Credit Policy

April 20, 2010

ING ORANGE VIEW

Policy measures

- RBI hiked Repo rate and Reverse Repo rate by 25 bps each to 5.25% and 3.75% respectively.
- RBI also hiked CRR by 25 bps from 5.75% to 6%, effective from April 24, 2010. This is expected to drain around Rs. 12,500 crs of liquidity from the system.
- Bank rate unchanged at 6%.

Policy assessment

- Strong recovery in growth despite a poor monsoon during FY2009-10 shows the resilience of domestic economy. GDP growth for FY2009-10 is estimated in the range of 7.2% to 7.5%.
- Strong recovery was seen in industrial activity with IIP showing more than 15% growth for the previous three months, driven by sharp rebound in capital goods sector indicating that there is good revival in investment activity.
- However, elevated level of inflation is worrisome with the headline WPI inflation number at around 10% as on March 2010. While, food price inflation is slowly subsiding, manufacturing inflation is increasing which points at the fact that specific inflation is slowly transforming into a more generalized inflation.
- Credit growth picked up by the year end and was at 16.9% by March 2010.
- GDP growth projection for FY2010-11 is placed at 8.0% with an upside bias. While baseline projection on WPI Inflation for March 2011 has been kept at 5.5%.

Policy stance

- The first phase of exit from accommodative monetary policy stance was in October 2009 with RBI restoring SLR and withdrawal of certain sector specific relief measures.
- January 2010 policy marked second phase of exit with CRR being hiked by 75 bps.
- RBI also hiked Repo rate and Reverse Repo rate in a surprise move during March 2010 as inflation exceeded 8.5% which was the baseline projection of RBI.
- April 2010 policy is guided by three major considerations:
  - a. Lower policy rates can give rise to inflationary expectations. Also, even after 25 bps rate hike in March 2010, the real policy rates (policy rates minus inflation) are still negative.
  - b. Inflationary pressures are very strong with evidence that from a specific food price inflation, it is now transforming into general inflation which would give rise to further inflationary expectations.
  - c. Managing government borrowing program for FY2010-11 is seen as a bigger challenge compared to last year as the previous year's borrowing program was supported by MSS unwinding as well as open market operations by RBI. Since, such support would not be available in any significant way for FY2010-11, RBI would have to ensure that the liquidity in the system is not too low for the government as well as private sector borrowing requirement.
- RBI would respond to inflationary situation swiftly and effectively to ensure that inflationary expectations are anchored.
- RBI would also manage liquidity actively to ensure that there is enough liquidity in the system for credit requirements of both public sector as well as private sector.

April 20, 2010

Our assessment

- We believe that the monetary policy stance would continue to target inflation in the foreseeable future and would give priority to "anchoring inflationary expectations" over "nurturing growth in the economy".
- We believe RBI would hike policy rates (both Reverse Repo rate and Repo rate) by 100-125 bps during FY2011. This is likely to happen in small doses of 25 bps from time to time with a possibility of unscheduled rate hikes between quarterly policies.
- We expect that RBI may hike CRR by lesser quantum, possibly 50-75 bps during FY2010-11 as it is worried about the adequacy of liquidity in the system and the credit requirement of both the private sector and to support the government borrowing program.
- We believe that markets will remain range bound between 7.95%-8.20% in the short term.

Our portfolio stance

- In line with our stance, we would like to manage duration actively with increasing duration when yields look attractive and reduce it at lower levels.
- **Interest rates have moved up sharply in last few months due to expectations of rate hikes from RBI as well as due to large government borrowing program. However, a lot has been priced in currently in the interest rates. At the same time, as inflation is peaking out we believe that rates may not harden too much from here. We would advise investors to now start looking at Income Funds and Gilt Funds from a one year or longer time horizon for investment.**