

Reserve Bank of India
First Quarter Review of Monetary Policy 2010-11

By
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Governor

Introduction

This First Quarter Review is being made in a macroeconomic environment that has changed significantly since our April policy announcement. At that time, there was some optimism about the sustainability of the global recovery, however modest the pace may be. This was reinforced by the International Monetary Fund (IMF) forecasts published earlier this month, which suggested that global growth would be marginally higher than their April 2010 projection. While most of that would come from emerging market economies (EMEs), the advanced economies would hold steady. However, in the aftermath of the Greek sovereign debt crisis and other visible soft spots in Europe and the US, there is renewed uncertainty about the sustainability of the recovery.

2. In contrast, on the domestic front, the recovery has consolidated and is becoming increasingly broad-based. There are rising concerns about capacity constraints being reached over a wide range of sectors. While inflationary pressures have also risen, the performance of the monsoon so far has been significantly better than during last year. While rainfall is still below the long

period average at the all-India level, it has been enough to induce a significant increase in sown area across a range of crops, the high prices of which have been a source of great worry.

3. The dominant concern that has shaped the monetary policy stance in this review is high inflation. Even as food price inflation and, more generally, consumer price inflation have shown some moderation, they are still in double digits. Non-food inflation has risen and demand side pressures are clearly evident. With growth taking firm hold, the balance of policy stance has to shift decisively to containing inflation and anchoring inflationary expectations.

4. This policy review should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank. This statement is organised in four sections: Section I provides an overview of the global and domestic macroeconomic developments; Section II sets out the outlook and projections for growth, inflation and monetary aggregates; Section III explains the stance of monetary policy; and Section IV specifies the monetary measures.

I. The State of the Economy

Global Economy

5. In its July Update of the World Economic Outlook (WEO), the IMF raised its global growth projection for 2010 to 4.6 per cent from its April projection of 4.2 per cent on the strength of Q1 growth rates. However, the IMF's expectation of slightly faster global growth is largely driven by somewhat greater optimism about EMEs. Several assessments of advanced economies show increasing pessimism about the sustainability of the current pace of recovery. There is widespread expectation of a slowdown of the global economy in the second half of 2010.

6. In the US, recovery remains constrained by high unemployment, modest income growth, lower housing wealth and tight credit. In the euro area, economic activity is weak, though more resilient than expected in the face of the recent turbulence. The growth outlook remains clouded by concerns about the sustainability of sovereign debt in some of the euro area economies.

7. In contrast, EMEs are witnessing strong growth, driven by strong domestic demand, restocking of inventories and, thus far, recovering global trade. In many EMEs, especially in Asia, growth is fast approaching the trend. Robust macroeconomic fundamentals, unimpaired balance sheets of corporates and households, sound banking sector and effective fiscal and monetary stimuli contributed to a significantly faster recovery in EMEs.

8. Inflation in advanced economies is subdued due to large output gaps and high unemployment rates. Inflation expectations also remain well anchored. In contrast, inflation in EMEs has been rising due to fast emerging capacity constraints, prompting many to reverse their expansionary monetary policies.

Domestic Economy

9. The Indian economy grew by 7.4 per cent in 2009-10. The momentum was particularly pronounced in Q4 of 2009-10 with growth at 8.6 per cent as compared with 6.5 per cent in the previous quarter. At constant market prices, the pick-up in Q4 growth was even sharper at 11.2 per cent, reflecting a significant turnaround in indirect tax collections.

10. The double digit growth in the Index of Industrial Production (IIP) that began in October 2009 continued during the current financial year although there was modest deceleration in May 2010. In the first two months of this fiscal, April-May 2010, the IIP recorded a year-on-year growth of 14 per cent with as many as fifteen out of the seventeen industry groups (two digits NIC classification) showing positive growth. The lead indicators of service sector also suggest increased economic activity.

11. The cumulative rainfall has been 14 per cent below its long-period average (LPA) during the current monsoon season so far (as on July 21, 2010). Even so, monsoon performance has been much better than it was last year, which augurs well for agricultural production. Data on

crop-wise area indicate a significant increase over the relatively low levels of last year.

12. However, the current inflation scenario is worrisome for a number of reasons. First, WPI inflation has been in double digits since February 2010. Headline inflation, as measured by year-on-year variation in WPI, rose to 10.6 per cent in June 2010, up from 10.2 per cent in May 2010. Notably, WPI inflation based on revised data for March at 11.0 per cent and for April at 11.2 per cent, were higher by over one percentage point as compared with the provisional numbers. If this pattern continues, final WPI inflation numbers for recent months can be expected to be higher.

13. Second, even as primary food articles inflation continues to be in double digits (14.6 per cent), year-on-year WPI non-food manufactured products (weight: 52.2 per cent) inflation, which was (-) 0.4 per cent in November 2009, rose sharply thereafter to 5.4 per cent in March 2010 and further to 7.3 per cent in June 2010. Non-food items inflation (WPI excluding food products and food articles), which was near zero in November 2009, rose sharply to 10.6 per cent by June 2010. Significantly, non-food items contributed over 70 per cent to WPI inflation in June 2010, suggesting that inflation is now very much generalised. Third, notwithstanding some moderation in recent months, consumer price inflation, measured by various indices, remains in double digits.

14. Money supply (M_3) growth on a year-on-year basis moderated from 16.8 per cent at end-March 2010 to 15.3 per cent as on July 2, 2010 reflecting a slowdown in the growth in bank deposits. Time deposits decelerated mainly because of withdrawal of deposits by public sector undertakings and mutual funds. In order to finance higher credit growth in the face of declining deposit growth, banks unwound their investments in mutual funds and accessed the repo window of the Reserve Bank.

15. Year-on-year non-food credit growth accelerated from 17.1 per cent in March 2010 to 22.3 per cent as on July 2, 2010, which was higher than the indicative trajectory of 20 per cent set out in the April 2010 Monetary Policy Statement. This reflects the combined impact of a pick-up in industrial activity and financing of the 3G and broadband wireless access (BWA) spectrum auctions. The increase in bank credit to the commercial sector has also been supplemented by higher flow of funds from other sources. Rough estimates show that the total flow of financial resources from banks, non-banks and external sources to the commercial sector during Q1 of 2010-11 was at Rs.2,50,000 crore as against Rs.61,000 crore during Q1 of 2009-10. Disaggregated data suggest that credit growth to all major sectors such as agriculture, industry, services and personal loans had begun to improve from November 2009 onwards.

16. On the deposit side, banks increased their term deposit rates by 75-100 basis points between March 2010 and July 16, 2010. On the lending side, benchmark prime lending rates

(BPLRs) of scheduled commercial banks remained unchanged from July 2009 till end-June 2010. The banking system switched over to the Base Rate system with effect from July 1, 2010. The Base Rates set by major banks are in the range of 7.25-8.0 per cent. While information on effective lending rates to major categories of borrowers is not yet available, it is expected that the Base Rate system will make credit pricing more efficient. Further, it will enhance transparency in lending rates and improve monetary policy transmission.

17. Money markets remained orderly during Q1 of 2010-11. A significant development was that the Liquidity Adjustment Facility (LAF) window of the Reserve Bank, after remaining in surplus mode for nearly 18 months, switched into deficit mode towards the end of May 2010 and has remained there since. This liquidity pressure was triggered by the increase in government cash balances on account of larger than expected 3G and BWA spectrum auction receipts combined with advance tax payments.

18. Consistent with the stance of active liquidity management and in order to prevent a disruption in credit flow, the Reserve Bank took several measures to ease the pressure. First, on May 26, 2010, the Reserve Bank announced additional liquidity support under the LAF to scheduled commercial banks to the extent of up to 0.5 per cent of their net demand and time liabilities (NDTL). A second LAF (SLAF) was also made available on a daily basis. Both these facilities, which were initially available till July 2, 2010, were later extended. While the additional liquidity support facility was extended up

to July 16, 2010, the SLAF remains extended up to July 30, 2010. Second, in consultation with the Government, the notified amounts for the issuance of Treasury Bills during June 2010 were reduced by Rs.22,000 crore. Third, during June 16-21, 2010, the Government bought back securities worth Rs.9,614 crore, ahead of schedule.

19. There was net injection of liquidity by the Reserve Bank in June and July 2010 (up to July 23). As a result, overnight interest rates, which generally remained around the floor of the LAF corridor up to May, moved up to the ceiling of the corridor in June 2010 and have remained there in July 2010 so far. Similarly, yields on other money market instruments increased, reflecting autonomous tightening of monetary conditions by 150 basis points, equivalent to the prevailing width of the LAF corridor.

20. At the longer end of the market, the monthly average yield on the 10-year benchmark government security fell to 7.59 per cent in June 2010 from 8.01 per cent in April 2010 in the expectation that the Government will reduce market borrowing because of higher realisations from spectrum auctions. Subsequently, the yield moved up to 7.73 per cent by the third week of July 2010.

21. Equity markets exhibited volatile conditions during the current financial year, although they have firmed up in recent weeks. Resource mobilisation by the corporates through public issues in the primary segment of the capital market continued its uptrend. The foreign

exchange market saw volatility increase relative to the previous quarter, with the rupee showing two-way movements in the range of Rs.44.33-Rs.47.57 per US dollar.

22. During the first quarter of 2010-11, both the nominal and real effective exchange rates (NEER and REER) have appreciated. While the appreciation in 36-currency NEER/REER at about 1.5 per cent (up to May) was similar, real appreciation on the basis of 6-currency REER was higher at 3.3 per cent as compared with 6-currency NEER appreciation of 1.4 per cent, reflecting higher inflation differentials between India and major advanced economies.

23. Of the budgeted net market borrowing of the Central Government for 2010-11 at Rs. 3,45,010 crore, about

38.5 per cent (Rs.1,32,900 crore) of the borrowing was completed by mid-July 2010. As against the budgeted amount of Rs 35,000 crore, the actual realisations under 3G and BWA auctions were about Rs. 1,06,000 crore, resulting in an increase in receipts by over one per cent of GDP. It is, however, important to ensure that this one-off increase does not slacken the much needed efforts towards fiscal consolidation.

24. During the first two months of 2010-11, both exports and imports continued to expand in contrast to the contraction they showed during the corresponding period of last year. The trade deficit widened during April-May 2010 to US\$ 21.7 billion, up from US\$ 14.4 billion in the corresponding period of the previous year, reflecting the sustained increase in domestic activity.

II. Outlook and Projections

Global Outlook

Growth

25. In its July Update of the World Economic Outlook, the IMF revised upwards its growth projection for the global economy for 2010 to 4.6 per cent from 4.2 per cent in April 2010 on the strength of robust Q1 growth. However, as indicated earlier, recent data and analysis suggest slowing down of the global growth momentum and the expectation is that global growth in the second half of 2010 will be lower than that in the first half.

Inflation

26. Just like growth, inflation around the world too has been multi-speed. The

inflation scenario in advanced economies has been shaped by high unemployment, low capacity utilisation and renewed uncertainties about the financial sector. Headline inflation in advanced economies, which inched up during January-March 2010, softened thereafter. Inflation expectations too remain well anchored; indeed, concerns about deflation have re-emerged in some of the advanced economies. In contrast, the relatively rapid recovery in EMEs has also been accompanied by faster growth in prices.

27. Significantly, with increasing uncertainty about the pace of global recovery, global energy and commodity prices have softened. This trend has been reinforced by the slowdown of the

Chinese economy. Consequently, global inflationary pressures are expected to be subdued over the next few months.

Domestic Outlook

Growth

28. The growth prospects of the Indian economy have improved since April 2010. Although cumulative rainfall so far has been 14 per cent below the LPA, the monsoon has been better than during last year. Should overall monsoon performance turn out to be as projected (102 per cent of LPA), there will be a pick-up in rural demand. This should give further momentum to the performance of the industrial sector, which has been growing firmly since October 2009.

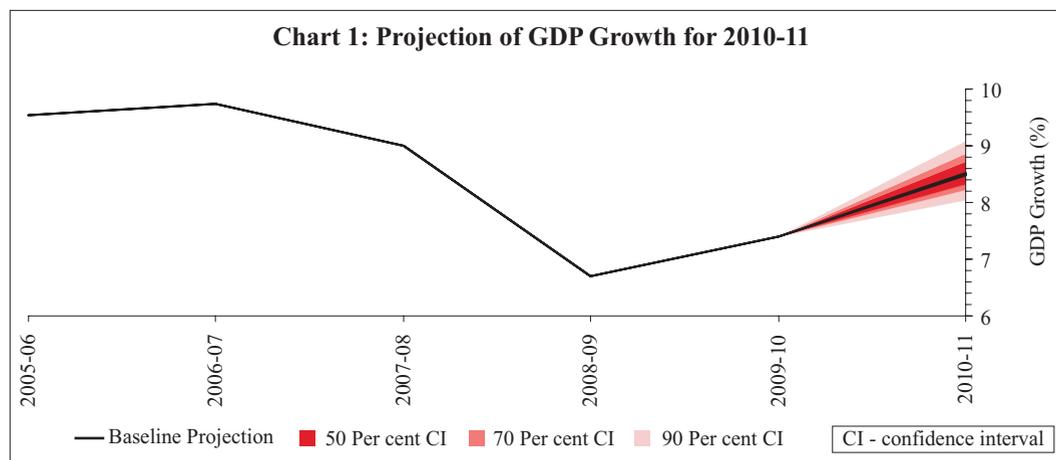
29. Growth in exports, which turned positive in October 2009, picked up further in subsequent months despite concerns over the external demand outlook due to the sovereign debt problem in euro area. Service sector activities have also shown buoyancy since the latter half of 2009-10. The leading indicators of

various services have shown significant improvements.

30. The strength of the recovery is also reflected in the sales and profitability growth of the corporate sector. Besides replenishment of inventories, investment intentions are being translated into action across sectors, particularly in power, telecom and metals. Increase in resource mobilisation by the commercial sector from both banks and non-banks and the widening of the current account deficit also suggest strong underlying growth momentum.

31. Domestic drivers of growth are robust. However, if the global recovery slows down, it will affect all EMEs, including India, through the usual exports, financing and confidence channels.

32. Taking into account the progress of monsoon so far and the prevailing global macroeconomic scenario, for policy purposes, the baseline projection of real GDP growth for 2010-11 is revised to 8.5 per cent, up from 8.0 per cent with an upside bias as indicated in April 2010 policy statement (Chart 1). This upward



revision is primarily based on better industrial production and its favourable impact on the services sector, giving due consideration to the global scenario.

33. The Reserve Bank's growth projection for 2010-11 is consistent with the median growth forecast from its professional forecasters' survey and other agencies. It must be noted that the IMF growth forecast for India at 9.4 per cent for calendar 2010 is based on GDP at market prices, whereas other projections, including that of the Reserve Bank, are based on GDP at factor cost. Adjusting for this, the IMF projections are in line with others.

Inflation

34. WPI inflation moved to double digits in February 2010 and has remained there since then. Even as food price inflation and consumer price inflation remain at elevated levels, inflation is now being significantly driven by demand side factors.

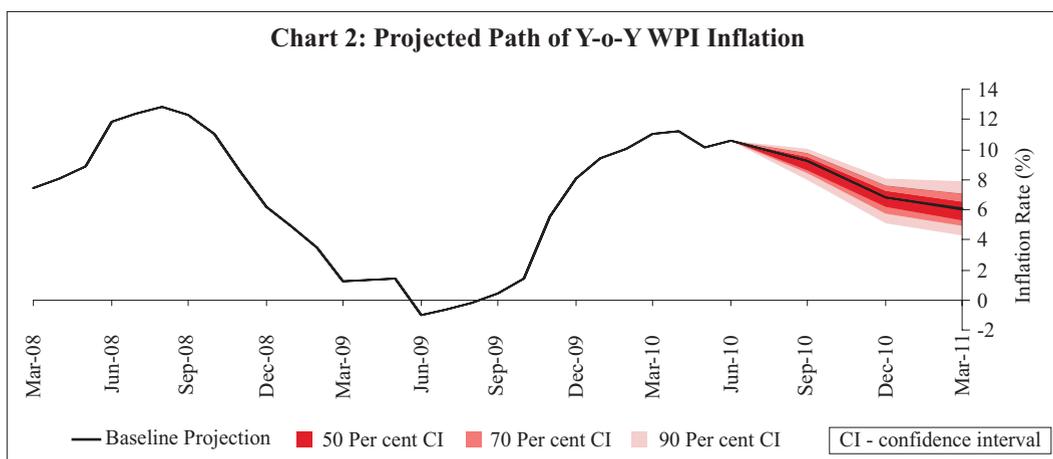
35. In its policy statement of April 2010, the Reserve Bank had placed the baseline projection for WPI inflation for March 2011 at 5.5 per cent. Subsequently, there has been an increase in prices of many administered/regulated items such as petroleum products, iron ore and electricity. The recent partial deregulation and increase in administered prices of petroleum products is welcome from the long-term fiscal consolidation and energy conservation perspective. Nevertheless, it will have an inflationary impact in the short term. Assuming that global crude oil prices remain stable, the immediate impact on inflation will be about one

percentage point on WPI inflation, with second round effects coming through in the months ahead.

36. Minimum support prices (MSPs) for some agricultural commodities have also been increased to incentivise farmers. Food price inflation has remained at an elevated level for over a year now, reflecting structural bottlenecks in certain commodities such as pulses, milk and vegetables. The Reserve Bank's quarterly inflation expectation survey conducted during the first fortnight of June 2010 indicates that short-term inflationary expectations have increased marginally.

37. Going forward, the outlook on inflation will be shaped by the following factors. First, the spatial and temporal distribution of rainfall in the remaining period of south-west monsoon 2010 is critical. A good *kharif* harvest will act as a major dampener on short-term food price inflation. Second, global energy and commodity prices have been showing distinct signs of softening over the past few weeks as expectations of global growth have moderated. If energy prices continue to decline, this will offset the inflationary impact of the recent fuel price hike. Further, idle global capacity in a range of sectors will allow competitive imports to reduce the momentum in domestic prices. Third, consequent on the strengthening of domestic growth drivers, demand-side pressures are building up.

38. Taking into account the emerging domestic and external scenario, the baseline projection for WPI inflation for March 2011 has been raised to 6.0 per cent from 5.5 per cent as indicated in the April policy statement (Chart 2).



39. The Reserve Bank will endeavour to achieve price stability and anchor inflation expectations. In pursuit of these objectives, the Reserve Bank will continue to evaluate an array of aggregate and disaggregated measures of inflation in the context of the evolving macroeconomic situation.

40. Notwithstanding the current inflation scenario, it is important to recognise that in the last decade (2000-01 to 2009-10), the average inflation rate, measured both in terms of WPI and CPI, moderated to around 5 per cent from the historical trend rate of about 7.5 per cent. A combination of factors played a role in this transformation. One of these was a monetary policy committed to keeping inflation low and stable. This record is an important foundation for the credibility of monetary policy and, more generally, the broader inflation management framework. Against this backdrop, 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 into the global economy.

Monetary Aggregates

41. While the current year-on-year money supply (M_3) growth at 15.3 per cent is below the indicative projection of 17.0 per cent, non-food credit growth at 22.3 per cent was marginally higher than the indicative projection of 20.0 per cent. It is expected that even with the higher growth projection, monetary aggregates will evolve along the projected trajectory indicated in the April policy statement. Accordingly, the M_3 and non-food credit growth projections for 2010-11 have been retained at 17 per cent and 20 per cent respectively. As always, these numbers are indicative projections and not targets.

Risk Factors

42. The above macroeconomic and monetary projections are subject to a number of upside and downside risks.

43. The main risk emanates from the global scenario and has two key dimensions. First, if the global recovery

falters, the risk of which has increased since the April 2010 policy announcement, the performance of EMEs is likely to be adversely affected. While India's trade linkages with the advanced economies are appreciably smaller than those of other major EMEs, a widespread slowdown in global trade will have an impact on important manufacturing and service sectors.

44. The more significant risk, though, is from a potential slowdown in capital inflows. India's rapid recovery has resulted in a widening of the current account deficit, as imports have grown faster than exports. Even if exports slow down, the strength of domestic growth drivers will keep imports buoyant, suggesting a widening of the trade deficit. However, in the face of a global slowdown, increasing risk aversion amongst global investors may significantly reduce the flow of capital into EMEs, including India. Apart from narrowing the comfortable buffer between the current account deficit and net capital inflows, this may constrain domestic investment, which is critical to achieving and sustaining high growth rates.

45. Admittedly, the risk of capital flows runs both ways. Given the present

state of global economy, central banks in advanced economies are likely to maintain accommodative monetary policies for an extended period. With the strong growth potential of EMEs, including India, this is likely to trigger large capital inflows. Large capital inflows above the absorptive capacity of the economy will pose a challenge for monetary and exchange rate management. This also has implications for asset prices. In this scenario, a widening current account deficit will help absorb a larger proportion of the inflows.

46. On the inflation front, the prospects of softening of domestic inflation around mid-year 2010-11 are contingent on moderating food prices. Rainfall has been generally adequate so far, indicating good prospects for the agricultural sector. But, with two months yet to go for the season, the risk of inadequate rainfall adversely affecting specific regions and crops remains.

47. However, with respect to controlling inflation, the global scenario may generate some favourable impulses. Slower global growth will help lower energy and commodity prices. Unutilised global capacity in many sectors will also ease pressure on prices.

III. The Policy Stance

48. Since October 2009, when it signalled the reversal of its policy stance, the Reserve Bank has cumulatively raised the CRR by 100 basis points and the repo and reverse repo rates under the LAF by 75 basis points each. The monetary policy response has been calibrated on the basis

of India's specific growth-inflation dynamics in the broader context of persistent global uncertainty.

49. Thus, our policy stance for 2010-11 has been conditioned by three major considerations:

50. First, domestic economic recovery is firmly in place and is strengthening. The 7.4 per cent growth in 2009-10 despite weak global growth and the insignificant contribution of the agriculture sector is a testimony of the resilience of the Indian economy. The Reserve Bank's upward revision of the GDP growth projection for 2010-11 to 8.5 per cent (from 8.0 per cent with an upside bias in April 2010) indicates that the economy is steadily reverting to its pre-crisis growth trajectory. However, even as this is happening, prospects of a sustained global recovery appear to be increasingly uncertain, with possible adverse consequences for the EMEs, including India.

51. Second, inflationary pressures have exacerbated and become generalised, with demand-side pressures clearly evident. Capacity constraints are visible in several sectors and pricing power is returning to producers. Inflationary expectations also remain at an elevated level. Given the spread and persistence of inflation, demand-side inflationary pressures need to be contained.

52. Third, despite the increase in the policy rates by 75 basis points cumulatively, real policy rates are not consistent with the strong growth that the economy is now witnessing. As articulated in previous policy statements/reviews, lower policy rates can complicate the inflation outlook and impair inflationary expectations, particularly given the increased generalisation of inflation. It is, therefore, imperative that we continue in the direction of normalising our policy instruments to a level consistent with the evolving growth

and inflation scenario, while taking care not to disrupt the recovery.

53. In this consideration, the liquidity situation plays a crucial role. It is well understood that transmission of monetary policy through rate actions works most effectively when liquidity is being injected into the financial system by the central bank, rather than when it is being absorbed. Our calibrated actions to absorb surplus liquidity from October 2009 onwards were reinforced by market conditions, which evolved in early June 2010 and still persist. Consequently, overnight call money interest rates have moved towards the upper bound of the LAF corridor, which is equivalent to effective tightening of rates by 150 basis points. This has also brought the system closer to a point at which policy rate actions are likely to have greater traction.

54. Current market conditions indicate that while liquidity pressures will ease, the system is likely to remain in deficit mode for now. This implies a significant change in the monetary operations, which has a direct bearing on our actions. In a deficit liquidity mode, the repo rate under the LAF has emerged as the operating policy rate. The LAF operates in such a manner that as systemic liquidity alternates from surplus to deficit, even at the margin, the overnight call money rates alternate between the reverse repo rate and the repo rate. This imparts volatility to call rates to the extent of the width of the LAF corridor.

55. There is no unique way to determine the appropriate width of the policy interest rate corridor. But the

guiding principles are: (i) it should be broad enough not to unduly incentivise market participants to place their surplus funds with the central bank; (ii) it should not be so broad that it gives scope for greater interest rate volatility to distort the policy signal. The challenge, therefore, is to strike the right balance.

56. As the systemic liquidity transits from an uni-directional surplus mode to a bi-directional mode, it will have implications for the effectiveness of monetary transmission. In the context of the changing liquidity dynamics, the operation of the LAF needs to be studied. Accordingly, it is proposed to set up a Working Group to review the current operating procedure of monetary policy of the Reserve Bank, including the LAF.

57. Against the above stated backdrop, the stance of monetary policy is intended to:

- Contain inflation and anchor inflationary expectations, while being prepared to respond to any further build-up of inflationary pressures.
- Maintain an interest rate regime consistent with price, output and financial stability.
- Actively manage liquidity to ensure that it remains broadly in balance so that excess liquidity does not dilute the effectiveness of policy rate actions.

Mid-Quarter Review of Monetary Policy

58. At present, scheduled policy announcements are made once in

a quarter. In a rapidly evolving macroeconomic situation, however, a gap of a quarter between policy reviews can be too long. In recent years, there have been several occasions (April, June and September-December 2008; January and March 2009; and March and July 2010) when the Reserve Bank had to take off-cycle policy actions in response to macroeconomic developments. While these instances challenge the discipline of the quarterly schedule, they also underscore the need for flexibility to manoeuvre. Many major central banks in the world make monetary policy announcements more frequently ranging generally from 8 to 12 announcements in a year. It is, therefore, proposed to formalise what is already an informal, internal process.

59. Accordingly, the Reserve Bank will now undertake mid-quarter reviews roughly at the interval of about one and half months after each quarterly review. As per schedule, mid-quarter reviews will be in June, September, December and March. They will be by way of a press release, which will provide a rationale for either action or maintenance of the *status quo*.

60. Mid-quarter Reviews are intended to communicate our assessment of economic conditions more frequently. By instituting these, it is our intention to take the surprise element out of the off-cycle actions. However, the Reserve Bank will have the flexibility, as always, to take swift and pre-emptive policy action, as and when warranted by the evolving macroeconomic developments.

IV. Monetary Measures

61. On the basis of the current assessment and in line with the policy stance as outlined in Section III, the Reserve Bank announces the following policy measures:

Bank Rate

62. The Bank Rate has been retained at 6.0 per cent.

Repo Rate

63. It has been decided to:

- increase the repo rate under the Liquidity Adjustment Facility (LAF) by 25 basis points from 5.5 per cent to 5.75 per cent with immediate effect.

Reverse Repo Rate

64. It has been decided to:

- increase the reverse repo rate under the LAF by 50 basis points from 4.0 per cent to 4.50 per cent with immediate effect.

Cash Reserve Ratio

65. The cash reserve ratio (CRR) of scheduled banks has been retained at 6.0 per cent of their net demand and time liabilities (NDTL).

Expected Outcomes

66. Monetary policy actions are expected to:

- a. Moderate inflation by reining in demand pressures and inflationary expectations.
- b. Maintain financial conditions conducive to sustaining growth.
- c. Generate liquidity conditions consistent with more effective transmission of policy actions.
- d. Reduce the volatility of short-term rates in a narrower corridor.

Mid-Quarter Review of Monetary Policy 2010-11

67. The next mid-quarter review of Monetary Policy for 2010-11 will be announced through a press release on September 16, 2010.

Second Quarter Review of Monetary Policy 2010-11

68. The second quarter review of Monetary Policy 2010-11, including developmental and regulatory policies, is scheduled on November 2, 2010.

Mumbai

July 27, 2010