RESERVE BANK OF INDIA

First Quarter Review of Monetary Policy 2009-10

Dr. D. Subbarao
Governor
Reserve Bank of India
Mumbai

July 28, 2009

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ACRONYMS

ADRs	-	American Depository Receipts
BE	-	Budget Estimates
BEI	-	Business Expectation Index
BoP	-	Balance of Payments
BPLRs	-	Benchmark Prime Lending Rates
BSE	-	The Stock Exchange, Mumbai
CBLO	-	Collateralised Borrowing and Lending Obligation
CD	-	Certificate of Deposit
CDS	-	Credit Default Swap
CP	-	Commercial Paper
CPI	-	Consumer Price Index
CRR	-	Cash Reserve Ratio
CSO	-	Central Statistical Organisation
ECB	-	European Central Bank
ECBs	-	External Commercial Borrowings
EMEs	-	Emerging Market Economies
EXIM	-	Export-Import Bank of India
FCCBs	-	Foreign Currency Convertible Bonds
FDI	-	Foreign Direct Investment
FICCI	-	Federation of Indian Chambers of Commerce and Industry
FIIs	-	Foreign Institutional Investors
FRBM	-	Fiscal Responsibility and Budget Management
GDP	-	Gross Domestic Product
GDRs	-	Global Depository Receipts
GSDP	-	Gross State Domestic Product
IIP	-	Index of Industrial Production
IMF	-	International Monetary Fund
LAF	-	Liquidity Adjustment Facility
LIC	-	Life Insurance Corporation of India
M_3	-	Broad Money
MSS	-	Market Stabilisation Scheme

NBFCs	-	Non-Banking Financial Companies
NDA	-	Net Domestic Assets
NDTL	-	Net Demand and Time Liabilities
NFEA	-	Net Foreign Exchange Assets
NHB	-	National Housing Bank
OECD	-	Organisation for Economic Co-operation and Development
OMO	-	Open Market Operation
PMI	-	Purchasing Managers' Index
PSBs	-	Public Sector Banks
Q	-	Quarterly
RBI	-	Reserve Bank of India
RE	-	Revised Estimates
REER	-	Real Effective Exchange Rate
RM	-	Reserve Money
RRBs	-	Regional Rural Banks
SCBs	-	Scheduled Commercial Banks
SIDBI	-	Small Industries Development Bank of India
SLR	-	Statutory Liquidity Ratio
SPV	-	Special Purpose Vehicle
T-Bills	-	Treasury Bills
UK	-	United Kingdom
US	-	United States of America
WEO	-	World Economic Outlook
WPI	-	Wholesale Price Index
Y-o-Y	-	Year-on-Year

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By
Dr. D. Subbarao
Governor

The global economy is showing incipient signs of stabilisation, *albeit* not recovery. The pace of decline in economic activity in several major advanced economies has slowed, frozen credit markets have thawed and equity markets have begun to recover. Recent months have witnessed industrial activity reviving in a number of emerging market economies (EMEs) such as China, Korea, Brazil and India. Notwithstanding some positive signs, the path and the time horizon for global recovery remain uncertain. Consumption demand remains subdued as unemployment levels have risen. Business and consumer confidence are yet to show definitive signs of revival. Global trade, according to the International Monetary Fund (IMF), is projected to shrink by over 12 per cent in 2009; private capital flows are also expected to decline. The continuing process of balance sheet adjustment by both households and businesses is inhibiting recovery in many economies. Reflecting these several uncertainties, the IMF, in its latest World Economic Outlook (WEO) update released in July 2009, has further revised downwards the global growth forecast for 2009 to (-)1.4 per cent from its April 2009 forecast of (-)1.3 per cent.

2. The crisis, which affected the global financial system and engulfed most countries of the world, had all the ingredients for a severe disruption of the world economy on the scale of the Great Depression. However, it was mitigated by bold, large and decisive actions taken in concert by governments and central banks in each country, and which came to be increasingly co-ordinated across countries. Consequently, while the financial sector appears to be stabilising, economic recession in the real sector persists.

3. The Indian economy experienced a significant slowdown in 2008-09 in comparison with the robust growth performance in the preceding five years, largely due to the knock-on effect of the global financial crisis. The worst hit has been the export sector, which has been recording negative growth since October 2008. This, in turn, impacted the manufacturing sector. Investment demand was also dented by the decline in corporate profitability and increased uncertainties about future prospects. Private consumption decelerated significantly. The services sector, which has been the main driver of growth for more than a decade, also slowed down. The financial sector, however, remained relatively unaffected despite the severe stress caused by the global deleveraging process, which

triggered capital outflows in the second half of 2008-09.

4. Quick and aggressive policy responses both by the Government and the Reserve Bank mitigated the adverse impact of the global financial crisis. The large domestic demand bolstered by government consumption, provision of forex and rupee liquidity coupled with sharp cuts in policy rates, a sound banking sector and well-functioning financial markets helped cushion the economy from the worst impact of the crisis. There are now signs of an upturn in industrial production and revival of credit demand, though the delayed monsoon has increased the downside risks to agricultural production.

5. This *First Quarter Review of Monetary Policy for 2009-10* is thus set in the context of a stabilising global economy and gradually recovering domestic economy. It is organised in three sections. Section I provides an assessment of the *Macroeconomic and Monetary Developments;* Section II delineates the *Stance of Monetary Policy; and* Section III sets out the *Monetary Measures*. This review should be read and understood together with the detailed review of *Macroeconomic and Monetary Developments* released yesterday.

I. Macroeconomic and Monetary Developments

Global Outlook

6. The deterioration in the global outlook that started in September 2008 continued in the second quarter of 2009, although some tentative signs of stabilisation have begun to emerge. Reflecting the continued decline, the IMF in its July Update of the World Economic Outlook (WEO) has projected that the global economy will shrink by 1.4 per cent in 2009, a shade more than the contraction of 1.3 per cent projected earlier in April 2009. The global economy is, however, projected to recover and expand by 2.5 per cent in 2010 (Table 1). Projections by other international agencies such as the World Bank also do not hold any promise of recovery in 2009.

7. In the US, real GDP declined at an annual rate of 5.5 per cent in Q1 of 2009, driven mainly by a decline in consumption and exports. The IMF's July WEO Update has projected real GDP of the US to shrink by 2.6 per cent in 2009, a slight improvement from a contraction of 2.8 per cent projected in the April WEO. The main macroeconomic indicators continued to be adverse in Q2 of 2009 with the unemployment rate increasing to 9.5 per cent in June 2009 accompanied by a dip in wage growth, industrial production, capacity utilisation and consumer sentiment.

Table 1: Global GDP Growth (%)

Country/Region	2009	2010
US	(-)2.6	0.8
UK	(-)4.2	0.2
Euro Area	(-)4.8	(-)0.3
Japan	(-)6.0	1.7
China	7.5	8.5
India	5.4	6.5
World	**(-)1.4**	**2.5**

Source: IMF World Economic Outlook, July 8, 2009.

Retail sales and consumption continued to be weak as households were still engaged in repairing their balance sheets ruptured by the fall in asset prices. The below trend growth is likely to persist for some more time. Consequently, spare capacity and unemployment are expected to rise.

8. The outlook for the euro area is worse than that for the US. Real GDP in the euro area declined by 4.9 per cent in Q1 of 2009 and unemployment rose to 9.5 per cent in May 2009. Although measures of consumer and business sentiment have improved somewhat, signs of recovery have been less evident than in the US. The July WEO Update has projected real GDP of the euro area to shrink by 4.8 per cent in 2009 and by 0.3 per cent in 2010. Real GDP in Japan contracted by 14.2 per cent in the quarter ended March 2009. However, subsequent data suggest that output is stabilising and consumer confidence is improving. According to the July WEO Update of the IMF, the Japanese economy is projected to shrink by 6.0 per cent in 2009 before recovering by 1.7 per cent in 2010.

9. Central banks across countries have continued with an easy monetary policy stance. Among the central banks in advanced countries, the European Central Bank (ECB) reduced its policy rate in two stages from 1.5 per cent in March 2009 to 1.0 per cent by May 2009 and also announced a programme to purchase bonds. The Federal Reserve, the Bank of Japan, the Bank of England and the Swiss National Bank have continued with their unconventional monetary policies, with policy rates in these countries being in the range of 0 – 0.75 per cent. The extraordinarily large, co-ordinated and concerted monetary measures by developed economies have begun to show results. Global credit spreads have tended to decline to levels prevailing prior to the collapse of Lehman Brothers in September 2008. In the US, domestic money market spreads have declined to around the lowest points since the onset of the financial crisis. The stress test results for the 19 largest banks in the US and the banks' subsequent actions in raising funds had a positive impact on financial markets as evidenced by the decline in the credit default swap (CDS) spreads in the period after the announcement of the stress test results. However, sovereign CDS spreads remain above the pre-crisis level reflecting concerns over rising public debt levels.

10. In recent weeks, there have been some indications of the negative growth rates moderating in several countries. Overall, OECD's Composite Leading Indicators point to an easing of the pace of deterioration in some major economies, especially Canada, France, Italy and the UK. Positive signals are also emerging in the world's three largest economies – the US, Japan and Germany. In the US, most of the manufacturing sector surveys showed further improvement in June and July, and the Chicago PMI rose with new orders and production indicating improvement in business sentiment. Inventories at US wholesalers fell in May for the ninth straight month accompanied by an increase in sales. In Japan, there has been a strong recovery in the manufacturing PMI as also a pick-up in export volumes, after a precipitous fall in the late 2008 and early 2009. While some analysts contend

that these ‘green shoots’ signal the beginning of a recovery, there is an influential view that the signals are too weak or fragile to indicate any sustainable turnaround before the close of 2009.

Emerging Market Economies

11. In its July WEO Update, the IMF projects the GDP growth of emerging and developing economies to decelerate to 1.5 per cent in 2009 from 6.0 per cent in 2008, before expanding to 4.7 per cent in 2010. The IMF, however, upgraded the growth outlook for developing Asia citing improved prospects in China and India. In 2009 so far (up to June 2009), industrial production has picked up in a wide range of Asian economies. The most notable has been the strong recovery in China’s industrial production following the very large increase in fixed capital investment by the public sector and strong credit growth. China has been able to at least partly neutralise the impact of contraction in exports by expanding domestic demand, especially government investment demand. Industrial output in Korea and Taiwan too has recorded a significant upturn.

Domestic Outlook

12. The Indian economy grew by 6.7 per cent in 2008-09 according to the revised estimates of the Central Statistical Organisation (CSO) – better than most analysts had expected, but lower than the growth of 9.0 per cent in 2007-08. The deceleration in GDP growth was particularly pronounced during the second half of 2008-09, largely due to the adverse impact of the global economic crisis (Table 2).

Agriculture

13. The agriculture sector, which recorded an average annual growth rate of 4.9 per cent during 2003-08, expanded only by 1.6 per cent during 2008-09. In 2008-09, foodgrains production was 233.9 million tonnes, up from 230.8 million tonnes last year. This was also an all-time high. Allied activities – horticulture, floriculture, forestry, livestock and fisheries – which account for a substantial share in agriculture remained buoyant. However, the production of commercial crops such as major oilseeds, cotton, jute and sugarcane was lower. Looking ahead to the current year, the progress of the south-west monsoon has been slow and halting.

Table 2: Real GDP Growth (%)

Activity	Financial Year		Quarterly Growth Rates (y-o-y): 2008-09			
	2007-08	2008-09	Q1 (Apr-Jun)	Q2 (Jul-Sep)	Q3 (Oct-Dec)	Q4 (Jan-Mar)
Agriculture	4.9	1.6	3.0	2.7	(-)0.8	2.7
Industry	7.4	2.6	5.1	4.8	1.6	(-)0.5
Services	10.8	9.4	10.0	9.8	9.5	8.4
Overall GDP	**9.0**	**6.7**	**7.8**	**7.7**	**5.8**	**5.8**

Source: Central Statistical Organisation (CSO).

By July 22, 2009, monsoon rainfall was 19 per cent below normal in the country as a whole. At a disaggregated level, rainfall was deficient/scanty in 19 of the 36 meteorological sub-divisions. While kharif sowing has picked up in July, the delayed monsoon can impact agricultural output. Although the share of agriculture and allied activities in GDP has declined over the years and is currently at 17.5 per cent, good agricultural performance is critical not only because it employs over 55 per cent of the labour force but also for ensuring stability in food prices.

Industry

14. Industrial sector growth decelerated significantly to 2.6 per cent in 2008-09 from 8.5 per cent in the previous year due largely to negligible/negative growth during four months in the second half of the year. This pushed down the growth rate of the index of industrial production (IIP) to an abysmally low of 0.4 per cent during the second half of 2008-09 from 5.0 per cent in the first half. During April-May 2009, however, industrial growth turned positive with IIP increasing by 1.9 per cent. While growth in the basic, intermediate and consumer durable goods sectors picked up, the capital goods and consumer non-durable sectors showed negative growth. The core infrastructure sector, with a weight of 26.7 per cent in the IIP, recorded a higher growth of 4.8 per cent during April-June 2009, up from 3.5 per cent in the corresponding period in the previous year. The leading indicators of industrial production, both quantitative and qualitative, suggest that the recent downturn has been arrested and a pick-up is on the way forward, *albeit* with some lag.

Services

15. The performance of the services sector during April-May 2009 presents a mixed but predictable picture. Trade-related services such as cargo handled at major sea and airports, as also passengers handled at international terminals continue to show deceleration/negative growth. Domestic activity-related services such as communication and construction are showing signs of upturn.

Demand Components of GDP

16. India's exports have contracted during each of the last eight months (October 2008-May 2009). However, imports in Q4 of 2008-09 contracted faster than exports on account of moderation in oil prices and reduction in non-oil imports. As a result, growth of net exports decelerated sharply. Private final consumption expenditure and gross fixed capital formation, together with a weight of nearly 90 per cent in GDP, decelerated significantly in the second half of 2008-09. However, a sharp increase in government consumption in the second half of the year, resulting from the Sixth Pay Commission payouts and fiscal stimulus measures, cushioned the overall decline in aggregate demand (Table 3).

17. In fact, the contribution of government final consumption expenditure to GDP growth expanded four-fold from 8.0 per cent in 2007-08 to 32.5 per cent in 2008-09, while the share of private final consumption expenditure nearly halved from 53.8 per cent to 27.0 per cent during the same period (Table 4).

Table 3: Demand Components of GDP: 2008-09

Item	Q1	Q2	Q3	Q4	Full year
Year-on-Year Growth Rate (%)					
Private Final Consumption Expenditure	4.5	2.1	2.3	2.7	2.9
Government Final Consumption Expenditure	(-)0.2	2.2	56.6	21.5	20.2
Gross Fixed Capital Formation	9.2	12.5	5.1	6.4	8.2
Net Exports	(-)75.9	(-)62.1	(-)75.4	(-)30.8	(-)41.2
Share in GDP (%)					
Private Final Consumption Expenditure	58.0	55.5	57.4	51.4	55.5
Government Final Consumption Expenditure	9.6	8.3	12.5	13.4	11.1
Gross Fixed Capital Formation	32.2	34.5	30.9	31.6	32.2
Net Exports	(-)1.3	(-)10.5	(-)8.5	(-)2.9	(-)5.8

Source: Central Statistical Organisation (CSO).

Corporate Performance

18. The performance of the private non-financial corporate sector deteriorated in the second half of 2008-09, reflecting both demand slowdown and moderation in prices (Table 5). Profit margins were eroded by deceleration in sales, increased interest outgo, significant drop in non-sales income and losses on foreign currency related transactions. Early corporate results for Q1 of 2009-10 indicate moderate sales growth over Q4 of 2008-09 with improved profit margins.

Table 4: Contribution of Demand Components to GDP Growth

Item	Share in GDP Growth (%)	
	2007-08	2008-09
Private Final Consumption Expenditure	53.8	27.0
Government Final Consumption Expenditure	8.0	32.5
Gross Fixed Capital Formation	43.6	42.5
Net Exports	(-)14.0	(-)29.5

Business Confidence

19. The Industrial Outlook Survey of the Reserve Bank, conducted during April-May 2009, shows a turnaround in the business sentiment. The assessment for Q1 of 2009-10 suggests that the slide in sentiment in the preceding three quarters has been arrested on key indicators such as production, order book position, capacity utilisation, financial situation and availability of finance.

20. The business expectation index (BEI) for the forward July-September 2009 quarter crossed the neutral 100-mark and moved into the growth terrain on the perception of improvement in demand conditions. The Survey indicates that during Q2 of 2009-10, businesses expect improvement in capacity utilisation as also increase in both input and output prices, returning some pricing power to them.

Table 5: Performance of the Private Corporate Sector

Item	2007-08 (Full Year)	2008-09		
		Full Year	First Half	Second Half
Growth Rate (%)				
Sales	18.3	17.8	32.4	5.5
Expenditure	18.4	20.2	37.5	5.7
Raw Materials Cost	16.8	19.6	43.7	(-)0.8
Staff Cost	19.4	16.3	17.4	15.2
Gross Profit	22.8	(-)3.9	11.3	(-)17.5
Net Profit	26.8	(-)18.2	1.3	(-)35.1
Ratio (%)				
Interest to Sales	2.2	3.1	2.9	3.4
Gross Profit to Sales	16.3	13.4	14.2	12.5
Net Profit to Sales	11.8	8.1	9.1	7.1

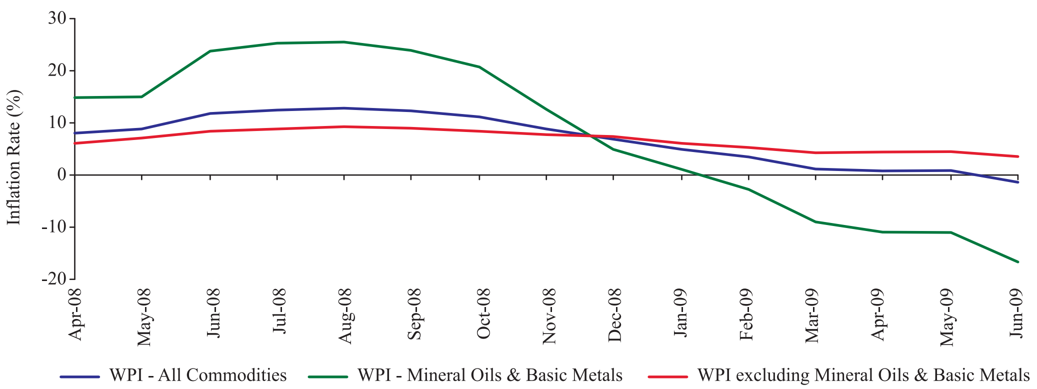
While there is a moderation of investment intentions in 2009-10 *vis-à-vis* 2008-09, capital investments by big companies are expected in food, rubber, paper and cement groups. The overall findings of the Reserve Bank's Industrial Outlook Survey are also corroborated by business confidence surveys conducted by other agencies such as Dun and Bradstreet, and FICCI.

Inflation

21. The headline inflation, as measured by year-on-year variations in the wholesale price index (WPI), decelerated from a peak of 12.91 per cent on August 2, 2008 to 0.84 per cent at end-March 2009 and turned negative in June 2009. The increased volatility in WPI inflation needs to be seen in the context of the behaviour of the global commodity prices. Reflecting the sharp increase in oil and metal prices, WPI inflation had risen to double digits in June 2008 and remained elevated till October 2008 tracking the firm global commodity prices. As the global commodity prices moderated from their peak levels, domestic prices also adjusted, setting off a converse movement in WPI inflation. That volatility in WPI flowed largely from international commodity prices is evident from the trend in WPI inflation excluding mineral oils and metals (weight in WPI: 15.3 per cent), which is less volatile than the overall WPI inflation (Chart 1).

22. WPI inflation for the week ended July 11, 2009 was (-)1.17 per cent. The negative WPI inflation is expected to persist for a few more months till the base effect wears off. The evolution of WPI inflation so far has been along the lines anticipated in the Annual Policy Statement of April 2009. The currently observed negative WPI inflation largely reflects the statistical effect of the high base of last year and should not be interpreted as structural deflation arising from demand contraction.

Chart 1: Commodity Prices and WPI Inflation



23. At a disaggregated level, WPI inflation, on account of food articles, is ruling high and WPI inflation for essential commodities (weight in WPI: 17.8 per cent) is also in double digits. On a financial year basis, WPI has already increased by 3.5 per cent in 2009-10 (up to July 11) as against an increase of 5.6 per cent in the corresponding period of the previous year. Various consumer price indices (CPIs) are also ruling at elevated levels. All these would suggest that the negative year-on-year WPI inflation cannot be attributed to structural deficiency in demand (Table 6).

24. The divergence between WPI and CPI inflation rates has become more

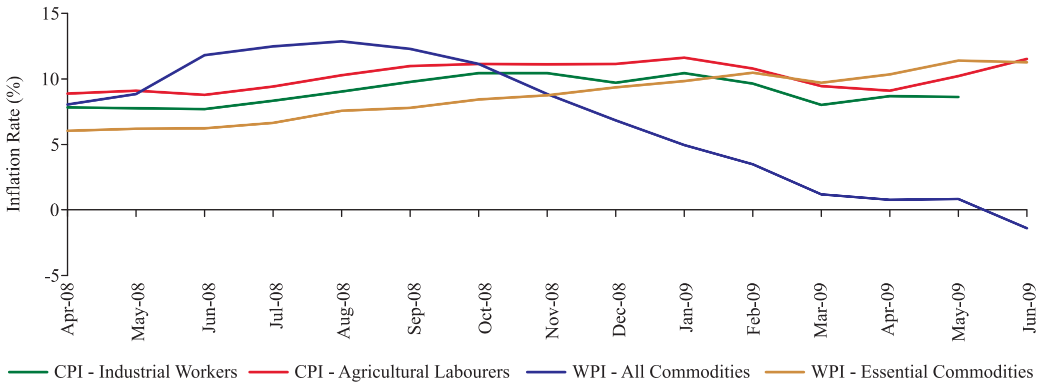
Table 6: Annual Inflation Rate (%)

Wholesale Price Index (WPI)	**July 12, 2008 (y-o-y)**	**July 11, 2009 (y-o-y)**
WPI - All Commodities	12.13	(-)1.17
WPI - Primary Articles	10.37	4.96
WPI - Food Articles	5.72	8.25
WPI - Fuel Group	16.90	(-)10.05
WPI - Manufactured Products	10.99	(-)0.05
WPI - Manufactured Food Products	14.09	9.80
WPI - Essential Commodities*	6.31	10.60
WPI - Excluding Fuel	10.82	1.39
WPI - Excluding Food Articles and Fuel	12.14	(-)0.28
Consumer Price Indices (CPIs)	**June 2008 (y-o-y)**	**June 2009 (y-o-y)**
CPI - Industrial Workers #	7.75	8.63
CPI - Urban Non-manual Employees #	6.76	9.68
CPI - Agricultural Labourers	8.77	11.52
CPI - Rural Labourers	8.75	11.26

* Essential commodities (weight in WPI: 17.8 per cent) include rice, wheat, jowar, bajra, pulses, potatoes, onions, milk, fish-inland, mutton, chillies (dry), tea, coking coal, kerosene, atta, sugar, gur, salt, hydrogenated vanaspati, rape & mustard oil, coconut oil, groundnut oil, long cloth/sheeting, dhoties, sarees & voiles, household laundry soap and safety matches.

\# Pertains to May.

Chart 2: Food Price Inflation and Price Indices



pronounced in the recent period with the WPI inflation turning negative, while the CPI inflation is ruling in the range of 8.6-11.5 per cent. This is in contrast to the historical trend when CPI inflation has tracked WPI inflation, *albeit* with a lag, as wholesale price changes are followed by retail price changes. In recent months, CPI inflation has remained stubborn at elevated levels due to increased prices of food items, which have a higher weight in the CPI basket than in the WPI. As would be expected, CPI inflation tracks the essential commodities component of WPI inflation quite closely (Chart 2). The divergence in various price indices evidently increases the complexity of inflation assessment. For its overall assessment of inflation outlook for policy purposes, therefore, the Reserve Bank, as always, monitors the full array of price indicators.

Fiscal Scenario

25. The ratio of tax receipts to GDP of the Central Government has declined from a peak of 12.6 per cent of GDP in 2007-08 to 11.8 per cent in 2008-09, and is budgeted to drop further to 10.9 per cent in 2009-10 due to the combined impact of the economic slowdown and the fiscal stimulus measures in terms of tax cuts to support growth (Table 7). On the other hand, aggregate expenditure has increased mainly on account of the implementation of the Sixth Pay Commission Award, the debt waiver scheme for farmers, the rural employment programme and spending on infrastructure.

26. As a result of fiscal stimulus measures, coupled with the reduction in the tax-GDP ratio, all the deficit indicators deteriorated sharply and deviated

Table 7: Fiscal Situation of the Central Government (% of GDP)

Item	2007-08 (Actual)	2008-09 (RE)	2009-10 (BE)
1. Gross Tax Revenue	12.6	11.8	10.9
2. Total Expenditure	15.1	16.9	17.4
Revenue Expenditure	12.6	15.1	15.3
Capital Expenditure	1.8@	1.8	2.1
3. Fiscal Deficit	2.7	6.2*	6.8
4. Revenue Deficit	1.1	4.6*	4.8
5. Primary Deficit	(-)0.9	2.6	3.0

* As per provisional accounts released by the Controller General of Accounts.
@ Net of acquisition cost of the Reserve Bank's stake in State Bank of India.

significantly from the targets stipulated under the Fiscal Responsibility and Budget Management (FRBM) Rules. The fiscal deficit increased from 2.7 per cent of GDP in 2007-08 to 6.2 per cent (pre-actual) in 2008-09. Of the increase in fiscal deficit due to the stimulus measures (3.5 per cent of GDP), a major portion (3.3 percentage points) has been on account of increase in expenditure. The revenue deficit also went up from 1.1 per cent of GDP in 2007-08 to 4.6 per cent in 2008-09. The primary surplus in 2007-08 turned into a deficit in 2008-09.

27. The consolidated fiscal deficit of the States for 2008-09 is expected to have risen to 3.0 per cent of GDP taking the estimated combined deficit of the Centre and the States to 9.1 per cent of GDP, a level last seen in 2002-03. Including the issuance of bonds to oil marketing and fertiliser companies, the combined deficit for macroeconomic purposes adds up to around 10.9 per cent of GDP in 2008-09.

28. Owing to the fiscal stimulus packages as also additional post-budget items of expenditure, the combined net market borrowings of the Central and State Governments in 2008-09 were nearly two and half times their net borrowings in 2007-08. As per budget estimates, the combined net borrowing requirements of the Central and State Governments for 2009-10 are estimated to be higher than the 2008-09 actual borrowings by as much as 34 per cent (Table 8).

29. The large government market borrowing in 2009-10, as projected in the Interim Budget, called for active liquidity management by the Reserve Bank. Accordingly, the Reserve Bank indicated its intention to purchase government securities under open market operations (OMO) for an indicative amount of Rs.80,000 crore during the first half of 2009-10. Considering the higher borrowing programme indicated in the Union Budget

Table 8: Borrowings of the Central and State Governments: 2009-10

(Rs. crore)

Item	2007-08 Actual	2008-09 Actual	2009-10		
			Interim Budget Estimates	Budget Estimates (BE)	% Increase in BE over 2008-09
Central Government					
Gross Market Borrowings $	1,88,215	3,18,550	3,98,552	4,91,044	54.2
Net Market Borrowings	1,08,998	2,98,536	3,08,647	3,97,957	33.3
State Governments					
Net Market Borrowings	56,224	1,03,766	1,26,000 *	1,40,000 *	34.9
Total Net Market Borrowings	**1,65,222**	**4,02,302**	**4,34,647**	**5,37,957**	**33.7**

$ Pertain to dated securities and 364-Day Treasury Bills.

* Estimated. The State Governments have been allowed to borrow an additional 0.5 per cent of Gross State Domestic Product (GSDP) as part of the fiscal stimulus package in 2008-09 and another 0.5 per cent of GSDP in the Union Budget 2009-10, raising their budgeted borrowings in 2009-10 to 4.0 per cent of GSDP.

2009-10, the revised borrowing calendar for Q2 (July-September) of 2009-10 was released on July 16, 2009. According to this revised calendar, the net market borrowing of the Central Government through dated securities during the first half will be Rs.2,65,911 crore (higher by Rs.58,000 crore from the Interim Budget).

30. It may be noted that nearly 63 per cent (Rs.1,67,911 crore) of the borrowing programme for the first half of the year has been completed by July 27, 2009. An additional amount of Rs.28,000 crore has been raised through de-sequestering MSS balances. The open market operations undertaken so far have been of the order of Rs.33,439 crore, accounting for about 42 per cent of the notified amount of Rs.80,000 crore. There is, therefore, sufficient headroom available to the Reserve Bank to manage the balance borrowing smoothly (Table 9).

31. The weighted average yield of dated securities issued under the Central Government borrowing programme, which increased from 8.42 per cent in Q1 of 2008-09 to 9.24 per cent in Q2, softened to 6.68 per cent in Q4 of 2008-09. The weighted average yield for the quarter ended June 2009 was, however, higher at 6.93 per cent. The weighted average maturity of securities issued during 2009-10 so far has been 11.5 years, shorter when compared with the average maturity of 15.2 years last year.

32. The net borrowings of the Centre and the States completed during 2009-10 (up to July 27, 2009) were higher as compared with the corresponding period of last year (Table 10).

Monetary Conditions

33. The movements in monetary aggregates since mid-September 2008 have been driven by the changes in liquidity conditions arising from the monetary policy response to global and domestic macroeconomic conditions. Reserve money

Table 9: Central Government Borrowings: First Half of the Fiscal Year

(Dated Securities)

(Rs. crore)

Item	First Half (April-September) Borrowings				
		2009-10			
	2008-09	Proposed earlier	Revised	Actual so far (up to July 27)	Balance
Gross Market Borrowings	**1,06,000**	**2,41,000**	**2,99,000***	**2,01,000***	**98,000**
Less: Repayment	44,028	33,089	33,089	33,089	0
Net Market Borrowings	**61,972**	**2,07,911**	**2,65,911**	**1,67,911**	**98,000**
Less: OMO Purchases@	0	80,000	80,000	33,439	46,561
Add: MSS (Net)*	5,263	(-) 42,000	(-) 42,000	(-) 38,500	(-) 3,500
Net Supply of Fresh Securities	**67,235**	**85,911**	**1,43,911**	**95,972**	**47,939**

@ The OMO purchase amount is indicative and the Reserve Bank has the flexibility to alter the amount depending on the assessment of the evolving liquidity conditions and its other operations.

* Excludes Rs.28,000 crore raised through MSS de-sequestering on May 2, 2009.

Table 10: Net Market Borrowings of the Central and State Governments – Progress so far

(Rs. crore)

Item	Up to July 27	
	2008-09	2009-10
A. Central Government	**73,472**	**1,65,513**
i. Dated Securities	47,982	1,67,911
ii. Additional 364-day T-Bills	(-) 819	(-) 3,549
iii. Additional 182-day T-Bills	6,503	200
iv. Additional 91-Day T-Bills	19,806	951
B. State Governments	**3,583**	**23,744**
Total (A + B)	**77,055**	**1,89,257**
Memo:		
*MSS (Net)**	2,763	(-) 38,500

* Excludes Rs.28,000 crore raised through MSS de-sequestering on May 2, 2009.

(RM) changes largely reflect the changes in the transaction demand for currency and reductions in the cash reserve ratio (CRR) of banks. RM growth decelerated significantly as on July 3, 2009 (y-o-y) in comparison with last year mainly due to the sharp reduction in the CRR in phases beginning October 2008. Adjusted for the first round effect of the CRR changes, the decline in RM growth was less pronounced (Table 11).

34. The money supply (M_3) growth on a year-on-year basis at 20.0 per cent as on July 3, 2009 has been well above the 17.0 per cent trajectory projected in the Annual Policy Statement of April 2009 (Table 11). The major driver of monetary expansion has been bank credit to Government which increased by 48.0 per cent.

35. Monetary management since mid-September 2008 has been guided by the continued need to provide liquidity to mitigate the impact of the global financial crisis and to improve the growth prospects in the medium-term. The Reserve Bank continued with its commitment to ensure comfortable domestic and foreign exchange liquidity and endeavoured to complete the large market borrowing programme of the Government in a non-disruptive manner. Accordingly, it provided foreign exchange liquidity to contain the volatility in the foreign exchange market, especially during the first two anxious months (September-

Table 11: Annual Variations in Monetary Aggregates as of July (%)

Item	2008-09 (July 4, 2008)	2009-10 (July 3, 2009)
Reserve Money	23.9	1.3
Reserve Money (adjusted for CRR changes)	17.5	16.8
Currency in Circulation	20.5	14.3
Money Supply (M_3)	21.1	20.0
M_3 (Policy Projection)	16.5-17.0 *	17.0**
Money Multiplier	4.5	5.4
Ratio of Net Foreign Exchange Assets of RBI to Currency	213.3	177.4

* Projection as indicated in the Annual Policy Statement 2008-09 (April 2008).
** Projection as indicated in the Annual Policy Statement 2009-10 (April 2009).

October 2008). This led to a decline in the Reserve Bank's net foreign exchange assets (NFEA) and that was made up by an expansion of net domestic assets (NDA). The Reserve Bank's intervention helped in maintaining orderly conditions in the foreign exchange market and ensuring overall comfortable liquidity in the system. The phenomenon of substitution of foreign assets by domestic assets, which began in the second half of 2008-09, continued during the first two months of the current year. Liquidity conditions have remained comfortable since mid-November 2008 with the call money rate remaining near or below the lower bound of the LAF corridor, consistent with the stance of monetary policy. During 2009-10 (up to July 24, 2009), the average daily amount absorbed by the Reserve Bank under the LAF window was Rs.1,20,368 crore, suggesting a large surplus with the banking system, equivalent to nearly 3 per cent of net demand and time liabilities (NDTL).

Credit Conditions

36. As on July 3, 2009, the year-on-year expansion in non-food credit was 16.3 per cent, lower than the growth of 25.5 per cent a year ago. The deceleration in the overall credit flow has mainly been due to subdued overall demand and lower credit requirement of oil marketing companies. While year-on-year growth in bank credit by public sector banks was more than the envisaged trajectory of 20 per cent indicated in the Annual Policy Statement 2009-10, credit expansion by private banks was substantially lower, and credit expansion by foreign banks was negative. While the deposit growth of public sector banks accelerated, that of private and foreign bank groups decelerated (Table 12).

37. During the current financial year (up to July 3, 2009), non-food credit expanded by 0.4 per cent as compared with 1.6 per cent last year. It is not unusual for non-food bank credit expansion to

Table 12: Bank Group-wise Deposits and Credit Annual Growth (y-o-y) as of July (%)

Bank Group	2008-09 (July 4, 2008)	2009-10 (July 3, 2009)
	Deposits	
Public Sector Banks	23.1	26.4
Private Sector Banks	17.4	6.7
Foreign Banks	20.9	16.4
Scheduled Commercial Banks*	21.5	21.9
	Credit	
Public Sector Banks	26.3	21.9
Private Sector Banks	22.3	4.2
Foreign Banks	33.3	(-)7.1
Scheduled Commercial Banks*	25.5	16.3

* Including RRBs.

decelerate in the early part of the year due to seasonal factors. However, during April-May 2009, non-food credit growth turned negative mainly due to a sharp decline in credit to petroleum and fertiliser companies (decline of Rs.18,796 crore in contrast to an increase of Rs.6,530 crore in the same period of last year). During the recent three fortnights of June 5, June 19 and July 3, 2009, non-food credit expansion has been higher at Rs.62,104 crore as compared with an increase of Rs.48,014 crore during the corresponding period of 2008.

38. As a result of the large deposit expansion coupled with moderation in credit demand, the scheduled commercial banks' investment in SLR securities (including securities acquired under the LAF) increased to 30.5 per cent of their NDTL as on July 3, 2009 compared with 27.7 per cent a year ago. Adjusted for LAF, their SLR investments were at 26.9 per cent of NDTL as on July 3, 2009. Excess SLR investments, over the prescribed SLR of 24 per cent of NDTL, were at Rs.2,83,086 crore as on July 3, 2009 (Rs.1,26,431 crore adjusted for LAF).

39. According to disaggregated data drawn from 49 banks accounting for 95 per cent of total bank credit, the year-on-year growth in bank credit to industry as of May 2009 was lower than that in the previous year. While the credit flow to agriculture, industry, real estate and NBFCs was sustained, it was significantly lower for housing (Table 13).

Total Flow of Financial Resources to the Commercial Sector

40. During 2008-09, the total flow of financial resources to the commercial sector declined as compared with the previous year, reflecting moderation in both bank credit and funds from other sources. While credit conditions have eased, the declining trend continued through Q1 of 2009-10, reflecting subdued credit demand conditions (Table 14).

Interest Rates

41. Since mid-September 2008, the Reserve Bank has reduced policy rates significantly: the repo rate by 425 basis points and the reverse repo rate by 275

Table 13: Annual Sectoral Flow of Credit

Sector	As on May 23, 2008 (y-o-y)			As on May 22, 2009 (y-o-y)		
	Amount (Rs.crore)	% share in total	Variations (%)	Amount (Rs.crore)	% share in total	Variations (%)
Agriculture	42,745	10.1	19.3	64,970	16.9	24.5
Industry	1,82,857	43.2	27.1	1,81,848	47.4	21.2
Real Estate	17,018	4.0	37.7	32,321	8.4	52.0
Housing	31,735	7.5	13.8	13,028	3.4	5.0
NBFCs	27,549	6.5	62.0	22,694	5.9	31.5
Overall Credit	**4,23,189**	**100.0**	**24.2**	**3,83,483**	**100.0**	**17.6**

Note: Data are provisional and relate to select banks which cover 95 per cent of total non-food credit extended by all scheduled commercial banks.

Table 14: Total Flow of Financial Resources to the Commercial Sector

(Rs.crore)

Item	Full Year		Financial Year so far	
	2007-08	2008-09	2008-09	2009-10
From Banks	4,44,807	4,21,091	30,631	5,697
From Other Sources*	5,87,659	4,66,895	1,28,490	84,969
Total Resources	**10,32,466**	**8,87,986**	**1,59,121**	**90,666**

* Includes borrowings from financial institutions (including LIC) and NBFCs as well as resources mobilised from the capital market and by way of ECBs, FCCBs, ADRs/GDRs, FDI and short-term credit as per the latest available data, adjusted for double counting.

basis points. The CRR was also reduced by 400 basis points of NDTL of banks (Table 15).

42. Taking cues from the reduction in the Reserve Bank's policy rates and the easy liquidity conditions, all public sector banks, most private sector and foreign banks have reduced their deposit and lending rates. The reduction in term deposit rates between October 2008 and July 20, 2009 has been in the range of 125-325 basis points by public sector banks, 100-375 basis points by private sector banks and 125-300 basis points by five major foreign banks. The reduction in the range of BPLRs was 125-275 basis points by public sector banks, followed by 100-125 basis points by private banks and 125 basis points by five major foreign banks (Table 16).

43. The frequency distribution of reduction in BPLRs by banks shows that most public sector banks reduced their BPLR by 200 basis points, most private sector banks by 100 basis points and most foreign banks by 50 basis points (Table 17).

44. The movement in the BPLRs does not fully and accurately reflect the changes in effective lending rates as nearly two-thirds of banks' lending takes place at sub-BPLR rates. The Reserve Bank's discussions with banks reveal that ample liquidity in the system and the subdued demand for bank credit have increased the competitive pressure on them to lend at sub-BPLR rates. Rough estimates show that the effective average lending rate for the scheduled commercial banks has declined from 12.3 per cent in March 2008 to 11.1

Table 15: Monetary Easing by the Reserve Bank since October 2008 (%)

Instrument	As in		Quantum of reduction (basis points)
	Early-October 2008	July 2009	
Repo Rate	9.00	4.75	425
Reverse Repo Rate	6.00	3.25	275
Cash Reserve Ratio	9.00	5.00	400

Table 16: Reduction in Deposit and Lending Rates

(October 2008 – July 20, 2009)

(basis points)

Bank Group	Deposit Rates	Lending Rates (BPLRs)
Public Sector Banks	125-325	125-275
Private Sector Banks	100-375	100-125
Five Major Foreign Banks	125-300	125

Table 17: Reduction in BPLR by Banks – Frequency Distribution
(July 20, 2009 over October 2008)

BPLR (Basis points) / Bank Group	25 bps	50 bps	75 bps	100 bps	125 bps	150 bps	175 bps	200 bps	225 bps	300 bps	325 bps	Total number of banks
Public Sector Banks	-	-	-	-	1	2	7	13	3	1	-	**27 (27)**
Private Sector Banks	2	2	3	6	1	2	2	1	1	-	-	**20 (22)**
Foreign Banks	-	4	3	2	-	1	-	2	-	1	1	**14 (28)**

Note: Figures in parentheses indicate total number of banks operating in India.

per cent by March 2009. The effective lending rate is expected to have declined further in Q1 of 2009-10. In effect, the BPLRs of banks have turned out to be the maximum lending rates in most cases, distorting their information content. Currently a Working Group (Chairman: Deepak Mohanty) is examining the BPLR system.

Financial Markets

45. Since October 2008, interest rates have declined across the term structure in the money and government securities markets. The call money rates have remained near or below the lower bound of the LAF corridor from November 2008. Primary yields on Treasury Bills have also moderated (Table 18).

46. The secondary market yield on the 10-year government security, however, crept up from 5.82 per cent in January 2009 to 6.57 per cent in March 2009 and further to 7.00 per cent in July 2009 on the back of the large market borrowing programme of the Government. Lower yields on Treasury Bills and higher yields on longer tenor government securities steepened the yield curve (Chart 3).

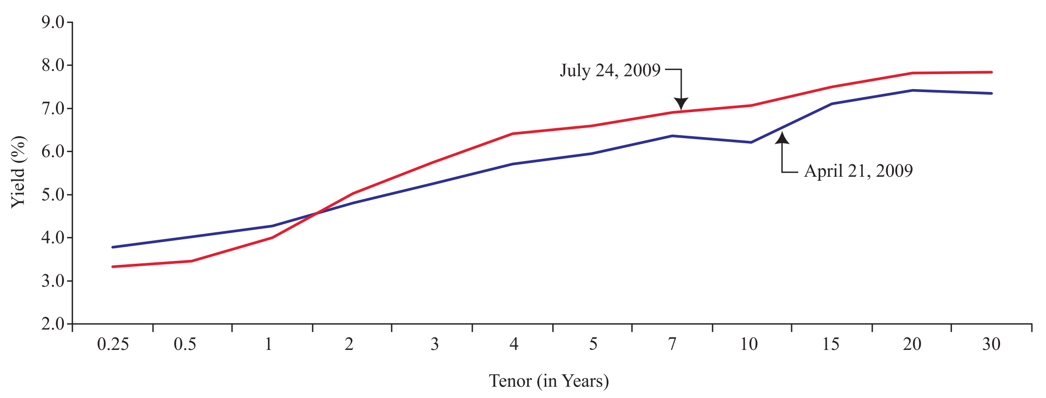
47. The foreign exchange market has remained orderly during 2009-10 (up to July 24, 2009) with the rupee exhibiting a two-way movement against major currencies.

Table 18: Interest Rates – Monthly Average (%)

Instrument/Segment	October 2008	January 2009	March 2009	April 2009	May 2009	June 2009	July * 2009
Call Money	9.90	4.18	4.17	3.28	3.17	3.21	3.15
CBLO	7.73	3.77	3.60	2.17	2.19	2.62	3.03
Market Repo	8.40	4.27	3.90	2.16	2.33	2.63	3.08
Certificates of Deposit (CDs)	10.00	7.33	7.53	6.48	6.20	4.90	3.40
Commercial Papers (CPs)	14.17	9.48	9.79	6.29	5.75	5.11	4.69
91-day Treasury Bills	7.44	4.69	4.77	3.81	3.26	3.35	3.22
10-year Govt. Security	7.80	5.82	6.57	6.46	6.41	6.82	7.00
Modal BPLR of PSBs	14.00	12.50	12.50	12.00	12.00	12.00	12.00

* Up to July 24, 2009.

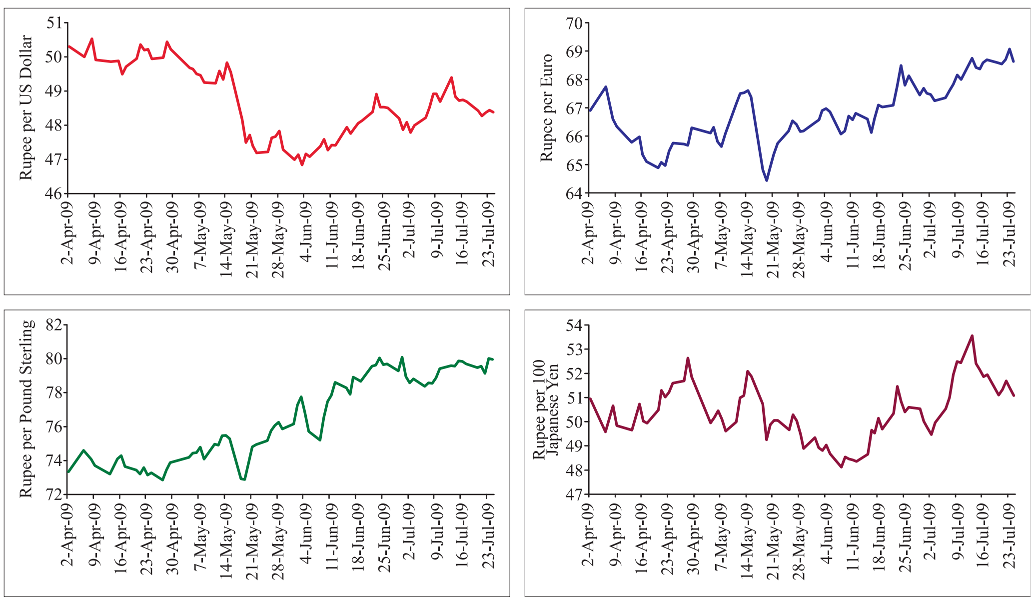
Chart 3: Secondary Market Curve for Government Securities



On the whole, the rupee appreciated by 5.3 per cent against the US dollar and 1.6 per cent against the Japanese yen, whereas it depreciated by 8.9 per cent against the pound sterling and 1.7 per cent against the euro (Chart 4). In terms of movement in indicators of the real exchange rate, the six-currency trade-based real effective exchange rate (REER) (1993-94=100) moved up from 96.25 at end-March 2009 to 100.18 by July 24, 2009 and remains competitive.

48. During 2009-10 so far, the domestic equity markets have been on the rise reflecting the global trend and increased optimism regarding the Indian economy. FIIs have made net investment of US$ 7.8 billion in 2009-10 (up to July

Chart 4: Movements in Exchange Rates



22, 2009) as against net disinvestment of US$ 4.0 billion during the corresponding period of 2008-09. The BSE Sensex increased from 9,709 at end-March 2009 to 15,379 on July 24, 2009.

Monetary Transmission

49. The efficacy of the monetary transmission mechanism hinges on the extent and speed with which changes in the central bank's policy rate are transmitted through the term structure of interest rates across markets. While the transmission of policy rate changes by the Reserve Bank has been faster in the money and government securities markets, it has been slow to the banks' lending rates. This has been a cause for concern. As indicated in the Annual Policy Statement, some of the major factors that impede the transmission of policy rates to the banks' lending rates are: (i) the administered interest rate structure on small savings, which constrains the reduction in deposit rates; (ii) a substantial portion of bank deposits is mobilised at fixed interest rates, which discourages banks to reduce their lending rates in line with the policy rates; (iii) concessional lending rates linked to BPLRs for some sectors, which make overall lending rates less flexible; and (iv) persistence of the large market borrowing programme of the government, which hardens interest rate expectations. As liquidity remains ample, the competitive pressure on lending rates has increased. Consequently, the transmission of policy rate changes to bank lending rates has improved since the last Annual Policy Statement in April 2009. As the short-term deposits contracted earlier at high rates mature and get repriced, it opens up room for banks to further reduce their lending rates.

Table 19: India's Balance of Payments

(US $ billion)

Item	Full Year		Quarterly: 2008-09			
	2007-08	**2008-09**	**Q1**	**Q2**	**Q3**	**Q4**
Exports	166.2	175.2	49.1	49.0	37.3	39.8
Imports	257.8	294.6	80.5	87.7	72.0	54.4
Trade Balance	(-)91.6	(-)119.4	(-)31.4	(-)38.7	(-)34.7	(-)14.6
Invisibles, net	74.6	89.6	22.4	26.2	21.7	19.3
Current Account Balance	(-)17.0	(-)29.8	(-)9.0	(-)12.5	(-)13.0	4.7
Capital Account *	109.2	9.7	11.3	7.8	(-)4.8	(-)4.4
Change in Reserves #	(-)92.2	20.1	(-)2.2	4.7	17.9	(-)0.3
Memo:						
As percentage of GDP						
Trade Balance	(-)7.8	(-)10.3				
Current Account Balance	(-)1.5	(-)2.6				
Net Capital Inflows	9.2	0.8				

* Including errors and omissions.
# On a BoP basis (*i.e.*, excluding valuation): (-) indicates increase; (+) indicates decrease.

External Sector

50. During 2008-09, India's current account deficit widened to 2.6 per cent of GDP from 1.5 per cent in 2007-08 reflecting a deterioration in the trade balance. As net capital inflows declined sharply from 9.2 per cent of GDP in 2007-08 to 0.8 per cent in 2008-09, reserves declined by US$ 20.1 billion, net of valuation changes, and by US$ 58.0 billion, inclusive of valuation changes (Table 19). The stress was maximum in Q3 of 2008-09 as the deteriorating current account balance was accompanied by net capital outflows, resulting in a substantial drawdown of reserves. The current account position turned around in Q4 of 2008-09 reflecting sharp moderation in international oil prices and sustained invisible surplus. While capital outflows persisted through Q4 of 2008-09, the trend reversed in Q1 of 2009-10.

51. The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements. In 2009-10 so far, foreign exchange reserves have increased by US$ 14.2 billion, taking them from US$ 252.0 billion at end-March 2009 to US$ 266.2 billion by July 17, 2009. The increase has largely been on account of valuation changes.

II. Stance of Monetary Policy

52. The thrust of the various policy initiatives by the Reserve Bank since mid-September 2008 has been on providing ample rupee liquidity, ensuring comfortable dollar liquidity and maintaining a market environment conducive for the continued flow of credit to productive sectors. The important measures initiated include reduction of the repo and reverse repo rates, reduction of the CRR and the SLR, institution of several sector-specific liquidity facilities, establishment of a forex swap facility and relaxation in the guidelines for raising external commercial borrowings (ECBs). Also, the Reserve Bank allowed restructuring of stressed assets by banks in order to increase the flow of credit for productive purposes.

53. In the Annual Policy Statement of April 2009, the reverse repo and repo rates were reduced by 25 basis points each. Currently, the reverse repo rate is at 3.25 per cent and the repo rate is at 4.75 per cent. These are at their historically lowest levels.

Liquidity Impact

54. The actions of the Reserve Bank since mid-September 2008 have resulted in augmentation of actual/potential liquidity of Rs.5,61,700 crore (Table 20). In addition, the permanent reduction in the SLR by one per cent of NDTL has made liquid funds of the order of Rs.40,000 crore available for credit expansion. Analytically, the various policy actions by the Reserve Bank since mid-September 2008 have resulted in

Table 20: Actual/Potential Release of Primary Liquidity - since Mid-September 2008

Measure/Facility	Amount (Rs. crore)
1. CRR Reduction	1,60,000
2. Unwinding/Buyback/De-sequestering of MSS Securities	1,55,544
3. Open Market Operations (purchases) *	80,080
4. Term Repo Facility	60,000
5. Increase in Export Credit Refinance	26,576
6. Special Refinance Facility for SCBs (Non-RRBs)	38,500
7. Refinance Facility for SIDBI/NHB/EXIM Bank	16,000
8. Liquidity Facility for NBFCs through SPV **	25,000
Total (1 to 8)	**5,61,700**
Memo:	
Statutory Liquidity Ratio (SLR) Reduction	40,000

* Include Rs.33,439 crore of OMO purchases during 2009-10 so far (up to July 27) against the proposed OMO purchases of Rs.80,000 crore during the first half of 2009-10.

** Includes an option of Rs.5,000 crore.

expansion of its domestic assets, through open market operations (OMO) and redemptions of bonds under the Market Stabilisation Scheme (MSS), among others, for creating base money to support the required monetary expansion. Liquidity expansion has been consistent with the Reserve Bank's stance of ensuring a policy regime that will enable credit expansion at viable rates while preserving credit quality.

55. The liquidity situation has remained comfortable as evidenced by the LAF window being in an absorption mode since mid-November 2008. During the current financial year, the Reserve Bank has been absorbing over Rs.1,20,000 crore on average daily basis under the LAF window. Call money rates have generally been close to or below the lower bound of the LAF corridor. Other money market rates such as those for CBLO and market repo, and discount rates of CDs and CPs, have also declined significantly in tandem with the call money rates. Most commercial banks have reduced their deposit and benchmark prime lending rates. As the overall liquidity conditions remain comfortable, the total utilisation under the special refinance/ liquidity facilities made available by the Reserve Bank has been low. However, bankers have indicated that the existence of these facilities – even if they have not been fully tapped – has provided the much needed comfort to them as a potential fall back option.

56. Since the crisis intensified in September 2008, the Reserve Bank has been taking necessary actions in order to cushion the economy from its worst impact. For this purpose, the Reserve Bank used a variety of instruments such as the repo and reverse repo rates, cash reserve ratio, statutory liquidity ratio, open market operations including the liquidity adjustment facility, the market

stabilisation scheme, special market operations and sector-specific liquidity facilities. The Reserve Bank has also used prudential tools to modulate the flow of credit to certain sectors consistent with the objective of financial stability. The Reserve Bank will continue to rely on these multiple instruments to modulate the liquidity and interest rate conditions in line with the evolving global and domestic macroeconomic conditions.

Growth Projection

57. In 2008-09, real GDP increased by 6.7 per cent, in line with the projection in the Reserve Bank's Annual Policy Statement of April 2009. However, the growth pattern was uneven as real GDP growth decelerated from 7.7 per cent in the first half of the year to 5.8 per cent in the second half. This was mainly because of the global financial crisis, which affected external demand, domestic private consumption and investment demand. The overall macroeconomic scenario continues to be uncertain, although it is expected that the fiscal and monetary stimulus measures will boost domestic demand in 2009-10.

58. Domestic and external financing conditions are also now more favourable than they were in the second half of 2008-09. The business outlook has turned positive signalling a revival of industrial activity. On the other hand, keeping in view the sharp contraction in world trade projected during 2009, export demand will continue to remain weak. Similarly, during the earlier part of 2009-10, the services sector may experience the drag of sluggish external demand and the lagged adverse impact of the weak industrial growth. Also, the onset of the south-west monsoon has been delayed and it remains below normal, increasing the downside risks to agricultural production. On balance, an uptrend in the growth momentum is unlikely before the middle of 2009-10. On current assessment, the growth projection for GDP for 2009-10 is placed at 6.0 per cent with an upward bias. This updated growth projection for 2009-10, thus, marks a slight improvement over the growth expectations of around 6.0 per cent indicated in the Annual Policy Statement.

Inflation Projection

59. Headline WPI inflation turned negative in June 2009 as anticipated in the Annual Policy Statement of April 2009. However, negative WPI inflation in India is due to the statistical base effect and, as indicated in the April Statement, it should not be interpreted as a contraction in demand. This transitory negative WPI inflation may not persist beyond a few more months. However, food price inflation continues to remain elevated. This is reflected in stubbornly high CPI inflation. The uncertain monsoon outlook could further accentuate food price inflation. Moreover, the sharp decline in WPI inflation has not been commensurately matched by a similar decline in inflation expectations.

60. Pressures from global commodity prices, which had been abating markedly since August 2008 on account of the slump in global demand, seem to have bottomed out in early 2009. In fact, commodity prices have rebounded ahead of global recovery. The Reserve Bank's inflation expectations survey shows that while

inflation expectations remain well anchored, a majority of the respondents expect inflation to rise over the next three months to one year.

61. In the Annual Policy Statement of April 2009, WPI inflation at end-March 2010 was projected at around 4.0 per cent. On a financial year basis, WPI inflation has already increased by 3.5 per cent by July 11, 2009. The base effect, which is generating the negative WPI inflation, is projected to completely wear off by October 2009. Thereafter, the year-on-year WPI inflation will creep up even without any major supply shock. Keeping in view the global trend in commodity prices and the domestic demand-supply balance, WPI inflation for end-March 2010 is projected at around 5.0 per cent. This is higher than the projection of 4.0 per cent made in the Annual Policy Statement of April 2009.

62. As always, the Reserve Bank will endeavour to ensure price stability and anchor inflation expectations. Towards this objective, the Reserve Bank will continue to take into account the behaviour of all the price indices and their components. The conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration with the global economy.

Monetary Projection

63. During 2008-09, money supply (M_3) increased by 18.6 per cent. The year-on-year growth in M_3 has remained over 20.0 per cent throughout the current financial year so far reflecting easy liquidity conditions. The major source of M_3 expansion has been the large increase in bank credit to the Government, which also included OMO by the Reserve Bank, while credit to the commercial sector decelerated. The Reserve Bank remains committed to providing ample liquidity for all productive activities on a continuous basis. In this context, it is important that the increased government market borrowing programme does not crowd out credit flow to the private sector. As such, money supply will have to be higher than envisaged in the Annual Policy Statement of April 2009. Accordingly, for policy purposes, money supply (M_3) growth for 2009-10 is placed at 18.0 per cent, up from 17.0 per cent projected in the Annual Policy Statement. Consistent with this, aggregate deposits of scheduled commercial banks are projected to grow by 19.0 per cent. The growth in adjusted non-food credit, including investment in bonds/ debentures/shares of public sector undertakings and private corporate sector and CPs, has been retained at 20.0 per cent as in the Annual Policy Statement. As always, these numbers are provided as indicative projections and not as targets.

Overall Assessment

64. At the global level, the financial sector seems to be stabilising, but the real sector continues to be in recession. In recent months, there have been some positive signals relating to consumer spending, credit spreads and financing conditions. However, the signals are too tentative and weak to suggest any firm turnaround. Both households and firms are still in the process of rebuilding their balance sheets ruptured

by the crisis. As such, despite some measured optimism of a turnaround sooner than expected, a firm recovery at the global level is unlikely before 2010. This continued uncertainty in the immediate outlook is reflected in the downward revision of global growth for 2009 by the IMF from (-)1.3 per cent made in April 2009 to (-)1.4 per cent in July 2009.

65. Since the release of the April 2009 Policy Statement, there have been progressive signs of recovery in India: food stocks have increased; industrial production has turned positive; corporate performance has improved; business confidence surveys are optimistic; leading indicators show an upturn; interest rates have declined; credit off-take has picked up after May 2009; stock prices have rebounded; the primary capital market has witnessed some activity; and external financing conditions have improved. On the other hand, there are some negative signs: delayed and deficient monsoon; food price inflation; rebound in global commodity prices; continuing weak external demand; and high fiscal deficit.

66. On balance, the risks to the current projections of real GDP growth and inflation for 2009-10 are on the upside. The comfortable levels of foodgrains stocks should help mitigate the risks in the event of price pressures from the supply side. The Reserve Bank also will closely monitor the level of liquidity so as to contain inflationary expectations if supply side price pressures were to rise.

67. The growth of 6.7 per cent during 2008-09 was better than most analysts had expected, and decidedly better than the performance of most other economies. The growth projection for the current year of 6.0 per cent with an upward bias reflects the absence of any firm signs of definite recovery in the world economy. The challenge for us is to return the economy to the high growth rate of 9 per cent that we averaged in the period 2005-08. Notwithstanding the temporary hiccups of the crisis period, India is not a demand constrained economy; it is a supply constrained economy. The critical requirement for accelerated growth is to raise the level of investment, particularly in infrastructure.

68. Since the outbreak of the crisis in mid-September 2008, the Reserve Bank has maintained an accommodative monetary stance. It will be the endeavour of the Reserve Bank to maintain a policy stance that will aid return of the economy to the high growth path. At the same time, there are factors – stubborn food price inflation, rebound in world commodity prices, expansionary monetary and fiscal policies – that could potentially build inflationary pressures. Accordingly, the task of returning the economy to a high growth path, viewed from the current perspective, throws up some important challenges. These are highlighted below.

69. First, the immediate challenge for the Reserve Bank is to manage the balance between the short-term compulsions of providing ample liquidity and the potential build-up of inflationary pressure on the way forward. As indicated earlier, the negative WPI inflation numbers are only a statistical feature and do not have any structural significance. Within WPI inflation, inflation of primary articles, particularly food

articles, remains significantly positive. Even as inflation of manufactured products is negative, inflation of manufactured food products is close to double digits. Moreover consumer price indices (CPIs) have remained elevated, indeed also hardened in recent months. The task for the Reserve Bank is to maintain the accommodative monetary stance till demand conditions further improve and the credit flow takes hold, but to be ready with a roadmap to reverse the expansionary stance quickly and effectively thereafter.

70. The second challenge for the Reserve Bank is to manage the Government's borrowing programme for 2009-10. As indicated earlier, Government borrowing expanded very rapidly in 2008-09. During the current year, the budgeted net borrowing of the Central Government is 33 per cent higher than the already elevated borrowing of last year. Despite active liquidity management by the Reserve Bank, yields on government securities firmed up from a low of 5.8 per cent in January 2009 to around 7.0 per cent in July 2009. The hardening of yields has clearly militated against the low interest rate regime that the economy requires in the current situation. Private credit demand remains subdued as of now, but is likely to pick up. In order to manage the government borrowing without crowding out present or potential private credit demand, the Reserve Bank will continue with its active liquidity management policy. It may be noted in this context that during the first half of 2009-10, planned OMO purchases and MSS unwinding will add primary liquidity of Rs.1,50,000 crore, which by way of monetary impact is equivalent to reduction of CRR by over 3.5 percentage points.

71. By way of challenges, the third is to spur private investment demand which has been dented by the crisis. The growth of gross fixed capital formation, with a weight of nearly 32 per cent in the real GDP, dropped from 12.9 per cent in 2007-08 to 8.2 per cent in 2008-09. Accelerating this ratio back to the pre-crisis level and indeed improving on that is critical for sustainable growth in the medium-term. Of particular importance is increased investment in infrastructure. The Reserve Bank has maintained a consistent stance of monetary accommodation over the last nine months in order to maintain a soft interest rate regime. The banks have responded to the monetary stance by reducing deposit and lending rates, although there is scope for further reduction. Going forward, the Reserve Bank will meet the challenge of spurring private credit demand by maintaining policy rates and liquidity conditions conducive for revival of private credit demand.

72. Shifting from the immediate to the short-to-medium term, the fourth challenge is fiscal consolidation. In order to make up for the deceleration in private consumption and investment demand, it was necessary for the Government to resort to countercyclical public spending. This has, in a large way, insulated the economy from the worst impact of the crisis. The large and abrupt increase in government borrowing has, however, led to hardening of yields on government securities which have impeded monetary transmission. Furthermore, large fiscal deficits, if continued strictly beyond the

recovery period, can crowd out private investment and trigger inflationary pressures. The Government will, therefore, need to return to a path of fiscal consolidation. This entails two facets on the way forward. The first is to lay down the roadmap for fiscal consolidation. This has to go beyond merely indicating revised FRBM targets to giving out the details of the adjustment that will take place on the revenue and expenditure fronts. That will lend credibility to the fiscal stance and also give predictability to economic agents. The second facet is to focus on the quality of fiscal adjustment even while pursuing quantitative targets.

73. Finally, the big medium-term challenge is to improve the investment climate and expand the absorptive capacity of the economy. Development experience clearly demonstrates that no country has been able to sustain a high growth episode without a sustained increase in investment together with improvements in productivity. This entails two tasks. The first is to move on with financial sector reforms to promote financial inclusion, further widen and deepen financial markets and strengthen financial institutions. In doing so, we will inevitably have to factor in the lessons of the global economic crisis. The second task is a big thrust on governance reforms that should inspire the trust and confidence of potential investors.

Policy Stance

74. On the basis of the above overall assessment, the stance of monetary policy for the remaining period of 2009-10 will be as follows:

- Manage liquidity actively so that the credit demand of the Government is met while ensuring the flow of credit to the private sector at viable rates.
- Keep a vigil on the trends and signals of inflation, and be prepared to respond quickly and effectively through policy adjustments.
- Maintain a monetary and interest rate regime consistent with price stability and financial stability supportive of returning the economy to the high growth path.

75. It is worth reiterating that the Reserve Bank will maintain an accommodative monetary stance until there are definite and robust signs of recovery. This accommodative monetary stance is, however, not the steady state stance. On the way forward, the Reserve Bank will have to reverse the expansionary measures to anchor inflation expectations and subdue inflationary pressures while preserving the growth momentum. The exit strategy will be modulated in accordance with the evolving macroeconomic developments.

III. Monetary Measures

Bank Rate

76. The Bank Rate has been retained unchanged at 6.0 per cent.

Repo Rate

77. The repo rate under the Liquidity Adjustment Facility (LAF) has been retained unchanged at 4.75 per cent.

Reverse Repo Rate

78. The reverse repo rate under the LAF has been retained unchanged at 3.25 per cent.

79. The Reserve Bank has the flexibility to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warrant.

80. The Reserve Bank retains the option to conduct overnight or longer term repo/reverse repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibly including the right to accept or reject tender(s) under the LAF, wholly or partially, so as to make efficient use of the LAF in daily liquidity management.

Cash Reserve Ratio

81. The cash reserve ratio (CRR) of scheduled banks has been retained unchanged at 5.0 per cent of net demand and time liabilities (NDTL).

Second Quarter Review

82. The Second Quarter Review of Monetary Policy for 2009-10 will be undertaken on October 27, 2009.

Mumbai

July 28, 2009