

## Impact: Third Quarter Review of the Monetary Policy

### Snapshot

**Table 1: Policy Measures**

	Policy Rate (%)	Policy Stance
<b>Repo Rate</b>	8.5	Unchanged
<b>Reverse Repo Rate</b>	7.5	Unchanged
<b>Marginal Standing Facility</b>	9.5	Unchanged
<b>Cash Reserve Ratio</b>	5.5	↓
<b>Bank Rate</b>	6.0	Unchanged
<b>Inflation (by march end)</b>	7.0	Unchanged
<b>GDP (for 2011-12)</b>	7.0	↓
<b>Money Supply (M3)</b>	15.5	Unchanged
<b>Bank Credit</b>	16.0	↓
<b>Aggregate Deposits</b>	16.0	Unchanged

The Reserve Bank of India in its Q3 Monetary Policy Review retained key interest rates at the existing levels and reduced Cash Reserve Ratio (CRR) by 50 bps in order to ease the prolonged tight liquidity conditions in the banking system.

CRR, the proportion of the net demand and time liabilities (NDTL) that banks have to hold with the RBI, has been reduced by 50 bps to 5.5% effective from 28<sup>th</sup> January 2012. The 50 bps cut in the CRR would infuse approximately Rs. 320 bn into the banking system. With this change the RBI intends to permanently address the structural liquidity shortage in the banking system caused mainly due to the infusion of Dollar by the RBI since November.

On account of the increased government borrowings and the slowdown in private credit demand, the RBI has retained M3 growth projection for 2011-12 at 15.5%, while non-food credit growth has been scaled down to 16.0%.

### Key Take-away:

#### 1. Cut in Cash Reserve Ratio

In reducing the CRR by 50 bps the RBI wishes to address the liquidity pressure prevalent in the banking system since early November 2011.

**Table 2: Liquidity condition in the banking system**

Rs. bn	Nov	Dec	Jan
<b>Avg. LAF borrowings</b>	938	1,177	1,245

Source: RBI

Table 3 illustrates very clearly that the banks have been borrowing over the Rs. 600 bn comfort level of the RBI. Further, a CRR cut will end up giving money to even those banks that have surplus liquidity. Therefore, an infusion of Rs. 320 bn as induced by the 50 bps CRR cut would benefit the liquidity conditions to some extent. However to the extent that the liquidity crunch is due to bank investments in GSecs, these CRR released funds could flow mainly into government paper and support borrowing programme of government as commercial credit growth is sluggish due to demand and interest rate conditions.

## 2. Impact on Liquidity

Based on the RBI's projections for growth in deposits (16% = Rs. 8,328 bn) and credit (16% = Rs. 6,301 bn) for FY12 along with the enlarged borrowing programme of the government (Rs. 5,099 bn), the following is the pattern of liquidity flows in the system.

**Table 3: Monetary Conditions**

Sr. No.	Rs. Bn	Apr-Dec '12	Jan-Mar '12
1	Incr. Aggregate Deposits	6,199	2,128
2	Deposits adj. for CRR	5,827	2,011
3	Incr. Bank Credit	4,236	2,066
4	Liquidity gap (3-2)	1,591	-55
5	Government Borrowing	3,830	1,269

Source: RBI

***Taking a closer look at the growth achieved so far in the financial year (Apr-Dec 2011-12), Table 3 shows that based on the RBI's assumptions, there will be a net gap of Rs 1,324 bn in the system, of which Rs 320 bn would be addressed through the present CRR cut. Assuming that there are another Rs 200 bn of OMOs, there would be a gap of Rs 800 bn which will have to be financed by other subscribers like PFs, Insurance companies, PDs, repos or CRR cut.***

The mitigating factors would be:

- Deposits grow at a faster rate
- Credit growth slows down further

## 3. Inflation

Headline inflation, which averaged 9.7% for the Apr-Oct period of 2011-12 moderated to 9.1% in November and further to 7.5% in December. However, it is critical to note that the slowdown in inflation has been driven by the moderation in the prices of primary articles, especially vegetables while inflation continues to be high for the core sector. Further, the decline in food inflation is likely to reverse ahead with the base effect waning and seasonality factors sneaking in. Fuel inflation has also remained elevated at 14.9% in December 2011-12 on account of high Global crude prices and rupee depreciation.

RBI has maintained that the inflation target of 7% by the end of March would be attainable despite the slow improvement in core sector inflation and uncertainties in the global economies. This target appears to be reasonable. More importantly, core inflation should move down for any RBI action on this front.

#### 4. Rate reduction

Further, speculation that CRR cut is guidance for interest reduction in the future, it is more likely that the RBI would be more cautious before reducing interest rates as it would be premature to begin reducing policy rates before a substantial and sustainable dip in overall inflation. **We do not expect this before early FY13.**

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