STCI
Primary Dealer Ltd

Amol Agrawal
amol@stcipd.com
+91-22-66202234

RBI's Mid-Quarter Monetary Policy Review: Sep 2012

In its Mid-Quarter Review of Monetary Policy held on 17-Sep-12, RBI kept the Repo rate unchanged and eased CRR by 25 bps.

- **Policy Rate changes**
  - Repo rate unchanged at 8%. Reverse Repo rate and Marginal Standing Facility (MSF) Rate automatically stands unchanged at 7% and 9% respectively.
  - Cash Reserve Ratio (CRR) eased by 25 bps to 4.5% of Net Demand and Time Liabilities (NDTL). The new ratio to be effective from fortnight beginning September 22, 2012.

- **Forward guidance statement**
  - Monetary policy also has an important role in supporting the growth revival. However, in the current situation, persistent inflationary pressures alongside risks emerging from twin deficits – current account deficit and fiscal deficit - constrain a stronger response of monetary policy to growth risks.
  - Stance of monetary policy will be conditioned by careful and continuous monitoring of the evolving growth-inflation dynamic, management of liquidity conditions to ensure adequate flows of credit to productive sectors and appropriate responses to shocks emanating from external developments.

I. Growth-Inflation Dynamics

Most RBI monetary policy decisions are based on this interesting trade-off between growth and inflation. While former has been on a downward trajectory, latter keeps surprising markets with its upward trajectory. We have discussed the growth inflation dynamics in our previous report as well (Indian Economy in Interesting Times (14-Sep-12)).

In this review, RBI said that sluggish momentum in growth trends is evident across all sectors of the economy, particularly in industry. The revival of monsoon will help boost higher agriculture growth and lower food inflation as well.

On inflation front, RBI welcomed the recent hike in diesel prices and rationalisation of LPG subsidy regime. However, it also noted that pass-through of administered prices remains incomplete. In the short-term these measures will lead to higher inflation but will strengthen India's macroeconomic fundamentals over a medium-term. RBI mentioned that these revisions were anticipated at the time of the April policy when RBI eased repo rates by 50 bps, thereby front-loading repo rate reduction. However, these decisions took much longer than expectations.

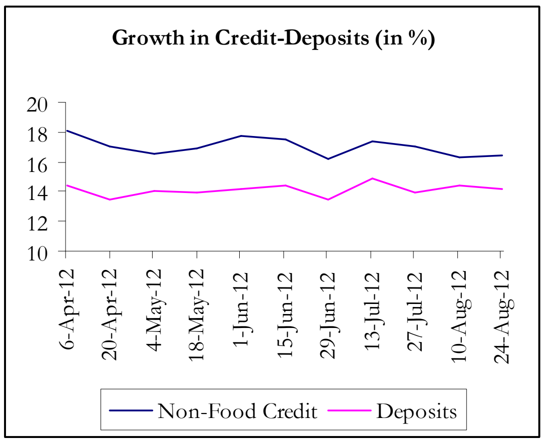
The statement said that government has taken right steps "by initiating a shift in expenditure away from consumption (subsidies) and towards investment (including through FDI)." However persistent inflation remains a challenge. In this evolving dynamics, "monetary policy will reinforce the positive impact of these actions while maintaining its focus on inflation management."

II. Rationale for CRR cut: Why not OMOs?

Liquidity has been comfortable since First Quarter Review in Jul-12. However, RBI cites several factors that could lead to tighter liquidity going ahead:

- Wedge between deposit growth and credit growth could widen: In Apr-12, deposit growth was 14.5% and credit growth was 18.1%. Credit growth since then has declined to 16.5% and deposit remains around 14.2%. This implies the wedge between credit and deposit growth has declined from Apr-12 onwards. However because of festival and a busy credit season this wedge could widen.

Figure 1



Source: RBI

- Outflows on account of advance tax payments
- As the festival season is around the corner, RBI anticipates some tightening of liquidity in coming months.

Based on these factors, RBI has eased the CRR by 25 bps infusing liquidity worth Rs 17,000 Cr in the system. RBI has been fairly proactive in liquidity management since the tight liquidity conditions witnessed during second half of 2011-12. This step is another such instance of RBI action despite liquidity situation remaining comfortable in the system.

It is interesting that RBI chose CRR over OMO purchases to infuse liquidity. RBI usually looks at OMO to alleviate frictional/temporary liquidity deficit conditions and CRR for structural liquidity deficit conditions. In a speech given on 3-Dec-11, RBI Deputy Governor Dr. Subir Gokarn mentioned that RBI has “range of instruments” to address liquidity deficit concerns:

- LAF Window: The first and natural response to widening liquidity deficit is higher borrowing via LAF window.
- MSF Window: More of an emergency measure for banks. A continued access of liquidity via this window serves as an early warning indicator. RBI watches this carefully.
- OMO purchases: Dr. Gokarn mentioned OMOs as first preference for liquidity injection. He added that they are tactical in nature and do not require a change in any policy stance, real or perceived.
- Statutory Liquidity ratio
- Cash Reserve Ratio: Dr Gokarn mentions usage of CRR as ultimate instrument.

Most of the above cited factors for deficit liquidity conditions ahead are in the temporary/frictional category. In 2011-12, RBI first used OMOs and only when liquidity deficit became more structural, reduced CRR. In its Jan-12 policy, RBI cut CRR by 50 bps. The statement said that though RBI has conducted OMOs to inject liquidity, the structural deficit in the system has increased significantly. This large structural deficit in the system presents a strong case for injecting permanent primary liquidity into the system. This was the reason for easing CRR by 50 bps in Jan-12 policy followed by another 75 bps in Mar-12 ahead of the mid-quarter review.

In 2012-13, RBI started again by doing OMOs to ease liquidity conditions and also lowered SLR in Jul-12. This led liquidity conditions also supported by higher forex flows in the system. Hence, lowering of CRR that too just 25 bps is not clearly understood. Some market participants had suggested a CRR cut but it was of a much larger percentage. The reason for lower CRR was to free resources for credit purposes. It was not really for liquidity which remains comfortable in the system.

Though difficult to say with conviction, it seems RBI is trying to signal to the government to not look increasingly at banking system to manage its public finances. This is also what markets speculated in Jul-12 policy. In a surprise move, RBI lowered SLR by 1% to 23% in Jul-12 policy. RBI said this was to free financial resources for credit allocation to productive sectors. Some analysts had opined that lower SLR also served as a signal to government. By lowering SLR, RBI lowered the demand for government securities which in turn might lead to some fiscal discipline.

This time also by choosing to lower CRR and not OMOs, RBI has tried to stay away from bond market purchases, which in turn leads to lower yields. Though these freed resources could also lead banks to invest in government securities and push yields lower, it will not be on account of RBI intervention.

III. Going Forward

Once again RBI chose to disappoint markets by pausing rather than cut policy rates. This time the expectations were even bigger in the backdrop of reforms announcement by the government. However, RBI maintains its focus on inflation and indicates that contribution of monetary policy in this growth momentum will be via inflation management. In its guidance statement it mentions that "Monetary policy also has an important role in supporting the growth revival." Though in the next sentence, it adds that persistent inflationary pressures constrain a stronger response of monetary policy to growth risks.

It is highly likely that RBI will maintain its focus on inflation in future as well. Inflation is a far more structural problem than appreciated by the market participants. The best available proof is how inflation has remained elevated despite growth falling off many blocks. Even core inflation which is a broad barometer for demand-side led inflation has hardly declined in commensurate with declining growth. It will take a very different approach to fight the inflation challenge facing the economy with large scale supply side reforms needed in most sectors of economy. RBI is playing a very important part in this whole dynamics by making sure that inflationary expectations as seen by central bank remains in the comfort zone. It is very easy for inflationary expectations to become unanchored if central banks do not emphasize on former's importance. That is what the role of central bank is and RBI is trying to stick to it despite all the criticism.

We do not expect RBI to lower policy rates till inflation moves in RBI's comfort zone of around 5%. In previous policy, RBI had even showed that high interest rates do not really lead to lower investment as is often the criticism. Now that government has finally made some attempts to revive the growth sentiment, RBI can look to focus on its task of inflation management.

STCI Primary Dealer Ltd.
A/B1- 801, A Wing, 8th floor, Marathon Innova, Marathon Next Gen Compound,
Off. Ganpatrao Kadam Marg, Lower Parel (w), Mumbai 400013.

Dealing Room: (022) 66202217-20 ● Settlements: (022)66202262-64, Fax (022) 66202288
Delhi Office: (011) 47676555-570 ● Bangalore Office: (080) 22208891
Please mail your feedback to stcipd@stcipd.com ● Website: http://www.stcipd.com