the (i) hawkish tone on inflation and financial risks and (ii) the latest CRR hike, further tightening can not be ruled out. The RBI summarizes its overall stance as follows:

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasize credit quality and orderly conditions in financial markets for securing macroeconomic and in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measure as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.

Given (i) the withdrawal of ceiling on the reverse-repo auctions (ii) the RBI's focus on liquidity management and (iii) the fact that the CRR is a blunt instrument of liquidity withdrawal, the RBI could raise the reverse-repo rate from its current 6% level. Additionally, the possibility of yet another CRR hike (depending on the extent of liquidity in the system) cannot be ruled out at this stage.

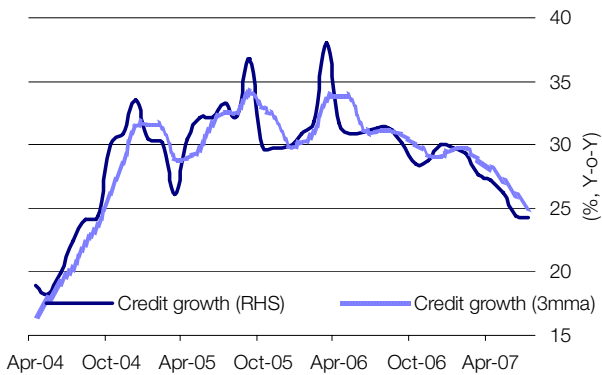
*** Our view**

We would like to point out, however, that macro-economic factors like credit growth and inflation do not warrant tightening at present. Further tightening indicated by the central bank in today's policy document will largely be a function of further developments in systemic liquidity. Moreover, the latest rate tightening may not have an impact on the economy going forward. Our banking analyst believes that it is unlikely that the latest rate hike will lead to a hike by lending rates by commercial banks. So long as a pass through does not take place, the economy at large will be insulated from the central bank's monetary tightening.

Key economy indicators in charts

Credit

Credit growth softens



Source: RBI, Edelweiss estimates

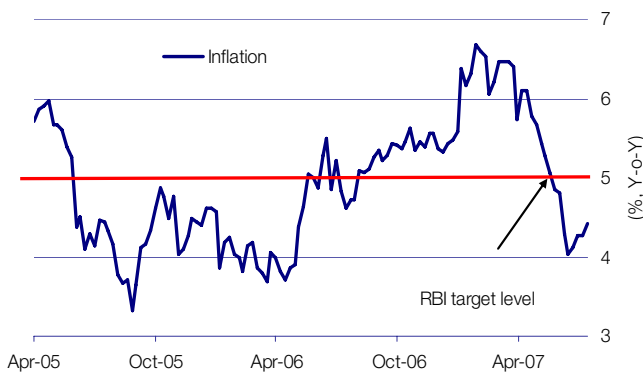
Sectoral credit growth	Q1 FY08*	Q1 FY07
Non-food Gross Bank Credit	26.4	44.6
Agriculture and Allied Activities	32.2	36.8
Industry	26.4	26.6
Services	26.1	207.1
Personal Loans	23.9	47.2
Real Estate Loans	69.7	102.4
Non-Banking Financial Companies	38.7	45.4

* Data up to May end

Source: RBI

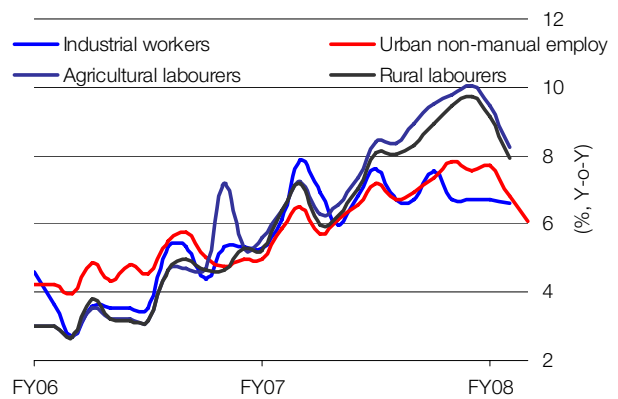
Inflation

Inflation below RBI target level



Source: Bloomberg, RBI, Edelweiss estimates

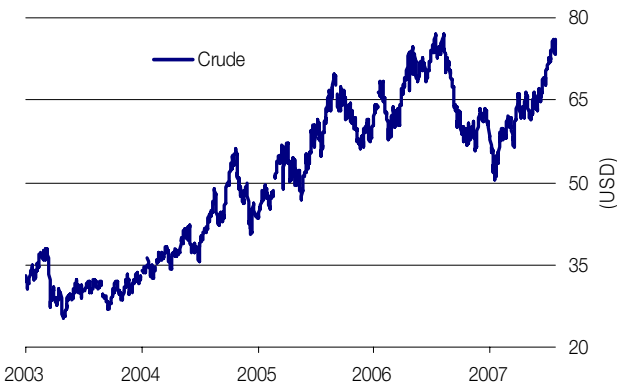
CPI indicators are dipping



Source: RBI, Edelweiss estimates

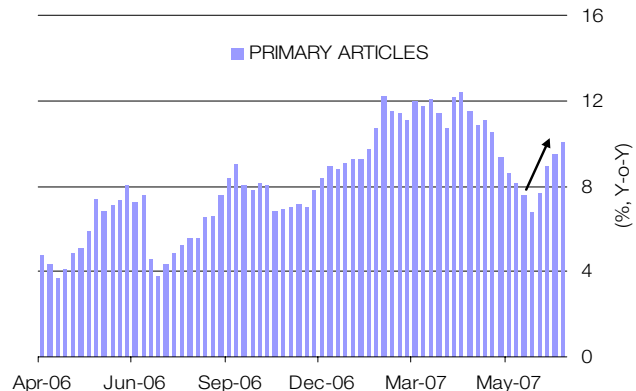
Commodity prices

Rising crude prices



Source: Bloomberg

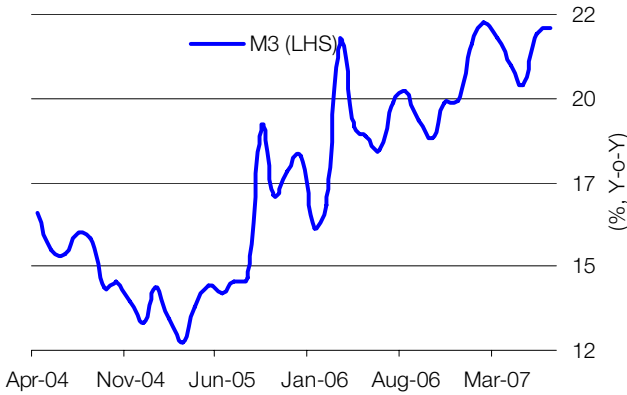
Primary articles prices strengthen



Source: Bloomberg, Edelweiss estimates

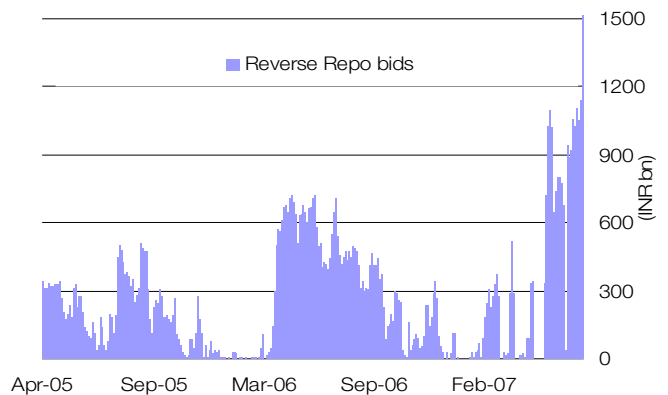
Liquidity and financial markets

High broad money growth



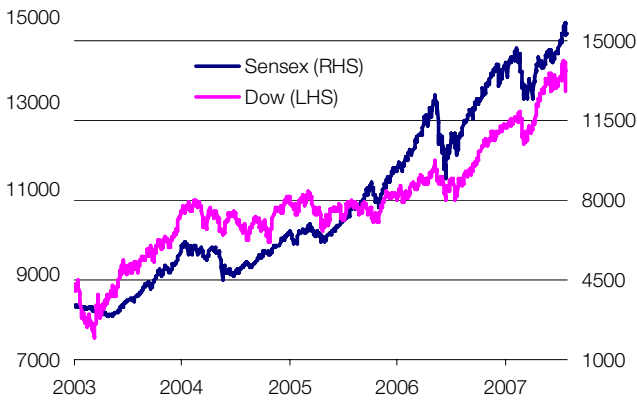
Source: Bloomberg

Rising short-term liquidity



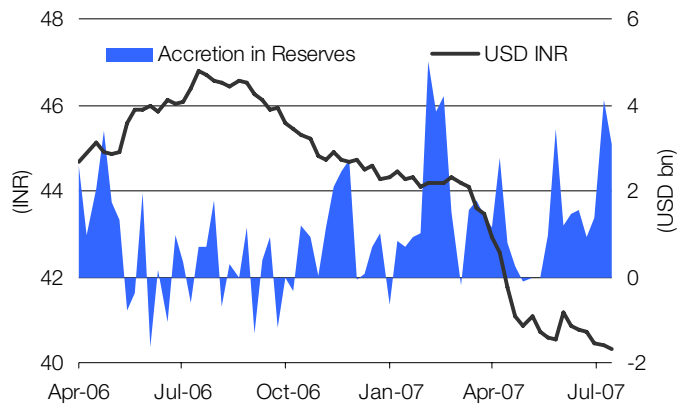
Source: RBI

Sensex and Dow



Source: Bloomberg

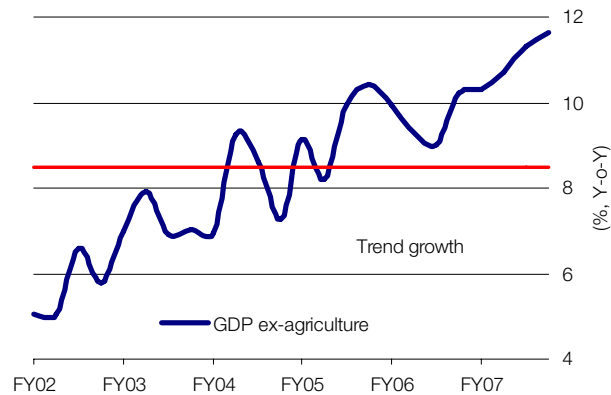
Sharp rupee appreciation



Source: Bloomberg, RBI, Edelweiss estimates

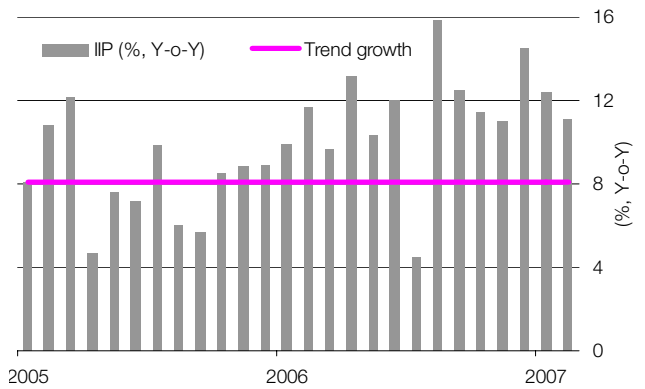
Real activity

Sustained economic activity



Source: CSO, Edelweiss estimates

Industrial production remains strong



Source: CSO, Edelweiss estimates

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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