

INDIA

India Econ Flash

Policy Makers on the Move – CRR cut; P-Note curbs lifted

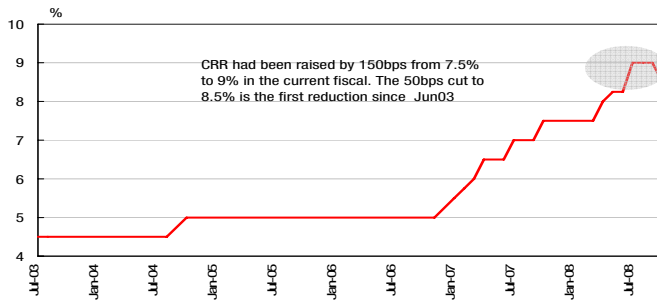
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- **RBI cuts CRR by 50bps to 8.5%:** In a bid to ease the liquidity shortage in the system, late last evening the RBI cut the CRR by 50bps to 8.5%. The move will inject liquidity to the tune of Rs200bn (US\$ 4.3bn) in the system effective Oct 11. This step follows the RBI’s Sept 16 measures to provide additional liquidity¹. While the RBI has said that the ‘*overriding priority*’ for monetary policy remains that of anchoring ‘*inflationary expectations*’, given the deterioration in the global financial markets seen since Sept, “*liquidity management will continue to receive priority in the hierarchy of policy objectives over the period ahead*”.
- **What next? Expect a continued easing in the CRR...:** While liquidity conditions have been in a deficit mode since this fiscal, conditions worsened in Sept due to (1) the timing mismatch between govt revenues and expenditures and (2) fx intervention². As a result the RBI has been injecting liquidity to the tune of US\$16bn on a daily average basis. While the timing mismatch between govt revenues and expenditure will get adjusted, given the global turmoil, the trend in capital flows is unlikely to be reversed soon (*India’s forex reserves are down US\$17.9 bn this fiscal*). With the CRR largely a liquidity injection/absorption tool, we expect the RBI to further reduce the CRR in the coming months. (*Since the beginning of this fiscal, the RBI has raised the CRR by 150bps and 425bps since the tightening cycle began in Sept04*). **Policy rates are likely to be on hold** till 1QFY09 – i.e till inflation eases to the single digit levels
- **...and more measures to enhance liquidity/flows:** Last month, besides providing additional liquidity, the RBI made NRI deposits more attractive, the MoF partially eased the norms on ECBs, while yesterday the SEBI lifted restrictions on P-Notes. Given the global turmoil, we expect further easing on the capital account (*see <https://www.citigroupgeo.com/pdf/SAP20665.pdf>*) and a reduction in SLR/unwinding of MSS to ensure that adequate credit is available for the real economy.

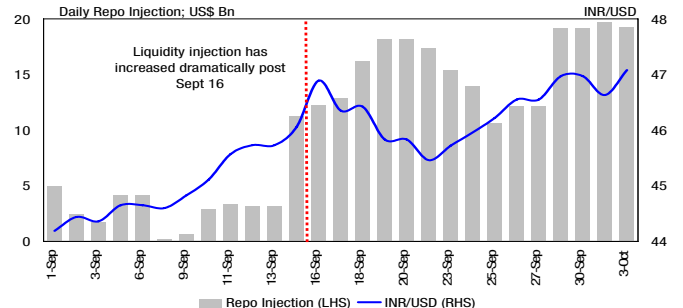
Note Released: 7-Oct-08

Trends in the Cash Reserve Ratio (CRR)



Source: RBI

Trends in Liquidity Injection and the Rupee (Rs Bn, INR/USD)



Source: RBI

¹Two key liquidity measures include (1) The extension of the SLAF to a daily basis and (2) Banks can borrow upto 1% of their net demand and time liabilities, which is tantamount to an SLR cut.

²Liquidity conditions worsened due to the 1) timing mismatch between the collection of advance taxes which absorbs liquidity, and govt spending which injects liquidity) and (2) fx intervention to stem the INR slide (RBI sells dollars which removes rupee liquidity)



Appendix: Text of RBI Measures

“It may be recalled that on September 16, 2008, the Reserve Bank announced several measures to alleviate the pressures on domestic financial markets brought on by external developments in response to the bankruptcy/sell-out/restructuring of some of the world's largest financial institutions. Since then, there has been a sharp deterioration in the global financial environment with the number of troubled financial institutions rising, stock markets weakening and money markets strained. Central banks across the world have stepped up their liquidity operations, including coordinated actions, and some have banned/limited short selling of financial stocks. These new developments have impacted domestic money and forex markets with a marked increase in volatility and a sharp squeeze on market liquidity as reflected in the movements in overnight interest rates and the high recourse to the LAF.

On a review of the current liquidity situation in the context of global and domestic developments, it has been decided to reduce the CRR from its current level of 9.0 per cent of net demand and time liabilities (NDTL) by 50 basis points to 8.5 per cent of NDTL with effect from the fortnight beginning October 11, 2008. As a result of this reduction in the CRR, an amount of about Rs 20, 000 crore would be released into the system. This measure is ad hoc, temporary in nature and will be reviewed on a continuous basis in the light of the evolving liquidity conditions.

Active liquidity management is a key element of the current monetary policy stance. Liquidity modulation through a flexible use of a combination of instruments has, to a significant extent, cushioned the impact of the international financial turbulence on domestic financial markets by absorbing excessive market pressures and ensuring orderly conditions. In view of the evolving environment of heightened uncertainty, volatility in global markets and the dangers of potential spillovers to domestic equity and currency markets, liquidity management will continue to receive priority in the hierarchy of policy objectives over the period ahead. The Reserve Bank will continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and open market operations (OMO) including the MSS and the LAF, using all the policy instruments at its disposal flexibly, as and when the situation warrants.

The overall stance of monetary policy in 2008-09 accords high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to continuation of the growth momentum, as set out in the Annual Policy Statement and reiterated in the First Quarter Review of July 2008. The overriding priority for monetary policy is to eschew any further intensification of inflationary pressures and to firmly anchor inflation expectations.”

Dated 6th October, 2008

See http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=19211 for details

Disclosure Appendix

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