Impact of monetary policy on companies profitability and its valuation

Meaning of monetary policy Monetary policy is the management of money supply and interest rates by central banks to influence prices and employment. Monetarypolicy works through expansion or contraction of investment and consumption expenditure. Monetary policy is the process by which the government, central bank (RBI in India), or monetary authority of a country controls : (i) The supply of money (ii) Availability of money (iii) Cost of money or rate of interest In order to attain a set of objectives oriented towards the growth and stability of the economy.

Monetary theory provides insight into how to craft optimal monetary policy. Monetary policy is referred to as either being an expansionary policy, or a contractionary policy, where an expansionary policy increases the total supply of money in the economy, and a contractionary policy decreases the total money supply. Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy involves raising interest rates in order to combat inflation. Monetary policy is contrasted with fiscal policy, which refers to government borrowing, spending and taxation. Credit policy is not only a policy concerned with changes in the supply of credit but it can be and is much more than this. Credit is not merely a matter of aggregate supply, but becomes more important factor since there is also issue of its allocation among competing users.

There are various sources of credit and other aspects of credit that need to be looked into are its cost and other terms and conditions, duration, renewal, risk of default etc. Thus the potential domain of credit policy is very wide. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate in order to achieve policy goals. Monetary policy, also described as money and credit policy, concerns itself with the supply of money as so of credit to the economy. Objective of monetary policyThe objectives are to maintain price stability and ensure adequateflow of credit to the productive sectors of the economy.

Stability ofthe national currency (after looking at prevailing economicconditions), growth in employment and income are also looked into. The monetary policy affects the real sector through long and variable periods while the financial markets are also impacted through shorttermimplications. Major objectives can be summarized as under: i) To promote and encourage economic growth in the economy & ensure the economic stability at full employment or potential level of output. It aims to achieve the twin objectives of meeting in full the needs of production and trade, and at the same time moderating the growth of money supply to contain the inflationary pressures in the economy. ii) Sectorial deployment of Funds. Depending upon the priorities laid down in the plans, the RBI has determined the allocation of funds, as also the interest rates among the different sectors.

There are four main ‘ channels’ which the RBI looks at: * Quantum channel: money supply and credit (affects real outputand price level through changes in reserves money, moneysupply and credit aggregates). * Interest rate channel. Exchange rate channel (linked to the currency). * Asset price.

Price stability has evolved as the dominant objective of monetary policy for sustaining economic growth and ensuring orderly conditions in the financial markets with increasing openness of the Indian economy… The fundamentalidea is that it is only in a low and stable inflation environment that economic growth can be continued. Monetary policy also aims to be directly supportive of growth by ensuring that the credit requirements of various segments are met adequately through an appropriate credit delivery and credit pricing mechanism and a conducive credit culture.

Monetary decisions today take into account a wider range of factors, such as: * short term interest rates; * long term interest rates; * velocity of money through the economy; * exchange rate * credit quality * bonds and equities (corporate ownership and debt) * government versus private sector spending/savings * international capital flow of money on large scales * financial derivatives such as options, swaps and future contracted. Monetary policy tools The monetary authority uses various instruments of monetary control in order to influence the goal variables in desired directions and degrees. The target variables are variables which the monetary authority tries to control or influence so as to influence the goal variables in the desired manner. To serve the target function well, a chosen target variable should possess the following four qualifications: a) It should be closely related to goal variables and this relation should be well understood and reliably estimable, b) It should be rapidly affected by policy instruments, c) Non-policy influences on it should be relatively small, i. , small relative to policy influences, and d) It should be readily observable (a measurable) with little or no time lag. Traditionally three variables have served as candidates for monetary-policy targets.

They are: money supply, bank credit, and interest rates in securities market. Various Monetary policy tools are: i. Monetary base Monetary policy can be implemented by changing the size of the monetary base. This directly changes the total amount of money circulating in the economy. A central bank can use open market operations to change the monetary base. The central bank would buy/sell bonds in exchange for hard currency.

When the central bank disburses/collects this hard currency payment, it alters the amount of currency in the economy, thus altering the monetary base. ii. Reserve requirements The monetary authority exerts regulatory control over banks. Monetary policy can be implemented by changing the proportion of total assets that banks must hold in reserve with the central bank. Banks only maintain a small portion of their assets as cash available for immediate withdrawal; the rest is invested in illiquid assets like mortgages and loans. By changing the proportion of total assets to be held as liquid cash, the Federal Reserve changes the availability of loanable funds.

This acts as a change in the money supply. Central banks typically do not change the reserve requirements often because it creates very volatile changes in the money supply due to the lending multiplier. iii. Discount window lending Many central banks or finance ministries have the authority to lend funds to financial institutions within their country. By calling in existing loans or extending new loans, the monetary authority can directly change the size of the money supply. v.

Interest rates The contraction of the monetary supply can be achieved indirectly by increasing the nominal interest rates. Monetary authorities in different nations have differing levels of control of economy-wide interest rates. The Federal Reserve can set the discount rate, as well as achieve the desired Federal funds rate by open market operations. This rate has significant effect on other market interest rates, but there is no perfect relationship. In the United States open market operations are a relatively small part of the total volume in the bond market.

One cannot set independent targets for both the monetary base and the interest rate because they are both modified by a single tool — open market operations; one must choose which one to control. In other nations, the monetary authority may be able to mandate specific interest rates on loans, savings accounts or other financial assets. By raising the interest rate(s) under its control, a monetary authority can contract the money supply, because higher interest rates encourage savings and discourage borrowing. Both of these effects reduce the size of the money supply. v.

Currency boardA currency board is a monetary arrangement which pegs the monetary base of a country to that of an anchor nation. As such, it essentially operates as a hard fixed exchange rate, whereby local currency in circulation is backed by foreign currency from the anchor nation at a fixed rate. Thus, to grow the local monetary base an equivalent amount of foreign currency must be held in reserves with the currency board. This limits the possibility for the local monetary authority to inflate or pursue other objectives.

1. Instruments of monetary policy in India The monetary policy is nothing but controlling the supply of Money. The RBI takes a look at the present levels and also takes a call on what should be the desired level to promote growth, bring stability of price (low inflation) and foreign exchange. The Reserve Bank of India (RBI) as a designated monetary authority has no control over the deficit financing of the central government and only limited control over its foreign exchange assets, we discuss below in detail the instruments of control used by the RBI: : A.

Quantitative measures: 1. Open Market operations: It means the purchase and sale of securities by central bank of the country. The sale of security by the central bank leads to contraction of credit and purchase thereof to credit expansion. It is useful for the developed countries. In India, the RBI enters into sale and purchase of government securities and treasury bills.

So the RBIcan pump money into circulation by buying back the securities and vice versa. In absence of an independent security market (all Banks are state owned); this is not really effective in India. The major Limitations are that * When the central bank purchases the securities the cash reserve of member bank will be increased and vice versa. The bank will expand and contract credit according to prevailing economic and political circumstances and not merely with reference to their cash reserves. * When the commercial bank cash balance increase the demand for loan and advance should increase.

This may not happen due to economic and political uncertainty. * The circulation of bank credit should have a constant velocity. 2. Bank rate policy: Popularly known as repo rate and reverse repo rate, it is the rate at which the RBI and the Banks buy or exchange money.

This results into the flow of bank credit and thusaffects the money supply. Bank rate- It is the minimum rate at which the central bank of a country provides loan to the commercial bank of the country. Bank rate is also called discount rate because bank provides finance to the commercial bank by rediscounting the bills of exchange. When general bank raises the bank rate, the commercial bank raises their lending rates; it results in fewer borrowings and reduces money supply in the economy.

Reverse repo rate– It is the rate that RBI offers the banks for parking their funds with it. Reverse repo operations suck out liquidity from the system. Major limitation is that : * Well organized money market should exist in the economy. Repo rate – * It is introduced through which RBI can add to liquidity in the banking system.

Through repo system RBI buys securities from the bank and there by provide funds to them. * Repo refers to agreement for a transaction between RBI and banks through which RBI supplies funds immediately against government securities and simultaneously agree to repurchase the same or similar securities after a specified time which may be one day to 14 days. A repurchase agreement or ready forward deal is a secured short-term (usually 15 days) loan by one bank to another against government securities. * Legally, the borrower sells the securities to the lending bank for cash, with the stipulation that at the end of the borrowing term, it will buy back the securities at a slightly higher price, the difference in price representing the interest. 3. Cash Reserve ratio (CRR): This is the percentage of total deposits that the banks have to keep with RBI.

And this instrument can change the money supply overnight. Changing cash reserve ratio is an excellent instrument of control. The bank has to keep certain amount of bank money with themselves as reserves against deposits. * The increase in the cash rate leads to the contraction of credit only when the banks excess reserves. * The decrease in the cash rate leads to the expansion of credit and banks tends to make more available to borrowers.

. 4. Statutory Liquidity Requirement (SLR)& liquidity adjustment facility (LAF)-this is the proportion of deposits which Banks have to keep liquid in addition to CRR. This also has a bearing on money supply. * LAF is the instrument of monetary policy from June 2000 to adjust on daily basis liquidity in the banking system.

* Through LAF, RBI regulates short-term interest rates while its bank rate policy serves as a signaling device for its interest rate policy in the intermediate period. RRBs are required to maintain SLR at 25 per cent of their NDTL in cash or gold or in unencumbered government and other approved securities. Unlike in the case of scheduled commercial banks, balances maintained in call or fixed deposits by RRBs with their sponsor banks are treated as “ cash” and hence, reckoned towards their maintenance of SLR. As a prudential measure, it is desirable on the part of all RRBs to maintain their entire SLR portfolio in government and other

approved securities, which many of them are already doing. All RRBs may maintain their entire SLR holdings in government and other approved securities. B.

Qualitative measures: 1. Credit rationing: Imposing limits and charging higher/lower rates of interests in selective sectors are what you see is being done byRBI. 2. Moral suasion: We hear of RBI’s directive of priority lending in Agriculture sector. Seems more of a directive rather than persuasion.

It implies the central bank exerting pressure on banks by using oral and written appeals to expand or restrict credit in line with its credit policy. It is a combination of persuasion and pressure which RBI is always in a position to use on banks in general and errant banks in particular. This is exercised through discussions, letters, speeches, and hints thrown to banks. This can be used by the RBI to urge banks to keep a large proportion of their assets in the form of government securities, lend their helping hand to develop a broad and active market in treasury bills and government securities, and not borrow excessively from the bank when it is engaged in fighting the forces of inflation. The main interst sensitive sectors are banking sector, automobile sectorand real estate sector Let me examine how the monetary policy impact on the major interast sensitive sectors ie banking sector and automobile sector. oth sectors are linked with the policy measurs of the RBI.

the change in interst rate casues a big impact on the profit earning capacity of the two sector companies Firstly the banking sector . This analysis takes a look at Indian monetary policy and how it will impact: a. Banks Profitability b. Availability of funds to trade and industry c. Other factor Interest on loans are the main income of the banks. when the reserve bank take an action which effect interest rate it will affect the banks income and profitability.

It may be positive or negative. Cost of fund will increase and it will reduce banks net interest margin to keep the net interest margin all banks raises lending rates When RBI hikes CRR it will directly affect by the profitability of banking companies. When RBI increase the CRR it will cause reducing the deposits available with the banks to make loans . Banks charge a very high interest rate on the loans they give. Banks take this measurer to retain the profit rate which earned during former CRR rate..

when the lending rate are high, general public and corporate postpone heir work to future period. so this cause to reduse the lending from banks, then the profit will decrease If the RBI reduce the CRR and SLR rate , the banks can give more loans at lower interest rate. the low interst rate attract more companies and people to take loan. so this cause to increase the profit of the banks Cash Reserve Ratio (CRR)| 6.

00% (w. e. f. 24/04/2010)| Increased from 5. 00% to 5.

50% wef 13/02/2010; and then again to 5. 75% wef 27/02/2010; and now to 6. 00% wef 24/04/2010| Now the CRR is 6. 00%. it from 24-4-2010. RBI increased CRR from 5.

00% to 6. 00% during the 4th quarter of 2009-2010 and 1st quarter of 2010-11. this change also change the net interest margin of the banks. 1% increase caused a negative impact of the profitability of the banks.

Statutory Liquidity Ratio (SLR)| 24%(w. e. f. 18/12/2010)| Decreased from 25% which was continuing since 07/11/2009| No more change in the SLR rate after 7-11-2009 have made an impact on the profit earning capacity of the banks Bank rate impact It is the minimum rate at which central bank provides loan to commercial banks. It is also called discounting rate because bank provides finance to the commercial banks by rediscounting the bill of exchange.

When central banks raises bank rate commercial banks raises lending rate and vice-versa When RBI rises the bank rate , the commercial banks rasies rasies its lending rates, it will adversely impact on the profitability of banks. Bank’s net interest margin will reduce. Repo rate impact When ever there is deficient of the fund with the banks then the banks barrow money from RBI, Repo rate is the rate at which all banks barrow rupees from RBI. When RBI increase repo rate , no banks ready to take loan from RBI. IF the RBI decrease the repo rate, bank will go to RBI to take loan at lower interest rate.

If the RBI increase the rate it will reduce the profit margin. Reverse repo effect If the RBI increase the reverse repo rate banks get high interest by putting money to safe hands. but it reduce the money supply in the economy . bank not have money to give loans to public and get interest on loan.

so interest earned on loans will decrease and the net interest margin reduced. Reverse Repo Rate| 6. 25% (w. e. f. 03/05/2011)| Increased from 5.

75% which was continuing since 17/03/2011 [Till 03/05/2011, reverse repo rate was an independent rate and announced by RBI. However, in the monetary policy announced on 03/05/2011, RBI has decided that now the reverse repo rate will not be announced separately, but will be linked to Repo rate. Reverse Repo rate will be 100 bps below the repo rate] | How monetary policy affect on the returns of auto sectorThe automotive industry remains one of the highest revenue-earning industries in India and contributed over 5% to India’s GDP in 2009, providing direct and indirect employment to more than 13 million people. The market outlook for the industry remains promising, especially in the small car segment. The Indian automobile market is currently dominated by the two-wheeler segment but with an expanding middle class population, growing earning power and industrial development, the demand for passenger cars and commercial vehicles will increase exponentially.

Also, the low vehicle presence (with passenger car stock of only around 11 per 1, 000 population in 2008) indicates a very low base with significant growth potential. As per ‘ Just-Auto’ analyst reports, sales of passenger cars in 2008-2016 are expected to grow at a CAGR of around 10%. In addition to increased domestic demand, there is also likely to be increased investment by global auto manufacturers to India due to its strong technological capability and availability of trained manpower at competitive prices. Currently, the foreign auto companies with assembly plants in India include, General Motors, Ford, Hyundai, Honda, Suzuki, Nissan Motors, Toyota, Volkswagen, Audi, Skoda, BMW, Fiat and Mercedes Benz. With the introduction of the Tata Nano, the cheapest car in the world at USD 2200, and FDI from Suzuki Motor Corp, Hyundai Motor Co, and Nissan Motor Co to make India their manufacturing hub for small cars, India has made huge inroads in the compact car segment. In fact, in 2009, India overtook China in the global auto exports of compact cars for the first time.

Increase or decrease in interest rate will directly affect the automobile industry because a majority of people are depending on car loans or two wheeler loans for buying vehicle. So if the interest rates are increasing, people won't be able to afford this and normally the demand for automobiles will come down this will have a very bad impact on the industry TATA MOTORS: TATA MOTORS Tata Motors is India's largest automobile company It is the leader in commercial vehicles and among the top three in passenger vehicles. The company is the world's fourth largest truck manufacturer, the world's second largest bus manufacturer. Tata Motors has auto manufacturing and assembly plants in Jamshedpur , Pantnagar , Lucknow , Ahmedabad , Sanand and Pune in India, as well as in Argentina, South Africa and Thailand.

Products : Passenger cars and utility vehicles Concept vehicles Commercial vehicles Military vehicles Financial results of tata motors 2009-10 2008-09 2007-08) Gross revenue38, 364. 1028568. 2133093. 93 2) Net revenue(excluding excise duty)35593. 0525629. 7328739.

41 3) Total expenditure31414. 7723877. 2925807. 82 4) Operating profit4178. 281752. 442931.

59 5) Other income1853. 45925. 97483. 18 6) Profit before interest and depreciation6031. 732678. 413414.

77 7) Interest and discounting charges(net)1103. 84673. 68282. 37 8) Cash profit4927. 892004.

734057. 84 Rising interest rates had a negative impact on company because when interest rates was raised, the cost of borrowing money rosed. Ultimately, the company profitability and ability to grow was reduced. When a company profits (or earnings) dropped, its stock became less desirable, and its stock price falled . A company success comes when it sells its products . But increased interest rates negatively impact its customers.

The financial health of its customers directly affected the company ability to grow sales and earnings. When interest rates rise, investors start to rethink their investment strategies i. e Investors sell shares in interest-sensitive stocks that they hold. Interest-sensitive industries include electric utilities, real estate, and the financial sector. Interest rates rises –sales effects – profitability is affected – dividend payments too effected.

The price of a stock depends on the earnings of the company. If the earnings slow down (because of higher interest rate payments), the prices of the stocks will dip and overall, the stock market will be hit. A rise in interest rates also cools down the economy . demand for goods and services rise. If the supply is not immediately forthcoming, the price of those goods and services rise. That leads to inflation.

Low interest rates are good for business, it makes it cheaper to borrow funds, invest in new projects, expand supply, etc. Low interest rates also increases consumption as debt finance becomes cheaper and people’s disposable income rises as existing interest payments are reduced. A decrease in interest rates therefore increases revenue expectations for most businesses. car sales down as compared to the previous year.

reducing costs wherever possible, consolidating brands and dropping model lines and deferring R; amp; D projects to conserve funds.