Economics

November 27, 2014

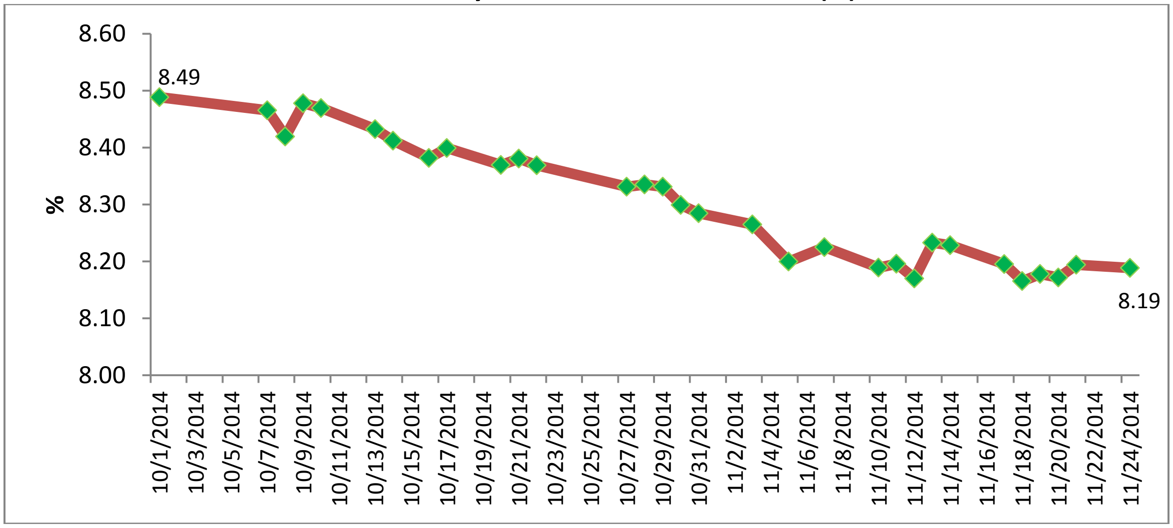
Analyzing the Prevailing Monetary Parameters

This Report brings to the fore the status of major monetary variables which would be considered when the RBI announces its credit policy and outlook on December 2, 2014.

10-yr G-Sec Yield

The 10 year Government Security has been moving downwards so far in this fiscal. The chart below shows the G-Sec yields from 1st October 2014. It has fallen from 8.49% on 1st October to 8.19% on 24th November 2014. The G-Sec yield has been moving downwards owing to excess liquidity in the system and an expectation of rate cut in the coming policy review on account of declining inflation

Exhibit 1: 10 year Government Securities (%)



Source: FIMMDA

Liquidity management

Since the recommendation of the Dr. Urjit Patel Committee in December '13, RBI has gradually shifted to managing liquidity through term repo auctions. This was with a view to better the transmission mechanism of the monetary policy as also to adequately manage the flow of liquidity across the spectrum.

Currently there appears to be less pressure on liquidity in the banking system as the aggregate deposits across banks stands at Rs 82,770 billion as of 31st October 2014, while the amount outstanding through the various repo borrowings stands at Rs 705 billion. Given the 1% of NDTL exposure for LAF, there is a sufficient window up to an additional Rs 185 billion approximately to further make available for repo borrowings.

Aggregate Credit and Deposit

The financial year so far has been characterized with low growth in credit relative to growth in deposit. As of 31st October 2014, credit growth stood at 4.6% as against 7.3% over the corresponding period in the previous fiscal. Deposit growth is comparatively higher at 7.4% compared with 9.5% over the corresponding period in FY14.

Credit off take has remained low. As of September 2014, the credit growth was negative for sectors such as industry and services, only agriculture experienced positive growth in credit. However, the month of October witnessed some pick up in credit; it increased from Rs 1,524 billion as on 19th Sept'14 to Rs 2,785 billion as on 31st Oct'14

Investments

Investments are marginally higher compared with their year ago levels. As of 31st October 2014, investments increased by 9.1% as against 9.0% over the corresponding period in the previous fiscal. Most of these investments are held in the form of government securities.

Table 1: 10 year Government Securities (%)

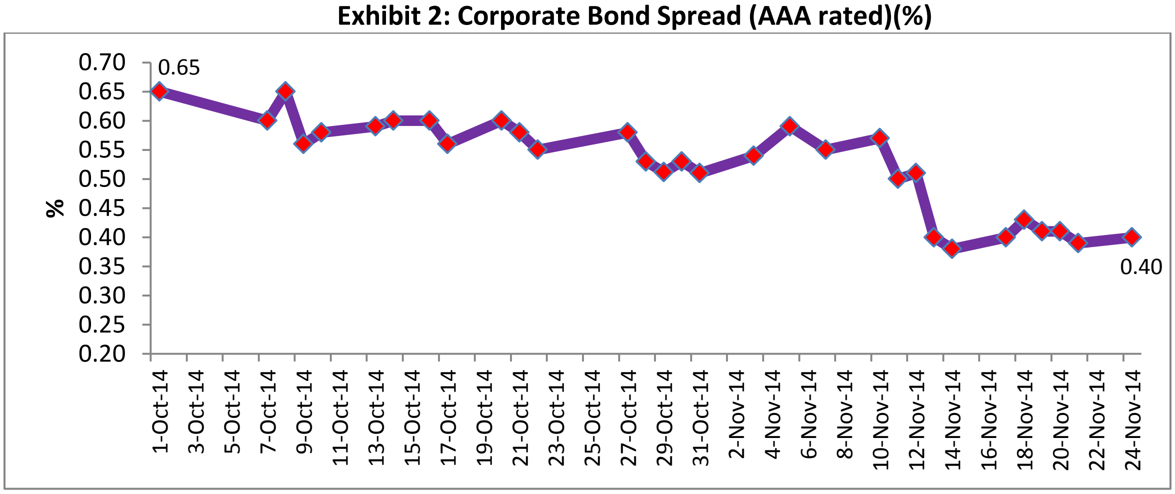
As on	8th Aug'14	5th Sept'14	3rd Oct'14	31st Oct'14
NDTL (Rs bn)	86,812	87,720	89,360	88,956
Investments (Rs bn)	23,685	24,298	24,109	24,151
SLR maintained by Banks (%)	27.3	27.7	27.0	27.2

Source: RBI

The RBI has mandated banks to invest 22% of bank deposits in government bonds. Banks continue to carry excess investments (5% more than the mandated requirement) due to lack of viable lending opportunities and the comfort of parking funds in highly safe assets.

Corporate Bond Spread – AAA (10 years)

Exhibit 2: Corporate Bond Spread (AAA rated)(%)



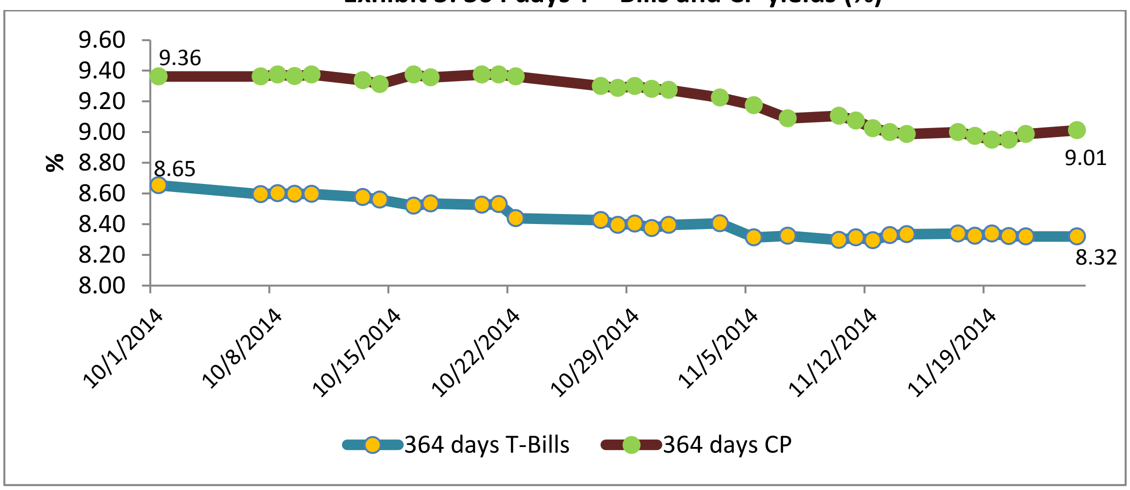
Source: FIMMDA

The bond spread refers to the difference between the yields of two bonds, namely government securities and corporate bond of the same maturity. The decline in the spread is indicative of reduced risks associated with the bond.

The above graph indicates that the spread has been declining over the months. It declined from 0.65% on 1st Oct'14 to 0.40% on 24th Nov'14. The reduced difference between government bonds and corporate securities would hopefully result in an increase in activity in the market once the economy picks up.

Treasury Bills and Commercial Paper

Exhibit 3: 364 days T – Bills and CP yields (%)



Source: FIMMDA

T Bill and Commercial paper yields have also declined on point to point basis. 364 days T-bill yield declined from 8.65% on 1st Oct'14 to 8.32% on 24th Nov'14 while 365 days CP yield declined by 35 bps to 9.01% on 24th Nov'14.

Expectations from the policy

The declining inflation for the fifth consecutive month poses a strong case for the RBI to consider a rate cut. However, one needs to view these inflation numbers with caution. First, the base effect is pronounced and will be so in November too when the CPI index peaked.

Table 2: CPI Inflation

Months	FY14	FY15	CPI inflation
October	137.6	145.2	5.5
November	139.4	145.2*	4.2
December	138.0	145.2*	5.2
January	137.4	145.2*	5.7

Source: MOSPI, *Assumption

If we assume zero inflation on month on month basis (i.e. an unchanged index) for the next three months, only the month of November would result in inflation of below 5%. In another Scenario, if the index is valued higher at 146 for the next 3 months; inflation would increase to 4.7% (Nov), 5.8% (Dec) and 6.3% (Jan) respectively. Thus, the critical part is to see how the inflation moves in the coming months.

Second, the Ministry of Agriculture has forecast lower kharif output for cereals, pulses and oilseeds. This would also put some upward bias on inflation in the coming months. Also, average CPI inflation in FY15 (Apr – Oct) stands at 7.4%. Third, the exchange rate has been depreciating, mostly driven by the dollar – euro relation and the higher imports.

Therefore, ***while a rate cut would help to assuage sentiment, the RBI may choose to defer the decision for the next review***

Contact:

Madan Sabnavis	**Anuja Jaripatke**
Economist	**Associate Economist**
madan.sabnavis@careratings.com	*anuja.jaripatke@careratings.com*
91-022-67543489	91-022-61443515