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# Credit policy

## IMPACT ANALYSIS

## Annual Monetary Policy 2008-09


### Summary

**Inflation**: The global pressure on inflation from primary commodities and oil, due to supply crunch, is not expected to ease soon. While inflation is expected to remain high in the next few months, we expect it to soften towards the end of the year, under a normal monsoon scenario. As a consequence, we expect inflation to settle at an average of 5.5 per cent in 2008-09.

**Interest rates**: We expect some monetary tightening measures by the central bank to rein in inflation in the future. As a result, the market rates will go up compared to the current year and we expect the 10-year G-sec rate to stay within the range of 7.5 to 7.7 per cent with an upward bias.

**Exchange rate**: Indian economy is expected to continue to attract foreign inflow as it presents an attractive investment opportunity relative to most other countries. The RBI will continue to intervene in the market to curb volatility and will try to maintain the exchange rate at around Rs 38.5-39.0 a dollar.

**Deposits**: We expect term deposits of SCBs to grow by 19 per cent in 2008-09 as compared with the 21.6 per cent growth in 2007-08. Aggregate deposits are forecast to increase by 18 per cent in 2008-09.

**Advances**: We expect non-food credit to grow by 21 per cent for 2008-09 on concerns of expected slowdown in GDP and a high interest rate environment, coupled with delays in capex spends due to high commodity prices.


**April 2008**

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# Annual Monetary Policy 2008-09

## Highlights

- Bank rate, reverse repo rate and repo rate kept unchanged.
- Following a CRR hike by 50 bps on April 17, the ratio hiked by further 25 bps to 8.25 per cent, with effect from the fortnight beginning May 24. This cumulative hike of 75 bps is expected to suck out liquidity worth Rs 277.5 billion from the system.
- GDP growth projection for 2008-09 in the range of 8.0-8.5 per cent.
- Inflation to be brought down to 5.5 per cent during 2008-09, with a medium-term objective of around 3.0 per cent.
- High priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while sustaining the growth momentum.
- Emphasis on credit quality and credit delivery while pursuing financial inclusion.
- M3 growth to be contained within the range of 16.5-17.0 per cent during 2008-09.
- Deposits projected to increase by around 17 per cent or Rs 5, 50,000 crores during 2008-09.
- Growth of non-food credit to be contained at around 20 per cent during 2008-09.
- The limit of bank loans for housing enhanced from Rs 20 lakhs to Rs 30 lakhs for applicability of reduced risk weights at 50 per cent.
- Currency futures to be introduced in eligible exchanges in consultation with Sebi; broad framework by the end of May 2008.
- A clearing and settlement arrangement for OTC rupee derivatives proposed.
- Indian companies allowed to invest overseas in energy and natural resources sectors such as oil, gas and coal in excess of the current limits.

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## An appropriate response

Our view of the macroeconomic scenario was that an interest rate hike was not needed. This was based on the premise that, while inflationary pressures were high, growth was decelerating. Under these circumstances, any action by the Reserve Bank of India to address one of these indicators would simply reinforce the tendency that the other was showing – a genuine dilemma. We have been analysing this trade-off with the help of concepts known as output and inflation gaps – statistical estimation of the gap between actual and potential GDP and inflation rates, respectively. These gaps, presuming that they are accurately estimated, provide objective guidance to policymakers. When the output gap is positive – actual is higher than potential – the economy is in an overheating situation and the appropriate response is to raise interest rates or otherwise tighten monetary policy. Of course, the validity of this response is increased if the inflation gap is also positive.

As our analysis of gaps later in this report shows, the economy is not in such an unambiguous situation today. The output gap is negative and has been so for the last three quarters, a clear sign of slowing down. However, the inflation gap is positive, which might suggest that a monetary tightening is in order. But, to the extent that the inflation gap is the result of supply, rather than demand forces, a conventional monetary response might have very little direct impact on it, while it almost certainly would have widened the negative output gap. In such a situation, the best response is usually to maintain the status quo, at least until further developments and that is precisely what the RBI did with the repo rate.

What about the hike in the CRR, coming so soon after a hike barely two weeks ago? The value of this is partly symbolic, in that it deflects criticism of the RBI from those who would argue that it must do something about inflation. However, there is a more practical aspect to it as well. As long as growth remains moderate, the CRR hike should not lead to any pressure on interest rates because the demand for credit will remain subdued. However, if growth were to accelerate and, consequently, reinforce the supply-side inflationary pressures with demand-side ones, the higher CRR would become a constraint on the banks' ability to expand lending beyond a point. In this sense, it is likely to be an effective defence against a potential overheating scenario, even as the measures that have been taken to contain supply-side inflation take effect.

At least as far as the repo rate is concerned, sometimes, doing nothing is the best policy.

## I. Macro analysis

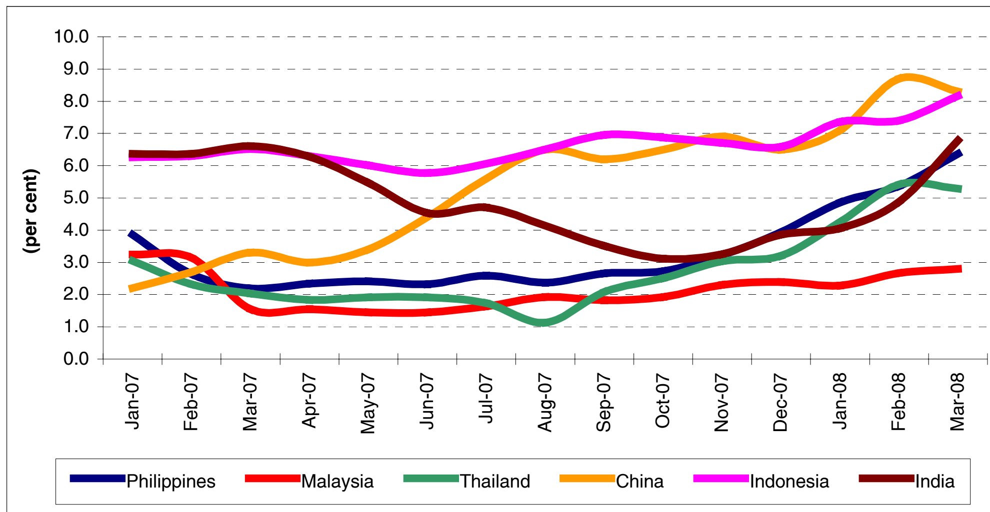
The Monetary Policy of April 29 comes in the backdrop of a slowing economy facing a sudden and a sharp surge in inflation. The WPI-based inflation touched 7.41 per cent in March and this is way above the comfort band of policy makers. At this juncture the growth moderating effects of tight monetary policy actions over the last two years are still coming through and a moderating global economy is reducing the external stimulus to growth. Also, the inflationary surge is not on account of demand-side factors but is rather due to a supply shock from energy, commodity and food prices. As monetary policy tools are more effective in controlling demand-driven inflation, the central bank faces a difficult choice of balancing downside risks to growth along with upside risks to inflation.

With the March inflation numbers (6.9 per cent) coming on the higher side of the RBI's target of 4-5 per cent, what followed was a series of fiscal measures like ban on exports of certain essential items and removal/reduction in import duties on others by the government to curb the price rise. The RBI also stepped in and hiked the cash reserve ratio (CRR) by 50 basis points (bps) before the Annual Policy on April 17 and then again by 25 bps on April 29 to suck out excess liquidity to rein in the inflationary pressures. Though the CRR hike is expected to drain liquidity worth Rs 277.5 billion from the system, its real impact on slowing down prices will come only with a lag.

India is not the only country which is facing the dual problem of balancing growth with high inflationary rates. In fact, central bankers world over are facing a similar dilemma. While the correct prognosis for a slowing economy is a rate cut, high inflation rates in most of the economies warrants an opposite policy action. Almost all the Asia-Pacific countries have seen their interest rates either increased or kept on hold to cool off inflationary tendencies. Most countries have witnessed unprecedented levels of inflation in the last few months. Even countries like Japan which have seen almost zero inflation rates for the past many years are grappling with it (fig 1). Rising prices for food, energy and other raw materials account for much of the pick-up in the inflation rates. Though some of the factors driving inflation are country-specific, like pork shortages in China, drought in Australia, hike in goods and services tax in Singapore, the fact that inflation has been rising everywhere suggests that some of the causes are global.

Many of the Asia-Pacific and developing countries, where consumers spend a large proportion of their income on food, have witnessed social unrest due to rise in food prices. Contribution of food inflation to headline inflation has been as high as 21 per cent in China and 30 per cent in Vietnam for March. On the other hand, core inflation (ex-food and energy prices) in these countries has been rather subdued, suggesting that pressures emanate primarily from the food and energy front. Governments, world over, have taken many pro-active steps, both fiscal as well as monetary, to curb inflation but the impact of monetary measures is debatable with inflation in the present scenario being mainly driven by supply-side factors. With the global food inflation staying firm and oil touching new highs the road ahead for majority of these economies is rather difficult. As of now, it seems that they would have to get used to living in an environment characterised by high inflation rates and slowdown in growth.

Figure 1: Headline inflation in select Asia-Pac economies



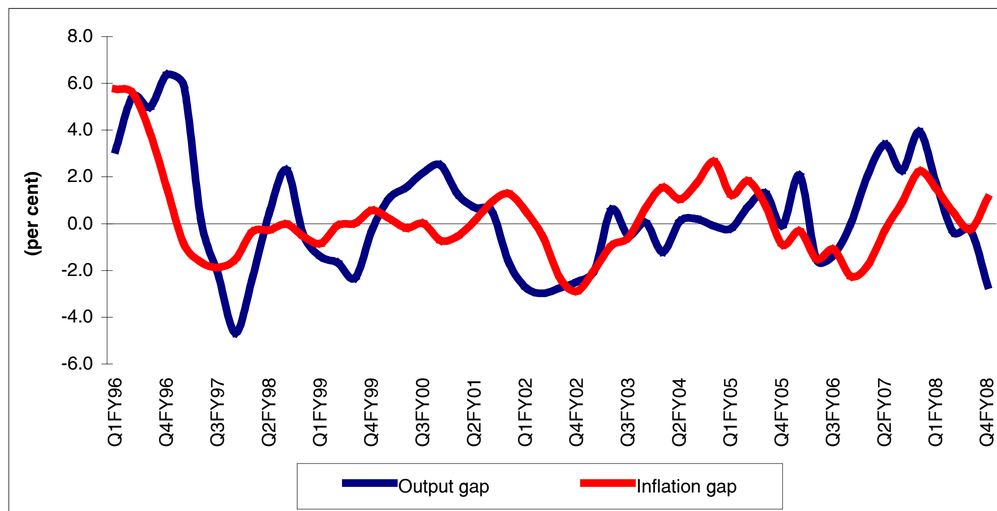

Source: CEIC Database

Back home, March inflation was particularly influenced by the prices of minerals and metals, which pushed the inflation up to 6.8 percent, the highest in over three years. The prices of iron and steel shot up by close to 30 percent as compared to the prices during the corresponding month previous year. Steep rise in the prices of important inputs, like iron ore, led to a surge in the metal industry. The last two weeks of March saw the prices of iron ore growing by over 50 percent. Within the food group, the prices of food grains, fruits and vegetables showed a rising pattern but these got subdued in April. With the reasonable rabi harvest and a normal monsoon forecast, the food situation seems to mark a lesser risk to inflation. However, the clouds of danger from global fuel and commodity prices still persist and are expected to stay for at least few more months.

## Output gap and inflationary tendency

The understanding of the link between real economy and inflation helps in the formulation of the monetary policy. Output gap, which is a measure of the difference between the actual output growth and its long-run/potential trend, is a key indicator to discern whether inflationary pressures in the economy are emanating from the demand side or not. When the output gap is positive (negative) the demand side pressure in the economy is more (less) relative to its capacity. This tends to put upward (downward) pressure on price levels. Thus the nature of pressure on prices emanating from the output gap is quite significant to take a call on the direction of the monetary policy. Another way of looking at the whole issue is to measure the inflation gap, a concept similar to the output gap. Inflationary gap shows the difference between actual and potential price rise. When the output gap is positive (GDP is above its long-term trend), then the likelihood of an interest rate hike by the central bank is more. Similarly, when inflation is above its target, there are more chances of monetary tightening.

**Figure 2: Estimates of the output and inflation gap**




Note: The results are based on the index of industrial production (manufacturing) and the wholesale price index (manufacturing). The potential growth rates were estimated using the Hodrick-Prescott filter. The deviations of the actual output and inflation series from their respective potential rates represent the estimates of the gaps.

**Source: CRISIL estimates**

The output gap estimates presented in figure 2 suggest that after remaining in the positive territory for six consecutive quarters since the fourth quarter of 2005-06, the output gap since the second quarter of 2007-08 has turned negative. This simply means that the actual output has slipped below its potential output lately. In terms of policy such a situation warrants loose monetary stance to prop up demand and in turn output. However, a look at the inflation gap, which is showing that actual inflation is running higher than potential/ target inflation, suggests just the opposite. This is the dilemma that RBI is facing presently. That despite the output gap being negative, the inflation gap being in the positive territory shows that inflationary pressures are not emanating from demand side pressures. It is more of an outcome of supply constraints/shocks as mentioned by the RBI document "Macroeconomic and Monetary Developments in 2007-08" released on April 28, 2008.

Against this backdrop, RBI had a difficult task at hand. It has indeed done a fine balancing act, by hiking only the CRR by 25 bps while maintaining status quo in case of other policy rates. This will help growth without putting undue pressure on interest rates.

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## II. Liquidity and interest rates

The fourth quarter saw the narrowing down of the spread between the 1-year and 10-year G-secs from an average 23 bps in the third quarter to 11 bps in the January-March quarter due to the firming up of yields of 1-year G-sec. The average yield on the benchmark 10-year G-sec declined by 29 bps to 7.59 per cent in the fourth quarter compared to the third quarter average of 7.88 per cent, whereas yield on 1-year G-sec declined only marginally from 7.50 per cent to 7.47 per cent over the corresponding period. The last week of March, however, saw large amount of volatility in the gilt market, with the yield on the 10-year G-sec inching up to 7.95 per cent by the end of the fiscal year. In fact, the yield breached the psychological 8.0 per cent level on April 11 and touched a nine-month high of 8.11 per cent on April 17. The rise was fuelled by expectations that the central bank would tighten the monetary policy to curb inflation, which is currently at its 3-year high.

The last quarter of 2007-08 was characterised by comfortable liquidity conditions interspersed with transient periods of tightness. Liquidity tightened towards the end of March due to the outflow of advance tax payments from the banking system and various other provisioning requirements which the banks have to meet before the financial year-end.

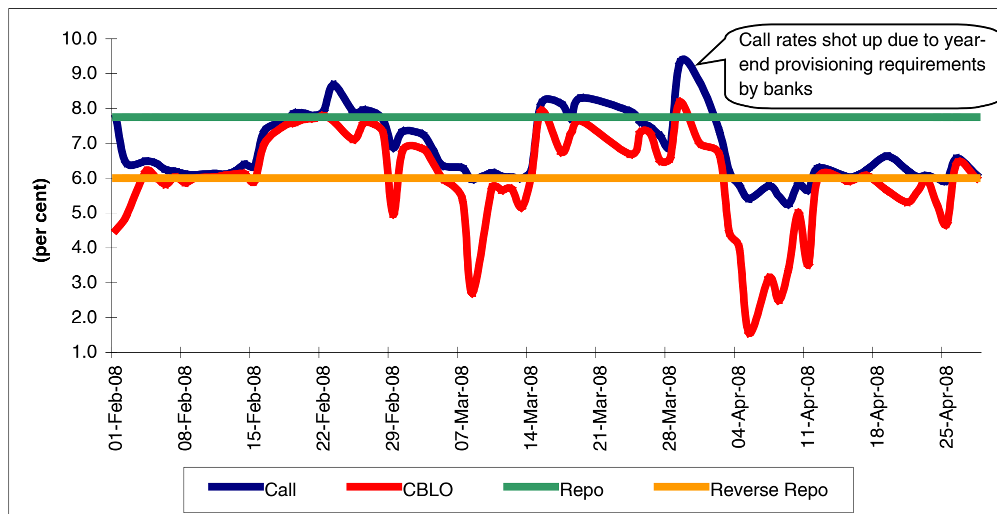
### Recent pattern

The central bank kept all the key policy rates unchanged in the third quarter review of the monetary policy on January 29, 2008. The decision of status-quo by the central bank reflects its cautious stand in the light of presence of inflationary tendencies, fuelled by surplus liquidity conditions in the economy and buoyed by healthy FII inflows. The month of March witnessed unprecedented high inflation levels in the economy, which caught both the government as well as the RBI off-guard and, hence invited a slew of fiscal measures by the government to control the situation. RBI also swung into action on April 17, when it hiked the CRR by 50 bps to 8.0 per cent, and this is expected to suck out liquidity worth Rs 185 billion from the banking system. This move by the RBI, along with the resumption of MSS issuance, will weigh on the systemic liquidity present in the system.

In the fourth quarter, after a month of comfortable liquidity in January due to robust government spending, liquidity tightened towards the end of February as banks kept aside funds to meet the advance tax payments deadline in March and other year-end financial requirements. The situation remained the same during the second half of March as well and RBI was seen injecting funds into the economy through its repo window under the LAF operations. An average of Rs 21,868 crore was injected during March 17-31, 2008. During these episodes of liquidity crunch, the call rates went outside the official corridor of repo and reverse repo rates. (Fig 3)

On November 7, 2007, the ceiling on the market stabilisation scheme (MSS) was increased to Rs 2,500 billion from Rs 2,000 billion in a bid to absorb excess liquidity from the system. In January 2008, auction of dated securities under MSS was resumed after a gap of two-and-half months keeping in view the changing liquidity situation in the economy. For the whole of 2007-08, RBI absorbed excess liquidity worth Rs 1683.92 billion under MSS operations compared to Rs 629.74 billion in the last fiscal. As a per cent of ceiling, the outstanding under MSS stands at 67 per cent and the current balance available to the RBI is Rs 816.08 billion as on March 31, 2008. The ceiling of Rs 2,500 billion has been retained for 2008-09 as well.

**Figure 3: Money market rates in 2008**




**Source: CCIL database**

## FII inflows moderate in the fourth quarter

The fourth quarter of 2007-08 stood out in the respect that it was the only quarter of FY08 which witnessed net FII outflows to the tune of $1.9 billion compared to a significant amount of net FII inflows in the previous three quarters. In fact, in January alone, FIIs were net sellers to the tune of $2.7 billion, the highest net sales by FIIs in a single month ever since they entered the Indian markets. A downturn in the pattern of FII flows in January mirrored the then prevailing uncertainty regarding the state of the US economy and the impending recession which seemed to have taken a toll on the global economic outlook and also significantly dented the risk appetite of the global investors. The outflows coupled with weakness in global markets were responsible for the Sensex crashing by more than 2,000 points in a single day in January. In the wake of an uncertain global scenario, FIIs again turned into selling mode in the equity as well as debt market, leading to combined net outflows of $0.25 billion during March as against net inflows of $1.05 billion during February.

## III. Impact analysis on the economy

### Inflation

In a situation of high inflation and moderation in growth, the central bank has tried to maintain a fine balance between growth and inflation by maintaining a status quo on repo rate and reverse repo rate and hiking the CRR by 25 bps. This act of RBI is likely to result in a total cash outflow of Rs 277.5 billion from the banking system. While the current inflation is being influenced more by the global phenomena leading to a supply crunch, a tighter policy would have hit growth prospects without reducing inflation. In an expected normal monsoon scenario, the inflationary pressure is likely to subside during the second part of the current fiscal. On balance, we expect the overall rate of inflation to hover around 5.5 percent during 2008-09.

### Interest rate

There was a relief rally in the bond market following the status quo stand of RBI on all the key interest rates contrary to market expectations of a rate hike. Post the policy announcement, the benchmark 8.07 per cent government security was trading at 8.03 per cent, down almost 12 bps points, from the start of the day. There is a clear overhang of liquidity in the system at present, primarily because of foreign exchange intervention by RBI as well as substantial reduction in cash balances of the central government. To address this issue, the central bank announced a CRR hike of 25 bps points to 8.25 per cent in April 29 policy. Along with the 50 bps hike announced earlier, it is expected to mop up a cumulative liquidity worth Rs 277.5 billion from the system. If inflation persists at high levels, further monetary tightening measures by RBI are not ruled out. Keeping all these factors in mind, we expect the yields on the 10-year G-sec to remain elevated in the near-term but eventually lie within the range of 7.7-7.9 per cent by the fiscal year-end.

### Exchange rate

Although fall in export revenues and higher import bill will exert lower pressure on the rupee, with relatively high growth compared to the major economies, India will continue to attract high financial inflows during 2008. Thus, RBI is expected to monitor the rupee carefully to maintain export competitiveness. The CRR hike will provide RBI more room to manoeuver, and we expect the rupee to trade at around 38.5-39.0 against the dollar by the fiscal year-end.

## IV. Impact analysis on banking

### Deposits

*RBI's assessment of developments*

Accretion to bank deposits, led by time deposits, remained buoyant. As per the RBI's document 'Macroeconomic and Monetary Developments in 2007-08', released on April 28, 2008, growth in demand deposits, as at end-March 2008 was higher at 19.2 per cent as compared with 17.1 per cent a year ago. Demand deposits, after remaining subdued for most part of the year, expanded during January and the beginning of February 2008, mainly reflecting developments in the equity market. The buoyancy in time deposits continued in 2007-08, although some moderation was observed during the last quarter. Growth in time deposits was 21.6 per cent at end-March 2008 as compared with 23.5 per cent a year ago. The RBI attributes the higher order of increase in time deposits to robust economic activity, higher interest rates on bank deposits relative to postal deposits, and extension of tax benefits under Section 80C for bank deposits with maturity of 5 years and above. On an aggregate basis, growth in deposits decelerated to 22.2 per cent at end-March 2008 as compared with 23.8 per cent a year ago.

The deposit rates of scheduled commercial banks (SCBs) softened, particularly at the longer end of the maturities during 2007-08. Interest rates offered by public sector banks (PSBs) on deposits of maturity of 1-3 years were placed in the range of 8.25-9.25 per cent in March 2008 as compared with 7.25-9.50 per cent in March 2007. Rates on deposits of maturity of above 3 years were placed in the range of 8.00-9.00 per cent in March 2008 as compared with 7.50-9.50 per cent in March 2007. Similarly, interest rates offered by private sector banks on deposits of maturity of 1-3 years were placed in the range of 7.25-9.25 per cent in March 2008 as compared with 6.75-9.75 per cent in March 2007, while those on deposits of maturity above 3 years were placed in the range of 7.25-9.75 per cent in March 2008 as compared with 7.75-9.60 per cent in March 2007.

*CRISIL Research opinion*

Wholesale funding costs for banks witnessed a decline in March 2008. Bulk deposit rates in March 2008 were 125 bps lower than in March 2007 due to excess liquidity in the system and slowdown in credit demand. A few banks even stopped accepting bulk deposits towards the end of 2007-08. The re-pricing of these high-cost bulk deposits is expected to improve margins of several banks in the first quarter of 2008-09, especially for those with a high proportion of bulk deposits. However, the latest hike in CRR by 25 bps to 8.25 per cent, with effect from the fortnight beginning May 24, 2008, as also the previous 50 bps hike to 8 per cent, may again increase the overall cost of resources for banks. Further, excess SLR, which is currently at close to 2.5 per cent, is no longer sufficient to fund credit growth. Consequently, a further slowdown in credit growth is likely, thereby forcing banks to revisit their deposit growth strategies. We believe that banks might further bring down short-term deposit rates to manage margins in the reduced credit off-take environment.

The two major regulatory measures by the RBI - successive increases in CRR and zero interest on CRR balances - have had a significant impact on interest yields for banks. Since June 2006, the RBI has not been paying any interest on CRR balances. Prior to this, the RBI had been paying interest at the rate of 3.5 per cent on CRR balances maintained by SCBs above the statutory minimum of 3 per cent and up to the prescribed level of 5 per cent (eligible cash balances). No interest was payable on any amount actually maintained in excess of the balance required to be maintained.

Assuming that lending rates and the yield on investments remained constant, SCBs as a whole have had to take a hit of 7 bps (annualised) on their spreads and net profitability margin (NPM) solely due to RBI's measures relating to CRR balances.

In this backdrop, we believe that banks might be required to further bring down short-term deposit rates to manage margins. As a result, CRISIL Research expects term deposits of SCBs to grow by 19 per cent in 2008-09 as compared with the 21.6 per cent growth in 2007-08. Aggregate deposits are forecast to increase by 18 per cent in 2008-09.

## Advances

### *RBI's assessment of developments*

Expansion in bank credit moderated, consistent with policy projections. As per the RBI's document 'Macroeconomic and Monetary Developments in 2007-08', growth in bank credit to the commercial sector moderated during 2007-08 after a strong pace of credit expansion for 3 consecutive years - growth in bank credit to the commercial sector decelerated to 20.3 per cent at end-March 2008 as compared with 25.8 per cent a year ago. The growth in non-food credit of SCBs decelerated to 22.3 per cent at end-March 2008 from 28.5 per cent at end-March 2007.

The deceleration in credit growth relative to the acceleration in deposit growth led to a decline in the incremental credit-deposit ratio of SCBs to 71.9 per cent at end-March 2008 from 84.3 per cent a year ago.

According to RBI data available up to February 15, 2008, about 45 per cent of incremental non-food credit (y-o-y) was absorbed by industry, around 9 per cent by agriculture, 16 per cent by personal loans, and the remaining 30 per cent by services.

The expansion of incremental non-food credit to industry during this period was led by infrastructure (power, port and telecommunication), textile, food processing, iron and steel, engineering, chemicals, vehicles, construction and petroleum industries. The infrastructure sector alone accounted for around 33 per cent of the incremental credit to industry as compared with 21 per cent in the corresponding period of the previous year. Within personal loans, the share of incremental housing loans was 46 per cent. Growth in loans to commercial real estate remained high, notwithstanding some moderation.

The benchmark prime lending rates (BPLRs) of PSBs and private sector banks were placed in the range of 12.25-13.50 per cent and 13.00-16.50 per cent, respectively, in March 2008 as compared with 12.25-12.75 per cent and 12.00-16.50 per cent, respectively, in March 2007.

The weighted average BPLR of PSBs increased from 12.4 per cent in March 2007 to 12.8 per cent in March 2008. Over the same period, the weighted average BPLR of private sector banks increased from 14.3 per cent to 15.1 per cent. The weighted average BPLR of foreign banks also increased from 12.6 per cent in March 2007 to 13.9 per cent in March 2008.

### *CRISIL Research opinion*

Of the aggregate deposits garnered, banks are stipulated to park minimum 25 per cent of their net demand and time liabilities (NDTL) in SLR securities and 8.25 per cent of NDTL (with the latest hike) as CRR balances with the RBI. Only the balance 66.75 per cent of total deposits, along with the borrowings, are available for deployment towards advances. The 25 bps hike in CRR is expected to pull out Rs 92.5 billion from the banking system. With the SLR levels falling from 38 per cent in 2004-05 to 27.4 per cent in 2007-08, and with reducing avenues for lending, banks now have to invest incrementally in SLR securities. Credit growth has slowed down considerably in January and February 2008, which have traditionally been busy months, due to a delay in capital expenditure (capex) spends. We are lowering our non-food credit growth forecast (given in our Banking Annual Review of September 2007) by 1 percentage point to 21 per cent for 2008-09 on concerns of expected slowdown in GDP and a high interest rate environment, coupled with delays in capex spends due to high commodity prices.

We believe the move enhancing the limit of housing loans for individuals from Rs 2 million to Rs 3 million is a positive one and may partly help in addressing the current slowdown in housing loan disbursements. We believe an important local factor that might have been taken into consideration in this policy change has been the inherent increase in the average ticket size on home loans that has taken place in the last couple of years, given the rising property prices. The measure may also have been aimed at incentivising bankers to claim the benefit of a lower risk weight, particularly in case of creditworthy borrowers with ticket sizes above Rs 2 million up to Rs 3 million and loan-to-value (LTV) below 75 per cent. Earlier, loans with ticket sizes above Rs 2 million up to Rs 3 million and LTV below 75 per cent attracted a risk weight of 75 per cent. The enhancement of loan limit will, therefore, positively impact the capital adequacy of banks, with a 25 per cent savings in capital charge. Further, we also believe that this measure might indirectly help in reducing the LTV on the high ticket home loan portfolio and create a cushion of margin money in the event of a likely fall in property prices.

At the same time, if housing loans below Rs 3 million were to be treated as part of priority sector lending, then it would provide a boost to the sector and would reduce pressure on banks to originate/buy priority sector loans. We await clarity regarding the treatment of these loans as part of priority sector.

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## V. Global context

The global economy is witnessing slowing growth and rising inflation. Yet, the emerging market economies continue to grow above the trend and are, in general, benefiting from high commodity prices. The continuing slump in the housing market continues to exert stress on the US economy and coupled with the increased difficulty in obtaining finance due to the subprime crisis, the consumer expenditure is also falling. Cut in interest rates by the Federal Reserve, in addition to the massive liquidity pump in, has helped the economy somewhat, but consumer spending is likely to gain some boost from the fiscal packages which have begun to be doled out yesterday. In addition, a weak dollar and demand for high technology capital goods from emerging economies have boosted US exports and will prop up growth this year. Another 25 bps rate cut by the Fed tomorrow is widely expected, though it is likely to be more if tomorrow's GDP growth estimates for the first quarter of 2008 comes out poor. Yet, the general outlook for US growth, though weak, remains optimistic as the impact of the fiscal package starts kicking in and further risk from subprime financial crisis begins to abate. The liquidity crunch and subprime mortgage-related risk re-appropriation will remain a key challenge along with curbing inflationary expectations.

A weak US consumer appetite has implications for the rest of the world. In case of the other major industrialised region – the Euro area and Britain— financial liquidity crunch and expensive euro and sterling (respectively) compared to the dollar has hit both the services and manufacturing sectors. Exports, which were leading the economies' growth, will suffer from high value of cost of inputs i.e. commodities and fuel in addition to high value of currency vis-à-vis the dollar. Housing slowdown in Britain is also contributing to an overall slowdown and moderating consumer demand further, although the recent 25 bps cut in the bank rate will help propel growth by easing borrowing. European Central Bank has held interest rates constant for ten months. Japan, however, is facing a bigger challenge of supply-led inflation as preferred to a demand-led inflation to pull it out of years of deflation as manufacturers are passing on high costs of raw materials and commodities, thus restraining domestic demand further. Impetus from exports has weakened and overall recover,y though remains on track, will be weak. Thus Bank of Japan is likely to hold interest rates constant.

The emerging markets, primarily China and India, continue to be relatively insulated from the subprime financial crisis, with ample liquidity in their domestic markets. Central banks in both countries have to cautiously balance the growth and inflation trade-off. In case of the former, the government has set the priority of curbing excessive inflation and slowing growth. Although the government targets to slow growth to about 8 per cent, it being above 9 per cent growth is widely expected. In the first quarter of 2007-08, the economy clocked 10.6 per cent growth and the industrial sector and investment continue to grow at a robust rate with constant upward trend in domestic spending. Thus the central bank has constantly raised CRR since 2006, now standing at 16 per cent. In case of India, inflation has been fired by energy, commodity and food prices. Other emerging economies of Asia will also moderate due to slower demand from the US and a slowing China, but the impact is likely to be smaller. But for food inflation, domestic forces of growth remain quite strong, emerging from higher government as well as private consumption. As seen in the past few months, monetary policy in the ASEAN-4 and newly industrialised countries switched from interest easing stance to holding rates constant due to inflation. They are likely to maintain rates constant despite lower growth till the threat to inflation looms. IMF projects global economy to clock 3.7 per cent growth in 2008 and 3.8 per cent in 2009, down from 4.9 per cent in the previous year.

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**Table 1: Monetary Policy stance in major countries**

| | Changes in the policy rate | | | | |
|---|---|---|---|---|---|
| | 2004-2006 | Jan-Jun 2007 | Jul-Sep 2007 | Oct 07- April 08 | Prevailing rate % |
| China | 0.54 | 0.54 | 0.72 | 0.18 | 7.47 |
| India | 1.5 | 0 | 0 | 0 | 7.75 |
| Malaysia | 0.8 | 0 | 0 | 0 | 3.5 |
| Philippines | 0.75 | 0 | -1.75 | -0.5 | 7.0 |
| South Korea | 0.75 | 0 | 0.5 | 0 | 5.0 |
| Taiwan | 1.38 | 0.38 | 0.13 | 0.25 | 3.5 |
| Euro area | 1.5 | 0.5 | 0 | 0 | 4.0 |
| United States | 4.25 | 0 | -0.25 | -2.5 | 2.25 |
| Thailand | 3.75 | -1.1875 | -0.25 | 0 | 3.25 |

Note: 0 = no change or interest rates held constant

**Source: Respective central banks**

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