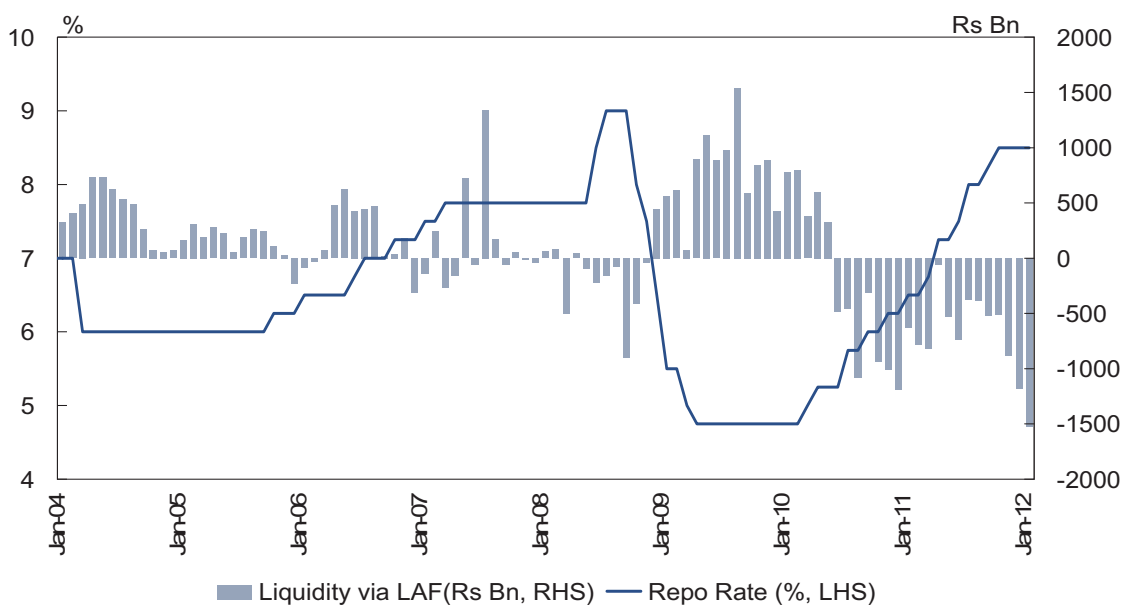


## RBI'S THIRD QUARTER REVIEW OF ANNUAL POLICY (FY12) - A PERSPECTIVE

### SALIENT POINTS

- Monetary Measures:
  - Reduced Cash Reserve Ratio (CRR) by 50 bps to 5.50%
  - Repo rate has been maintained at 8.50%
  - Consequently the Reverse Repo rate and the Marginal Standing Facility rate stand unchanged at 7.50% and 9.50% respectively
- Policy move in line with expectations - central bank adopts cautious stance, given upside risks to inflation and high fiscal deficit.
- The CRR cut will inject about Rs. 32,000 crores liquidity in the system and help reduce ongoing liquidity stress amidst high government borrowing and slowdown in capital flows.
- Has revised GDP growth projections downwards to 7.0% from 7.6% earlier, factoring in the sluggish investment activity and global uncertainties. Expects GDP growth to be relatively stronger in FY13.
- Has retained WPI projections for March 2012 at 7% and revised non-food credit growth forecasts downwards to 16% from 18%, given lower demand for credit.
- Looking ahead, the bank has indicated a reversal in monetary policy cycle depends on sustainable decline in inflation and policy actions to contain fiscal deficit.

Trends in liquidity and the repo rate (Rs. Bln, %)



Source: RBI, Citigroup

## FT's VIEWS

RBI's latest policy move was along expected lines and needs to be seen against the backdrop of a high liquidity deficit (LAF deficit was about Rs. 150,000 crore) and continued strength in core inflation drivers. The recent decline in inflation to 7.6% (from 9%+ levels) is primarily driven by seasonal factors and the high base effect – structural demand-side pressures persist in various commodities (protein-based commodities) and a weak rupee (despite the appreciation seen in recent weeks) is exacerbating the impact of still high global oil prices. The central bank reiterated its concerns about the rising fiscal deficit and has explicitly stated that the same is limiting scope for monetary easing. Overall, the policy statement signals interest rates have peaked, while emphasizing that the upside risks to inflation remain “high”.

Select economic data has been encouraging in recent weeks, but the broad issues of decelerating investment activity and a challenging global environment remain. The economy is still witnessing the lagged impact of monetary tightening and the latest reduction in RBI's GDP growth forecasts reflects these factors. The bank expects growth trends to improve in FY13 alongside marginal decline in inflation.

While systemic liquidity has been deficit for the past year now, moderation in capital flows alongside high government borrowings have exacerbated the cash crunch. RBI had been managing the shortfall by conducting OMOs over the last couple of months. The cut in CRR will free up cash resources to the tune of Rs. 32,000 crores and reduce systemic stress. The bank has reduced projections for non-food credit as slower capex and weak business sentiment has reduced demand for credit from corporates.

## MARKETS

The CRR cut came as a surprise for some of the market participants and benchmark government bond yields eased initially. However, yields at longer end of the curve firmed up later in the day on speculation the bank may not continue to hold OMOs.

	Yesterday's close	Today's close
1-year Gilt yield	8.30%	8.30%
5-year Gilt yield	8.20%	8.32%
10-year Gilt yield	8.17%	8.36%
5-yr Corporate Bonds (AAA)	9.52%	9.63%

Domestic equity markets registered sharp gains following the policy announcement. Banking stocks witnessed a sharp rally on expectations the CRR cut will boost earnings.

Equity Indices	(% change since yesterday's close)
BSE Sensex	1.46
Nifty	1.61
S&P CNX 500	1.62
BSE Bankex	3.21
BSE CG	3.30
BSE Realty	1.14

## OUTLOOK

Notwithstanding the recent pick-up in economic activity in select developed markets, global growth is expected to be below trend in the quarters ahead. Global markets have however had a positive run in the month so far and are hopeful of a positive outcome from the ongoing discussions over Euro-zone debt crisis.

Despite the weakening growth trends, RBI has been wary of reversing the rate hikes due to the high fiscal gap and structural supply-demand imbalances. Policy statements indicate the tightening cycle is behind us, though the timing of reversal rests on government efforts to control the fiscal deficit and sustainable moderation in inflation. The central bank will keenly watch the upcoming Union Budget for measures on these fronts. Inflation is likely to ease through the first part of 2012 on the back of high base effect and falling food prices. However, escalation of geo-political tensions in Middle East could push oil prices and any additional weakness in rupee could mitigate benefits. From a medium term perspective, a meaningful decline in inflation can be achieved by addressing the infrastructure bottlenecks impacting supply.

RBI has been entrusted with the role to manage the government's borrowing programme in a manner that is non-disruptive and does not crowd out private borrowers from the market. In that sense, the cut in CRR is a step in the right direction. Going forward, trends in capital flows alongside seasonal factors (read advance tax outflows) will determine RBI's OMO strategy.

We continue to believe that funds focused on short-term corporate debt and/or utilizing high accrual strategy are good bets in the current environment. Whenever RBI cuts rates, we expect the yield curve to steepen, with the shorter end of the curve outperforming the longer end. Investors actively pursuing trading opportunities can look to invest in long-bond funds.



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### < GAIN FROM OUR PERSPECTIVE >

For any queries, our investor line is available to assist you at [1-800-425-4255](tel:1-800-425-4255) or [60004255](tel:60004255) (if calling from a mobile phone, please prefix the city STD code; local call rates apply for both numbers) from 8 a.m to 9 p.m, Monday to Saturday. Alternatively, you can also e-mail us at [service@templeton.com](mailto:service@templeton.com).

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