RBI's THIRD QUARTER REVIEW OF MONETARY POLICY 2011-12

RBI has kept the policy rates unchanged

- Repo Rate 8.50%
- Reverse Repo 7.50%
- Marginal Standing Facility 9.50%

Reserve requirements have been changed

- Cash Reserve Ratio (CRR) cut by 50 bps to 5.5% from 6% of NDTL effective the fortnight beginning 28 January 2012
- Statutory Liquidity Ratio (SLR) remain unchanged at 24% of NDTL

RBI's considerations behind lower CRR and unchanged policy rates:

- Impact of persistent pressure of liquidity tightening on growth
  - High liquidity deficit in the banking system will disrupt the credit flow and ultimately aggravate the risk of lower growth.
  - Cut in cash reserve ratio reinforces cut in rates in the coming months.
- Inflation moderated but too early to conclude
  - Lower policy rates would come into effect only when there will be sustainable signs of inflation moderation. Risk of elevated inflation still prevails as majority of the drop was due to seasonal food items while manufacturing products remains elevated.
  - Upside risk to inflation persist due to incomplete pass through of global crude oil prices, impact of rupee depreciation and slippage in the fiscal deficit.
- Focus has been shifted to growth but containing inflation is necessary
  - Downside risk to growth has increased despite higher inflation, pushing RBI to focus on growth but containing inflation is a key to boost productivity.
- Lowering policy rates would also require strong fiscal consolidation.

RBI's expectations from the policy actions announced in this review:

- Cut in CRR will help to ease liquidity conditions for a sustained period of time.
- Easing liquidity will help to manage the asset-liability mismatch and reduce the pressure of loan slippages to a certain extent.
- Overall, this will help to maintain smooth flow of credit, which will mitigate risk to growth and help to reduce the inflationary expectations.

Revised projections in outlook for Mar-12/ FY12

- RBI has revised its Gross Domestic Product (GDP) growth rate for 2011-12 to 7% from the earlier estimate of 7.6%. The reasons for the downward projection are global uncertainty, weak industrial growth and slowdown in investment activity.
- The central bank has retained the Wholesale Price Index (WPI) inflation projection at 7% for March 2012 as it is moving in line with the projection.

Impact on Equity Market

The key benchmark indices rose sharply after the announcement CRR cut by RBI. More so, the sharp rise in the high weighted banking sector-the major beneficiary of the move pushed up the benchmark index. BSE banking sector gained 3.5% while sensex was trading higher by 1.5%. In the previous trading sessions, expectations of a policy rate cut led to a rally in rate sensitive sectors like capital goods and realty. Now upside in these sectors looks limited after the policy rates remained unchanged.

Impact on Bond Market

The announcement of a cut in reserve ratio came as a relief to the money market segment which was under stress due to tight liquidity condition. Short term CDs corrected by 10-15 basis points. Post announcement, the yield on benchmark 10 year G-Sec initially came down to 8.08%, lower than the previous close of 8.17%, however after RBI Governor's comments on OMOs it witnessed a sharp pull back and ended at 8.37% level. Corporate bond market remained largely flat with upside bias on yield as a CRR cut was already priced in.

Our recommendations

- Drop in CRR was required due to consistently higher liquidity deficit as compared to the RBI's target of maintaining the same at a moderate level. This will also provide room to increase the credit flow towards the productive sectors of the economy.
- The cut in CRR by 50 bps is the first step towards the process of reversal in interest rate cycle which is likely to begin from the next quarter.
- If WPI inflation remains at around 7% level till February or March, this could give RBI sufficient room to start lowering policy rates in the next monetary policy in March or April 2012.
- The forthcoming Union Budget will be viewed carefully and would like to see prudent steps from the Government towards fiscal consolidation in 2012-13.
- We continue to recommend investing in ICICI Prudential Short Term Plan and ICICI Prudential Regular Savings Fund.

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