



Confederation of Indian Industry

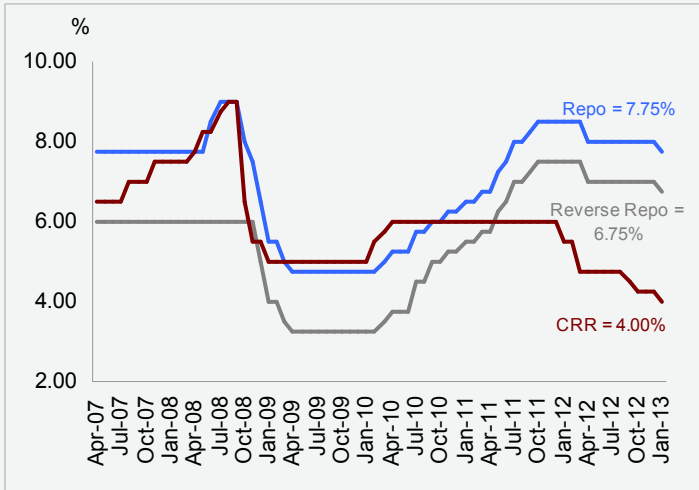
# Economy Update - Monetary Policy



RBI Finally Bites the Bullet, Obliges by Cutting the Interest Rates

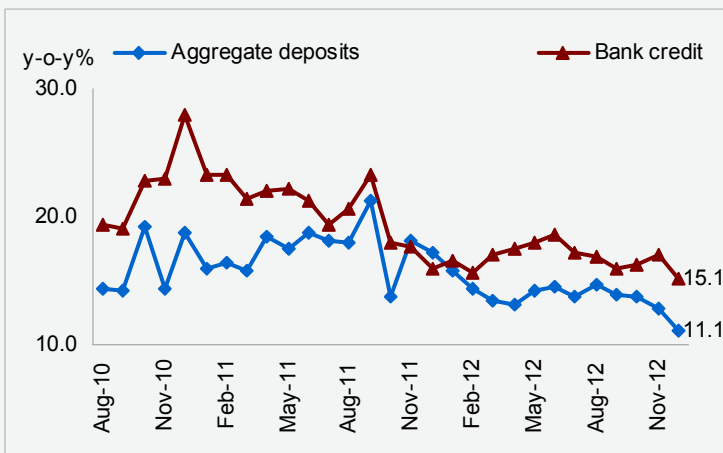
29 January, 2013

## Repo rate and CRR cut by 25 bps each



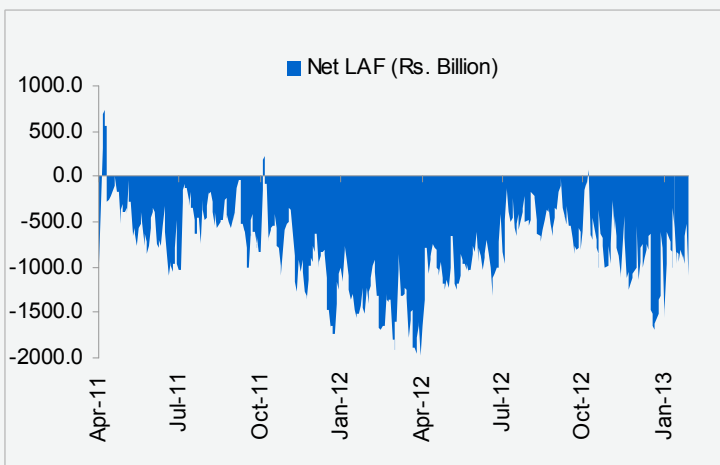
In response to slowing consumption and investment demand, the RBI chose to cut the repo rate and cash reserve ratio (CRR) by 25 bps each in its third quarter review of monetary policy held today. CII has been for long advocating for an interest rate cut in the view of sharp moderation in WPI-inflation in the last few months. RBI too revised its WPI-inflation projection for March-2013 downwards to 6.8 per cent from 7.5 per cent. Importantly, core inflation which is widely regarded as the indicator of demand-side pressures in the economy has also softened. Growth momentum on the contrary still remains worrisome, with the RBI too acknowledging this fact and hence revising its growth forecast downwards to 5.5 per cent from 5.8 per cent estimated earlier for the current fiscal.

## Wedge between credit and deposit growth increases



Bank credit growth to the commercial sector moderated to 15 per cent as of end-December 2012 as compared to 16 per cent posted in the same month last year. Aggregate deposits growth too remains lackluster, in fact declining at a faster rate as compared to credit growth. Consequently, the wedge between the credit and deposit growth widened in the third quarter FY13, forcing the banks to tap the inter-bank market to fund this gap. With already tight liquidity conditions, the widening wedge poses a concern as it is likely to worsen the tight liquidity conditions. In this regard, the RBI's decision to pare the CRR further is indeed a welcome move as adequate liquidity is essential for facilitating monetary policy transmission and thus enabling adequate flow of credit to the productive sectors of the economy.

## Liquidity conditions remain tight



Liquidity conditions tightened in third quarter of 2012-13 due to build up of government cash balances and strong currency demand. With moderating inflation, RBI has taken measures to combat tight liquidity conditions. The Reserve Bank conducted open market operations (OMOs) on five occasions during December 2012 to January 2013, thereby injecting liquidity of Rs 470 billion into the banking system. Despite these measures, the average net LAF borrowings at Rs 910 billion in January 2013 (up to January 27), were above the Reserve Bank's comfort level. In this context, it is heartening to note that the RBI in its policy review held today, cut the cash reserve ratio (CRR) by further 25 bps in order to infuse liquidity into the cash-starved financial system.

Source: RBI

**Outlook:** RBI's decision to ease the monetary policy through a repo rate and CRR cut is a welcome step as it sends out a positive signal that the Central bank has now joined hands with the government to revive the growth momentum of the economy, which had to so far largely focused on containing inflation. Government's continued thrust on reforms along with the downtrend in WPI-based inflation has provided necessary leg-room for RBI to maneuver its policy in favour of growth. However, CII would have been happier with a larger reduction in repo rate.