Economics

June 3, 2014

CARE Ratings
Professional Risk Opinion

Monetary Policy: June '14

Delivering to market expectations, the RBI announced no change in the key interest rate i.e. the repo rate thereby continuing with the pursuance of a cautionary stance on inflation and anchoring inflationary expectations to build an environment conducive to growth in due course. However, there is an indication to ease liquidity with the SLR being lowered by 50 bps.

Highlights–

- Interest rates
    - Repo rate under liquidity adjustment facility (LAF) kept status quo at 8%.
    - Accordingly, reverse repo rate stands unchanged at 7%
    - MSF rate unchanged at 100 basis points above the repo rate at 9%.
- Key Ratios
    - Cash Reserve Ratio (CRR) of Scheduled Commercial Banks kept constant at 4% of Net Demand and Time Liabilities (NDTL)
    - Statutory Liquidity Ratio (SLR) of scheduled commercial banks reduced by 50 basis points from 23% to 22.5% with effect from 14th June 2014
- Liquidity measures
    - Reduce the liquidity provided under the Export Credit Refinance (ECR) facility from 50% of eligible export credit outstanding to 32%
    - Introduction of a special term repo facility of 0.25% of NDTL to compensate fully for the reduction in access to liquidity under the ECR.
    - Liquidity provision under 7-day and 14-day term repos of up to 0.75% of NDTL to continue.

Rationale for Policy Stance

- ***Inflation provoked caution remains:*** Inflation measured by the CPI marked an increase in March and April '14 driven by the rising food prices. While, there are seasonal factors at play, there still remain upside risks to inflation going ahead in the form of a delayed and reduced monsoon, global geo-political tension which could impact oil prices and uncertainty in the domestic economy relating to the setting of administered prices**.** However, the upside risks may be balanced with the strong new Government's action on food supply and better fiscal consolidation.
- ***Term repos- key for dissipation of credit:*** Dr. Urjit Patel Committees' report continues to remain in the spotlight as the RBI decided to reduce the credit available to the Export Credit region through the Export Credit Refinance (ECR) facility from 50% to 32% with immediate effect. The Committee stressed upon ending the sector specific discharging of credit and in turn gravitate towards a more generalised provision of liquidity while also facilitating the transmission of policy across the interest rate spectrum. Secondly, this reduction in the availability of credit will be compensated by the introduction of special term repo facility equivalent to 0.25% of NDTL. This was also a

recommendation of the Dr. Patel Committee to employ the term repo as a key rate for the provision of liquidity in the system.

- ***Increasing credit availability to meet investment demand:*** The RBI reduced the SLR requirement of the commercial banks to 22.5% of their NDTL from the previous level of 23%. This move was attributed to the anticipated rise in demand for credit as investments increase in the wake of a recovery in the economy. RBI expects credit need to increase such that it eventually assists towards supply. Hence, in order to enable banks to lend more than their existing ability, the SLR was reduced. However, the SLR of banks at 28.5% is currently met well above the stipulated rate of 23%. Hence, the reduction to 22.5% is not expected to make a significant difference in Bank lending.
- ***Deepening and strengthening the FOREX Market:*** In a welcome move, the RBI is to allow Foreign Portfolio Investments in the domestic Exchange Traded Currency Derivatives Market to the extent of their underlying exposures and also an additional US $ 10 mn. This is a good step as it will improve the depth and liquidity of the domestic FOREX market and also provide cover for corporates who take to this market to hedge risks. Further, FOREX outflows have also been liberalised given the stability in the exchange rate and sufficient FOREX reserves in the country.
- ***Easing of outward remittances. It*** has been decided to enhance the eligible limit under Liberalized Remittance Scheme from $ 75,000 to US$ 125,000 without end use restrictions except for prohibited foreign exchange transactions such as margin trading, lottery and the like. This is indicative of improvement in the external balance of the economy.

RBI's Outlook

- ***Real GDP in the range of 5-6% in FY15:*** Given that inflation continues to be reined in as per the desired disinflationary path, a real GDP growth between 5-6% is expected in FY15. The risks appear balanced presently as domestic supply bottlenecks are expected to ease down and implementation of stalled projects will make head way. These factors should support the manufacturing and the services sector. The agricultural sector in turn is contingent on the monsoon. Hence, an evenly balanced risk spread supports the RBI's projection of a 5.5% GDP growth in FY15. ***CARE's projection still stands at 5.2-5.5% depending on El Niño and monsoon effect.***
- ***CPI target of 8% by January 2015 and 6% by January 2016 reiterated:*** The CPI targets put forward by the Dr. Patel Committee were reinstated in the policy announcement with a clear commitment of the RBI signalled to rein in inflation.
- ***Positive sentiment and strong Government to provide fillip:*** Given the election of a strong Government juxtaposed with the positive sentiment, it is likely to create a conducive environment for policy implementation and generate a revival in aggregate demand which should better the growth prospects. Further, the recent growth in exports is likely to continue buoyed by the increasing demand from developed trade partners.

CARE's view

- ***Going ahead, given the uncertainty surrounding the monsoon and a likelihood of the El Nino, we expect RBI to maintain repo rate at 8% and continue with its stance until there is clarity over the nature of monsoon.*** A reversal in the stance to promote growth can be expected in Q4- FY15 provided inflation remains within the comfort corridor.
- Further conjectures about the economy will follow upon the announcement of the Union Budget for FY15 as it will establish the Government's borrowing plan for the ongoing fiscal.

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