

Mid-Term Review of Monetary Policy for 2008-09: Expectations

October 23, 2008

Namrata Padhye
 +91-22-66177922
namrata@idbigilts.com

At its upcoming Mid-Term Review we expect RBI to maintain a status quo on interest rates. As a result, we expect the RBI to maintain the Cash Reserve Ratio at 6.50%, LAF Repo and LAF Reverse Repo rate at 8.00% and 6.00% respectively.

No Move on Rates

The RBI has only recently eased the interest rate in the economy by 100bps, which was much higher than what certain segment of the market was expecting. The market was expecting the RBI to cut interest rate by 50bps at the policy. The quantum of rate cut has definitely surprised the market, but at the same time raised fears over the economic situation. The reason being that the recent readings on industrial activity has been very dampening. The equity markets too have signaled concerns over the economic outlook. Therefore there are concerns that the problem of systemic liquidity and tightness in lending activity of banks might just be the "tip of the iceberg". But still we feel, that the RBI would wait for some more time before signaling further moves on interest rates. Therefore we expect the RBI to maintain a status quo on interest rates.

Moreover, the RBI has also cut the Cash Reserve Ratio aggressively by 250bps to tide over the short-term liquidity problem in the system. This liquidity problem had arisen partly on account of the massive intervention of central bank in the forex markets to mute the rupee depreciation. The first fortnight of October has seen forex reserves of the country decline by around USD 18 billion. As a result we feel that at the upcoming policy the RBI would deal with issues that will lead to improvement of the forex situation of the country and also remove the pressure off the rupee. At the same time we also feel that the RBI will also try and address the tightness in lending activity to corporates, which is in turn hampering the industrial activity.

Modifications in Reserve Requirements for FCNR & NRE

Recently the RBI raised the interest rates on the FCNR and NRE deposits with banks to attract foreign inflows. On the FCNR deposits the interest rate ceiling was increased from LIBOR/SWAP rate minus 25bps to LIBOR/SWAP rate plus 25bps. On the NRE deposits (one to three year maturity) the interest rate ceiling was raised from LIBOR /SWAP rates plus 50bps to LIBOR/SWAP rates plus 100bps. At the upcoming policy review the RBI could consider further revising the rates upwards to make the deposits even more attractive. Apart from boosting inflows in these accounts, the RBI could also consider measures that would release these funds for the bank lending. At the policy review, we expect the RBI to announce modifications to reserve requirement on these deposits. For improving the liquidity requirement of banks for lending activities, we expect the RBI to do away with reserve requirements (CRR & SLR) on these deposits only on the incremental flows. So this would address both problems, on foreign flows as well as liquidity tightness with banks that is hampering their lending activity to corporates.

Review of the Provisioning Norms and Risk Weightages

The corporate sector has been facing tremendous pressure in meeting their working capital requirements. Even if the lending for short term is taking place, it is happening at relatively very high rates. This has put considerable burden on the corporate sector. The RBI could announce some further measures to tide away with tightness in the lending activity of banks to productive sectors.

The RBI, at its upcoming review could consider lowering of the provisioning requirements and risk weightages for the productive sectors. However, the sectors like retail and housing may not be considered, as it is the aggression in lending activity to these very sectors that has led to asset bubbles and concerns over possibility of rise in the NPA's of banks.

Considerations for Repo on Corporate Bond

The RBI, at its Mid-Term Review of held in October 2007, had mentioned that the introduction of repo on corporate bonds would be considered after certain prerequisites were met. The requirements were largely related to the secondary market activity and considerable primary issuances to the public. Regarding the secondary market activity, the trading activity had improved considerably since the beginning of April 2008. However, the activity has reduced over the past couple of months, as the corporates yields in the primary and secondary market began to rise considerably. The sharp rise in yields has made it difficult for the corporates to access borrowing through the primary route. Especially when the lending through banks has tightened. As a result the primary issuance activity too has taken a backseat. Therefore, we expect the RBI to announce a path for introduction of repo on corporate bonds. The RBI could initiate with introduction of only AAA rated PSU bonds for repo. If the activity in using these bonds for collateral increases, the secondary market yields could get a breather. Moreover, the impact could also be felt in the primary market yields. This would in turn reduce the cost of borrowing for corporates through the primary issuances.

Interest Rate Futures

The RBI had put up on its website, the final report on Interest Rate futures in August 2008, which put forth progressive recommendations for introduction of such a product in the market. We expect the RBI to announce a roadmap for introduction of interest rate futures market in the country. Especially in the current falling interest rate scenario, introduction of such a product would gain higher level of acceptance from market participants.

Can the RBI Consider a Cut in SLR??

The RBI, on 14 October 2008, announced a temporary measure of allowing banks to avail additional liquidity support exclusively for the purpose of meeting the liquidity requirements of mutual funds to the extent of up to 0.5 per cent of their NDTL. This support would terminate 14 days from the closure of the special term repo facility announced on October 14, 2008. The facility was in addition to the permission of availing liquidity upto 1 per cent of SLR announce earlier. So all together, the banks have a leeway to borrow upto 1.5% more of their NDTL. This implies that the banks need to maintain only 23.5% of their NDTL for SLR requirements as of now. Can the RBI consider regularizing this 1.5% to a permanent cut in SLR? An SLR cut has always been considered as a progressive measure to be undertaken for reforming the banking sector and doing away with the system of having a captive investment for government borrowings. But going ahead with the SLR cut right now will only hurt the market movement and also impact the government's borrowing programme, which is expected to overshoot the budget.

In what way can the RBI ensure that such a measure does not affect the market, but actually helps ease liquidity and lending concerns? Most of the banks may have already utilized the facility of borrowing excess of upto 1% of their NDTL. But there may be some banks, which have yet to utilize this facility. By giving a cut in SLR upto 1.5%, the RBI could simultaneously also announce that the banks can utilize

this cut to unwind their MSS portfolio.

The RBI had conducted aggressive auctions under the MSS at a time when the country was having problems of huge forex flows. Now the situation has reversed. We are currently facing huge pressures from forex outflows. In order to tide over liquidity crunch created by interventions in forex market and at the same time tide over the lending crunch, the RBI could aggressively undertake unwinding of the MSS portfolio.

In order not to hurt the market and pricing of bank's MSS portfolio, the RBI could announce Open Market Operations. Ideally a particular security could be announced under an OMO for fixed rate. This fixed rate could in turn be the weighted average cut-off yield at which that particular security was issued originally. This will ensure that the banks do not have market-to-market losses on their portfolio and in turn would release liquidity for lending to corporates.

Thus by cutting the SLR by 1.5% and ensuring that the yields do not rise, so as not to hurt the borrowing programme, the RBI could actually have a leeway to cut interest rates further in the economy going ahead.

IDBI Gilts Limited (A wholly owned subsidiary of IDBI Ltd.)
1st Floor, Janmabhoomi Bhavan, Janmabhoomi Marg, Fort, Mumbai – 400 001.
Phone: (91-22) 6617 7900. Fax: (91-22) 66177999

Disclaimer

This report has been prepared by IDBI Gilts Limited (IDBI Gilts) and is meant for the recipient for use as intended and not for circulation. This report should not be forwarded or copied or made available to others. The information contained herein is from the public domain or sources believed to be reliable. While reasonable care has been taken to ensure that information given is at the time believed to be fair and correct and opinions based thereupon are reasonable, due to the very nature of research it cannot be warranted or represented that it is accurate or complete and it should not be relied upon as such. IDBI Gilts, its directors and employees will not in any way be responsible for the contents of this report. This is not an offer to sell or a solicitation to buy any securities. The securities discussed in this report may not be suitable for all investors. Investors must make their own investment decision based on their own investment objectives, goals and financial position and based on their own analysis. IDBI Gilts, its directors or employees may from time to time, have positions in, or options on, and buy and sell securities referred to herein. IDBI Gilts, during the normal course of business, from time to time may solicit from, or perform investment banking or other services, for any company mentioned in this report.