Reserve Bank of India
Third Quarter Review of Monetary Policy 2008-09

Statement by
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This quarterly review is set in the context of a deteriorating global economic outlook and heightened uncertainty about the global financial sector. In fact, there has been a rapid and marked downturn in the global economic outlook since the Reserve Bank's Mid-term Review in October 2008. The continued bad news from large international financial institutions on a regular basis renews concerns as to when the global financial sector might attain a semblance of stability.

2. The initial hope that the crisis could be contained in the financial sector has been belied. With all the advanced economies – the US, Europe and Japan – firmly in recession, the crisis has fully transmitted from the financial sector to the real economy. The loss of confidence in the global financial markets has set off a chain of deleveraging, declining asset values, falling income, contracting demand and rising unemployment. Governments and central banks around the world are responding to the crisis with bold and unconventional initiatives. Even so, there is a contentious debate on whether these measures are adequate and appropriate, and when, if at all, they will begin to have an impact. There is also considerable uncertainty about when we might see the bottom of the asset and business cycle. There is emerging consensus though that there may be no recovery till late 2009; indeed, some analysts believe that recovery may be delayed beyond 2009. Contrary to the expectation of decoupling, which was a commonly held view even till recently, the crisis has spread to the emerging economies too through all the channels – the financial channel, the real channel, and importantly as happens in all financial crises, through the confidence channel.

3. The Indian economy experienced a cyclical moderation in growth accompanied by high inflation in the first half of 2008-09. There is now distinct evidence of further slowdown as a consequence of the global downturn. The

knock-on effects of the global financial crisis, economic slowdown, and falling commodity prices are affecting the Indian economy in several ways. Capital flow reversals intensified in September and October 2008 though they have stabilised since then; international credit channels continue to be constrained; capital market valuations remain low; industrial production growth has slackened; export growth has turned negative during October-November 2008; and overall business sentiment has deteriorated. On the positive side, the headline inflation has decelerated, though consumer price inflation is yet to show moderation; and the domestic financial markets are functioning in an orderly manner. Although bank credit growth has been higher than in the previous year, rough calculation shows that flow of overall financial resources to the commercial sector in the current financial year has declined marginally as compared with the previous year. This was on account of decline in other sources of funding such as resource mobilisation from the capital market and external commercial borrowings (ECBs).

4. To manage the impact of the crisis, since mid-September 2008, the Reserve Bank has taken a number of monetary easing and liquidity enhancing measures. The Government has also launched two fiscal stimulus packages to boost aggregate demand. Against this background, this Statement provides an assessment of *Macroeconomic and Monetary Developments* (Section I), followed by the *Stance of Monetary Policy* (Section II), and *Monetary Measures* (Section III). Yesterday, the Reserve Bank issued an analytical review of macroeconomic and monetary developments providing information and technical analyses in greater detail. This Statement should be read and understood in conjunction with the yesterday's review.

I. Macroeconomic and Monetary Developments

Global Outlook

5. The global economic environment continues to be uncertain. The world economy, which was passing through unprecedented financial turmoil since August 2007, experienced a jolt in September 2008 when the failure of Lehman Brothers led to widespread panic across global financial markets. The liquidity crisis that ensued not only engulfed developed markets but also quickly

transmitted to emerging markets, including India. The US Federal Reserve responded by infusing dollar liquidity into large financial centres through currency swap arrangements with major foreign central banks in addition to massive injection of liquidity in the domestic market through several innovative schemes.

6. Many systemically important commercial banks, investment banks, insurance companies and other financial institutions in the US and Europe have suffered large losses that undermined their capital bases. The credit spreads for corporate paper went up sharply. The US Federal Reserve and other central banks/governments have rescued financial institutions through large bailout packages, but financial markets continue to suffer from a crisis of confidence. The unfolding developments have broader ramifications for both growth and stability in an integrated world where cross-exposures, particularly among banks/financial institutions, and trade links are inextricably large and complex. There is yet no sign of any early resolution as damage to collaterals continues unabated with house prices tumbling in the US and also in parts of Europe.

7. According to the November 2008 update of the World Economic Outlook (WEO) issued by the International Monetary Fund (IMF), global real GDP growth, on a purchasing power parity basis, is projected to decelerate from 3.7 per cent in 2008 to 2.2 per cent in 2009. In market exchange rate terms, the projected deceleration is even sharper from 2.6 per cent in 2008 to 1.1 per cent in 2009. Furthermore, the IMF has cautioned that the downside risks to these global growth projections have further intensified.

8. The US, the UK, the Euro area and Japan, which together accounted for nearly half of world GDP in 2007, are officially in recession. All evidence suggests that contractionary forces are strong: demand has slumped, consumer confidence is at a historic low, production has declined, job losses are on the rise and asset prices continue to fall. Reflecting the slowdown of international demand, crude oil prices declined sharply in the last quarter of 2008. Prices of many other key commodities such as metals, cement, cotton and wheat too have dropped sharply. Consequently, consumer price inflation has declined significantly in many countries including the US, the Euro area, Japan and the UK. The international financial system continues to remain dysfunctional amidst extreme risk aversion, freezing of money and credit markets, and disruption of international capital flows. In response, central banks in advanced countries have

reduced their policy interest rates to historically low levels. The major global concern now is to forestall the worst ever recession since the 1930s. While monetary ammunition has been nearly exhausted in many countries, at least in terms of setting nominal interest rates, measures such as quantitative easing, credit easing and fiscal stimulus are on the policy agenda.

Emerging Market Economies

9. The emerging market economies (EMEs), which showed considerable resilience in weathering the crisis up to September 2008 on the strength of domestic demand supported by sustained export growth, came under strain in the last quarter of 2008 through contagion from trade and financial channels. The slowdown of world trade was deeper than anticipated causing reduction in aggregate demand in the EMEs. In a sign of flight to safety, capital flows from developed countries to the EMEs declined sharply in 2008. Reflecting lower flows through both current and capital accounts, currencies of the EMEs depreciated against the US dollar. EME equity markets suffered large losses in the wake of reversal of portfolio flows. Bank lending to the EMEs declined and credit spreads increased sharply due to the prevailing credit crunch in advanced economies. EME exports declined because of tighter trade credit coming on top of slumping export demand. Going forward, exports to advanced economies are expected to decline further posing a major risk to growth in the EMEs.

10. In evaluating the current and potential problems arising from the crisis, it is important to note some broad differences between the advanced economies of Europe and North America and the EMEs. The crisis originated in the financial sector in the US, which led to the near collapse of their largest financial institutions and banks. Because of linkages across the financial system, the crisis spread almost immediately to Europe with European banks reporting very large losses. Both the US and European governments responded through large scale infusion of funds into the banking systems. Furthermore, with the erosion of banks' balance sheets, mistrust among banks intensified, as a result of which money markets dried up, and inter-bank markets choked. This engendered a credit squeeze which transmitted to the real economy. The first line of defence in fighting the crisis was aggressive monetary policy action, including rate cuts followed by quantitative monetary and credit easing. These measures were also

accompanied by a significant expansion of central banks' direct participation in money markets in several ways.

11. The situation in the EMEs has been quite different. By and large, their financial institutions have not exhibited fragility, inter-bank confidence has been relatively normal and inter-bank money markets have continued to function. Nevertheless, the crisis has affected the EMEs in mainly three ways. The first was the exit of foreign equity which resulted in decline in stock markets, capital flow reversals and pressures on the exchange rate. The second source of impact was the drying up of overseas lines of credit for banks and corporates which shifted demand to the domestic credit market. The third source of impact is the significant deceleration in global trade growth reducing the demand for EME exports. Monetary policy actions by the EMEs have, therefore, been more in response to emerging real economy problems rather than financial sector problems. It is important to keep this distinction in view in designing and evaluating responses to the crisis.

Domestic Outlook

12. Like other EMEs, India too has been affected by the global financial crisis. Real GDP growth moderated to 7.8 per cent in the first half of 2008-09 as against 9.3 per cent in the first half of 2007-08 (Table 1). The third quarter of 2008-09 witnessed signs of further moderation in growth, especially in the industrial sector and some segments of the services sector.

Agriculture and Industry

13. Good sowing and favourable weather conditions suggest that agricultural production during 2008-09 may be close to or better than last year's record production. During April-November 2008, the index of industrial production (IIP) growth decelerated to 3.9 per cent from 9.2 per cent a year ago. Episodes of large inventory build-up, production cuts and temporary closure in some sectors such as automobiles at the beginning of the second half of 2008-09 indicate a period of stress on account of lack of demand.

Corporate Performance

14. During the first two quarters of 2008-09, despite high top-line growth, operating margins of the private corporate sector were eroded by higher input

costs and significant drop in ‘other’ income. In light of the subsequent slowdown, industrial investment plans are slowing down, although ongoing investment projects appear to be continuing. The erosion in pricing power of corporates was reflected in rising inventories as a proportion to sales. While the downside risk to corporate profitability has increased, this may at least be partly offset by falling input prices and a gradual reduction in borrowing costs.

Table 1: Real GDP Growth (%)

Sector	**First Half Year (April-September)**	
	2007-08	**2008-09**
Agriculture	4.5	2.9
Industry	9.1	5.0
Services	10.6	9.9
Overall	**9.3**	**7.8**

Business Confidence

15. The Reserve Bank’s latest round of quarterly Industrial Outlook Survey shows weak and deteriorating business sentiment among private manufacturing companies for the last quarter of 2008-09. The survey indicates weak demand conditions and decline in sentiment for production, order books, capacity utilisation and exports. Corporates also reported a significant decline in employment expectations for January-March 2009. This picture is consistent with business confidence surveys conducted by other agencies.

Lead Indicators

16. In terms of lead indicators, service sector activity appears to be moderating in several sub-sectors, barring communications and freight movement. On the positive side, sustained performance of the agricultural sector, fiscal stimulus, falling global crude oil prices and softening of domestic input prices such as energy, cement and steel would have a positive impact on industrial production in the coming months.

Inflation

17. Headline inflation, as measured by year-on-year variations in the wholesale price index (WPI), fell by more than half from its intra-year peak of 12.91 per cent on August 2, 2008 to 5.60 per cent by January 10, 2009. While prices of primary articles and manufactured products increased, fuel prices declined (Table 2). In terms of relative contribution to decelerating headline inflation between August 2, 2008 and January 10, 2009, petroleum and basic metals (combined weight of 13.2 per cent in WPI) together accounted for 79.4 per cent, followed by 'oilseeds, edible oils & oil cakes' (16.4 per cent). Clearly, the fall in commodity prices reflecting global trends has been the key driver of the sharp fall in WPI inflation although effective management of domestic demand too has contributed to this moderation.

Table 2: Annual Inflation Rate (%)

Wholesale Price Index (WPI)	**January 12, 2008 (y-o-y)**	**January 10, 2009 (y-o-y)**
WPI - All Commodities	4.36	5.60
WPI - Primary Articles	4.49	11.64
WPI - Fuel Group	3.69	-1.32
WPI - Manufactured Products	4.57	5.90
WPI - Excluding Fuel	4.55	7.53
WPI - Excluding Food and Fuel	5.21	6.52
Consumer Price Index (CPI)	**December 2007 (y-o-y)**	**December 2008 (y-o-y)**
1. CPI for Industrial Workers*	5.51	10.45
2. CPI for Agricultural Labourers	5.90	11.14
3. CPI for Rural Labourers	5.63	11.14
4. CPI for Urban Non-Manual Employees*	5.06	10.79

* Pertains to November.

18. On the other hand, inflation based on various consumer price indices (CPIs) is still in double digits due to the firm trend in prices of food articles and the higher weight of food articles in measures of consumer price inflation (Table 2). As the decline in input prices percolates over time to the prices of manufactured and other products, consumer price inflation too is expected to soften in the months ahead. For its overall assessment of inflation outlook for policy purposes, the Reserve Bank continues to monitor the full array of price indicators.

Fiscal Scenario

19. As a proportion of the budget estimates (BE), both tax and non-tax revenue receipts of the Central Government for the period April-November 2008 were lower than those in the corresponding period of the previous year. On the other hand, both revenue expenditure and total expenditure, as a proportion to the BE, were higher than a year ago. Consequently, the revenue deficit and the gross fiscal deficit (GFD) were significantly higher during April-November 2008 as compared with the corresponding period of the previous year (Table 3).

Table 3: Fiscal Position of the Central Government

Item	**April-November**			
	Percentage to Budget Estimates		**Growth (%)**	
	2007-08	**2008-09**	**2007-08**	**2008-09**
1. Revenue Receipts	56.5	52.2	24.2	14.7
2. Gross Tax Revenue	55.5	52.0	25.2	17.5
3. Tax Revenue (Net)	54.6	50.0	24.5	15.1
4. Non-Tax Revenue	65.7	64.1	22.7	13.2
5. Total Expenditure	60.5	65.8	22.2	20.1
	(58.7)		*(11.7)*	*(31.5)*
6. Revenue Expenditure	61.8	69.3	12.7	32.4
7. Capital Expenditure	54.5	40.7	116.3	-43.4
	(37.8)		*(1.2)*	*(21.0)*
8. Revenue Deficit	97.9	256.2	-17.2	102.0
9. Fiscal Deficit	63.8	132.4	-11.0	83.3
	(63.0)		*(-12.2)*	*(85.7)*

Note :Figures in parentheses are net of transactions relating to transfer of the Reserve Bank's stake in State Bank of India to the Government.

20. For 2008-09, the Central Government had budgeted gross market borrowing of Rs.1,78,575 crore and net market borrowing of Rs.99,000 crore. Subsequently, the Government presented two supplementary demands, as a result of which the market borrowing programme of the Central Government was raised to Rs.2,52,154 crore (gross) and Rs.1,75,374 crore (net). Against this enhanced borrowing programme, market borrowing of the Central Government

was Rs.2,22,154 crore (gross) and Rs.1,51,697 crore (net) during 2008-09 so far (up to January 23, 2009). The weighted average yield and weighted average maturity of central government dated securities issued during 2008-09 (up to January 23, 2009) were at 8.03 per cent and 14.59 years respectively as compared with 8.10 per cent and 14.38 years in 2007-08. The State Governments have borrowed a net amount of Rs.46,327 crore up to January 23, 2009.

21. The evolving scenario raises some concerns on the extent of stress on the fisc in the current year emanating from several factors. First, the Centre is expected to suffer revenue losses from lower direct tax collection on account of the economic slowdown. Second, the Centre is likely to lose further revenues worth about 0.6 per cent of GDP due to cuts in excise and customs duties. Third, there has been a disproportionate growth in expenditure of the Central Government during April-November 2008, particularly in respect of revenue expenditure arising out of increase in subsidies, disbursements as well as implementation of the recommendations of the Sixth Pay Commission and the farm debt waiver scheme. The net cash outgo indicated in supplementary demands for grants would be of the order of 2.8 per cent of GDP (Rs.1,50,310 crore). Thus, additional expenditure coupled with foregone revenue would raise the fiscal deficit from the budget estimate of 2.5 per cent to at least 5.9 per cent of GDP. In addition, special bonds for Rs.44,000 crore and Rs.14,000 crore, amounting to 1.1 per cent of GDP, have been issued to oil marketing companies and fertiliser companies respectively during 2008-09 (up to January 23, 2009). In its latest *Review of the Economy* (January 2009), the Economic Advisory Council to the Prime Minister has placed the consolidated fiscal deficit of the Central Government, including full issuances of oil and fertiliser bonds, at 8.0 per cent of GDP for 2008-09.

22. The consolidated budgeted revenue surplus of the States in 2008-09 may not, in fact, materialise. Consequently, the consolidated fiscal deficit of the States is expected to rise to 2.6 per cent of GDP. While some of the increase in the revenue and fiscal deficits is on account of post-budget expenditure commitments such as payment of arrears resulting from the Sixth Pay Commission Award, a substantial increase is also due to the economic downturn arising from the impact of the global financial crisis. Although the fiscal stimulus packages have meant deviation from the roadmap laid out by the Fiscal

Responsibility and Budget Management (FRBM) Act, reversing the consolidation process of the last several years, they were warranted under the prevailing circumstances. It is critically important, however, that the Centre and States re-anchor to a revised FRBM mandate once the immediacy of the crisis is behind us.

Monetary Conditions

23. Growth in key monetary aggregates – reserve money and money supply (M_3) – in 2008-09 so far has reflected the changing liquidity positions arising from domestic and global financial conditions and the monetary policy response to the evolving macroeconomic developments. Reserve money variations during 2008-09 have largely reflected increase in currency in circulation and reduction in the cash reserve ratio (CRR) of banks.

24. Reduction in the CRR has three inter-related effects on reserve money. First, it reduces reserve money as bankers' required cash deposits with the Reserve Bank fall. Second, the money multiplier rises. Third, with the increase in the money multiplier, M_3 expands with a lag. While the initial expansionary effect is strong, the full effect is felt in 4-6 months. Reflecting these changes, while the year-on-year increase in reserve money as on January 2, 2009 was lower, it was significantly higher when adjusted for the first round effect of CRR reduction. The annual M_3 growth as on January 2, 2009 though lower compared with last year, was higher than the trajectory projected in the Annual Policy Statement (Table 4).

Table 4: Annual Variations in Monetary Aggregates (%)

Item	**Annual Variations (y-o-y)**	
	January 4, 2008	**January 2, 2009**
Reserve Money	28.8	7.4
Reserve Money (adjusted for CRR changes)	18.1	19.4
Currency in Circulation	15.6	16.6
Money Supply (M_3)	22.6	19.6
M_3 (Policy Projection)*	17.0-17.5	16.5-17.0
Money Multiplier	4.66	5.20

* Policy projections are for the financial year as indicated in the Annual Policy Statements of the respective financial years.

25. Since September 2008, monetary conditions have been evolving following changes in monetary policy in response to global developments and also due to slackening of domestic demand conditions. As the Reserve Bank had to provide dollar liquidity, its net foreign exchange assets (NFEA) contracted. The Reserve Bank sought to compensate the fall in NFEA by expanding its net domestic assets (NDA) through: (i) buy-back of securities held under the market stabilisation scheme (MSS); (ii) purchase of oil bonds; (iii) enlargement of the refinance window; and (iv) repo operations under the liquidity adjustment facility (LAF). Thus, a notable feature of monetary operations during the third quarter of 2008-09 was the substitution of foreign assets by domestic assets to keep the overall liquidity conditions comfortable. Liquidity conditions have indeed improved since mid-November 2008 as reflected in daily absorption under the LAF reverse repo and moderation in market interest rates.

Credit Conditions

26. The year-on-year (y-o-y) growth in non-food bank credit at 23.9 per cent as on January 2, 2009 was higher than that of 22.0 per cent as on January 4, 2008 (Table 5). Increase in total flow of resources from the banking sector to the commercial sector (*i.e.*, non-food bank credit together with investments in shares/bonds/debentures and commercial papers issued by public sector/private sector companies) was also higher at 23.4 per cent as compared with 21.7 per cent a year ago. Despite the expansion in bank credit, there was a perception of lack of credit availability. This could be attributed to reduced flow of funds from non-bank sources, notably the capital market and external commercial borrowings.

Table 5: Annual Variations in Banking Indicators (%)

Item	**January 4, 2008 (y-o-y)**	**January 2, 2009 (y-o-y)**
Aggregate Deposits	25.1	21.2
Bank Credit	21.4	24.0
Non-food Bank Credit	22.0	23.9
Total flow of Resources from Banks to the Commercial Sector	21.7	23.4
SLR Investments	25.8	19.2
Incremental Credit-Deposit Ratio	63.1	81.4

27. During 2008-09 so far, the total flow of resources to the commercial sector from banks and other sources was marginally lower than in the previous year reflecting contraction of funds from other sources (Table 6).

Table 6: Flow of Financial Resources to the Commercial Sector

(Rs. crore)

Item	2007-08 (Up to January 4, 2008)	2008-09 (Up to January 2, 2009)
From Banks	2,24,921	2,93,243
From Other Sources*	2,74,563	1,91,470
Total Resources	**4,99,484**	**4,84,713**

* Includes borrowings from financial institutions 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.

28. At a disaggregated level, the year-on-year increase in bank credit to industry as of December 2008 was sharply higher than that in the previous year reflecting the substitution effect of other sources of funding by bank credit (Table 7).

Table 7: Annual Sectoral Flow of Credit

Sector	As on December 21, 2007 (y-o-y)		As on December 19, 2008 (y-o-y)	
	Amount (Rs. crore)	Variations (%)	Amount (Rs. crore)	Variations (%)
Agriculture	38,139	19.3	53,612	22.7
Industry	1,56,192	24.9	2,36,064	30.2
Real Estate	13,621	35.8	24,827	48.1
Housing	31,780	14.6	21,989	8.8
NBFCs	22,953	59.6	24,668	40.1
Overall Credit	**3,54,802**	**21.8**	**4,90,199**	**24.8**

29. There has been a noticeable variation in credit expansion across bank groups. Expansion of credit by public sector banks was much higher this year than in the previous year, while credit expansion by foreign and private sector banks was significantly lower. The relatively slower pace of credit expansion by foreign and private sector banks has also added to the perception of inadequate credit flow in the system. There has also been perceptible deceleration in growth of deposits with private and foreign banks (Table 8).

Table 8: Bank Group-wise Deposits and Credit

Bank Group	**Annual Growth (y-o-y) (%)**	
	As on January 4, 2008	**As on January 2, 2009**
	Deposits	
Public Sector Banks	24.2	24.2
Foreign Banks	34.1	12.1
Private Sector Banks	26.9	13.4
Scheduled Commercial Banks *	**25.1**	**21.2**
	Credit	
Public Sector Banks	19.8	28.6
Foreign Banks	30.7	16.9
Private Sector Banks	24.2	11.8
Scheduled Commercial Banks *	**21.4**	**24.0**

* Including regional rural banks (RRBs).

30. Commercial banks' holdings of SLR securities became more liquid on account of two factors. First, banks were permitted to use SLR securities to the tune of 1.5 per cent of their net demand and time liabilities (NDTL) under the LAF to meet the funding requirements of mutual funds, non-banking finance companies (NBFCs) and housing finance companies (HFCs). Second, the reduction in SLR by one percentage point to 24.0 per cent of NDTL in November 2008 released funds for credit deployment. Commercial banks' SLR holdings declined from 27.8 per cent (28.4 per cent adjusted for LAF) of NDTL in March 2008 to 25.8 per cent (28.1 per cent adjusted for LAF) in mid-October 2008 reflecting the banks' reliance on the repo facility under the LAF as liquidity conditions tightened. Reversing this trend by early January 2009, banks' SLR holdings increased to 28.9 per cent of NDTL (27.1 per cent adjusted for LAF)

reflecting improved liquidity conditions and increased government market borrowings.

31. Bank deposit and lending rates, which had firmed up during the current financial year up to October 2008, started easing from November 2008. Between November 2008 and January 2009, all public sector banks, several private sector banks and some foreign banks reduced their deposit and lending rates. The magnitude of reduction by public sector banks was larger than that by foreign and private sector banks (Table 9).

Table 9: Deposit and Lending Rates of Banks (%)

Bank Group/Maturity	October 2008	January 2009
Domestic Deposit Rate		
Public Sector Banks		
61-90 days	5.25-6.00	5.25-6.00
180 days – 1 year	8.00-8.75	7.25-8.00
1-3 years	9.50-10.50	8.00-9.00
> 3 years	8.75-9.75	8.25-8.50
Private Sector Banks		
61-90 days	4.00-6.25	4.00-5.50
180 days – 1 year	8.00-9.00	7.75-8.00
1-3 years	9.00-10.10	8.00-9.00
> 3 years	8.50-9.75	8.00-8.75
Foreign Banks		
61-90 days	6.00-8.50	5.25-7.00
180 days – 1 year	7.00-9.50	7.50-9.00
1-3 years	7.50-9.00	7.50-8.50
> 3 years	7.50-10.00	7.50-7.75
Benchmark Prime Lending Rate (BPLR)		
Public Sector Banks	13.75-14.00	12.00-12.50
Private Sector Banks	15.25-17.25	14.75-16.75
Foreign Banks	14.25-15.50	14.25-15.50

Note: Data relate to five major public sector banks, four private sector banks and three foreign banks.

32. The interest rate response to monetary policy easing has been faster in the money and bond markets as compared to the credit market because of several structural factors. First, the administered interest rate structure on small savings could potentially constrain the reduction in deposit rates below some threshold. Second, a substantial portion of bank deposits is mobilised at fixed interest rates with an asymmetric contractual relationship. During the upturn of the interest rate cycle, depositors have the flexibility to prematurely terminate the existing deposits and re-deposit the funds at higher interest rates. However, in the downturn of the interest rate cycle, banks have to necessarily carry these deposits at higher rates of interest till their maturity. Third, competition among banks for wholesale deposits for meeting the higher credit demand in the upswing leads to an increase in the cost of funds. Fourth, linkage of concessional lending rates to banks' BPLRs makes overall lending rates less flexible. Fifth, persistence of the large market borrowing programme of the government hardens interest rate expectations. Sixth, with increase in risk aversion, lending rates tend to be high even during a period with falling credit demand. From the real economy perspective, however, for monetary policy to have demand inducing effects, lending rates will have to come down.

33. Notwithstanding the various factors that impede monetary transmission, market interest rates do respond to changes in policy interest rates. As such, current deposit and lending rates have significant room for further reduction. Interest rates in the money and bond markets have already declined perceptibly since their peaks in October 2008 (Table 10). Major public sector banks have also reduced their term deposit rates in the range of 50-150 basis points. Benchmark prime lending rates (BPLRs) of major public sector banks have come down by 150-175 basis points. Major private sector banks have reduced their BPLRs by 50 basis points, while major foreign banks are yet to do so. As a result of several measures initiated by the Reserve Bank since mid-September 2008, banks' cost of funds would come down. This should encourage banks to reduce their lending rates in the coming months.

Financial Markets

34. The overnight interest rates generally ruled above the ceiling of the LAF rate corridor at the beginning of October 2008 when the domestic money and

foreign exchange markets came under pressure. The overnight interest rates eased in mid-October 2008 in response to the successive monetary easing measures by the Reserve Bank which alleviated the liquidity pressures. The overnight interest rates have remained below the upper bound of the LAF corridor since November 3, 2008. Interest rates on various other segments of the money market and government securities market have also softened markedly (Table 10).

Table 10: Interest Rates (%)

Segment/Instrument	October 2008	January 23, 2009
Call Money	9.90	4.21
CBLO	7.73	3.85
Market Repo	8.40	4.24
Commercial Paper	14.17	10.98*
Certificates of Deposit	10.00	8.85*
91-day Treasury Bills	7.44	4.67
10-year Government Securities	7.45	5.87

* Pertains to December 2008.

35. The rupee had appreciated against major currencies in 2007-08 due to large capital inflows. It depreciated during 2008-09 so far reflecting extraordinary developments in international financial markets and portfolio outflows by foreign institutional investors (FIIs). It has remained range-bound since November 2008 (Table 11).

Table 11: Rupee Exchange Rate

Rupee per Unit of	Range	April 2008	November 2008	January* 2009
US Dollar	Maximum	40.46	50.52	49.19
	Minimum	39.89	47.18	48.37
Euro	Maximum	63.80	64.68	68.09
	Minimum	62.25	60.57	63.60
Pound Sterling	Maximum	79.94	80.26	74.42
	Minimum	78.66	72.14	67.61
100 Japanese Yen	Maximum	39.58	53.12	55.58
	Minimum	38.36	47.31	51.90

* Up to January 23, 2009.

36. Equity markets weakened sharply till end-October 2008 in tandem with global stock markets, particularly Asian markets, reflecting further deterioration in the global financial market sentiment, FII outflows, slowdown in industrial growth and lower corporate profits. The BSE Sensex declined from an all-time high of 20873 on January 8, 2008 to a low of 8451 on November 20, 2008. The equity market has since remained generally range-bound; the BSE Sensex was at 8674 on January 23, 2009.

37. The outlook for the domestic financial markets will be determined largely by the developments in global financial markets and domestic liquidity conditions. The banking system has been in surplus liquidity mode since mid-November 2008. The pressure on the exchange rate of the rupee has eased due to moderation in capital outflows. In addition, the decline in global commodity prices, particularly crude oil, is expected to further ease the pressure on foreign currency on account of oil imports.

External Sector

38. India's current account deficit (CAD) of the balance of payments (BoP) widened in the first half of 2008-09 in comparison with the corresponding period of the previous year due to a large trade deficit, reflecting high oil prices even as private transfers and software export earnings were sustained. As net capital flows declined sharply, the overall balance of payments position turned marginally negative during the first half of 2008-09 as against a large surplus in the corresponding period of the previous year (Table 12). Import growth had moderated during October-November 2008 reflecting the fall in international oil prices and slowing domestic demand. During the same period, export growth turned negative reflecting slowing global demand. Going forward, it is expected that imports may slow down faster than exports.

Table 12: India's Balance of Payments

(US $ billion)

	April-September	
	2007-08	**2008-09**
Exports	72.6	96.7
Imports	115.9	165.9
Trade Balance	- 43.2	- 69.2
Invisibles, net	32.3	46.8
Current Account Balance	- 11.0	- 22.3
Capital Account*	51.4	19.8
Change in Reserves#	(-) 40.4	(+) 2.5

On a BoP basis (excluding valuation): (-) indicates increase; (+) indicates decrease.

* Including errors and omissions.

39. The reversal of capital flows has raised concerns about management of the BoP, particularly with reference to outstanding external debt with residual maturity of less than one year. These concerns are somewhat misplaced as the following analysis will show.

40. India's external debt with residual maturity of less than one year as at end-March 2008 was estimated at around US $ 85 billion (as per revised data), which would mature during the financial year 2008-09. Sovereign debt and commercial borrowings are most likely to be rolled over during 2008-09. Indeed, the BoP data for the first half of the year (April-September 2008) indicate net positive accretions beyond roll-over under both these heads. Current trends indicate that under NRI deposits, not only will the maturing debt be rolled over but there will be net accretions as a result of the upward adjustment in interest rate ceilings on such deposits. Here again, available data up to December 2008 show net accretions. That leaves trade credit of the order of US $ 43.2 billion to be repaid during 2008-09. Of this, as much as US $ 28.1 billion has already been disbursed during April-November 2008 leaving a balance of US $ 15.1 billion. There are reports that large inflows are in the pipeline on account of commitments of buyers' credit by the importers and oil companies. Even conservatively projecting that only a small portion of this balance would be rolled over, India's external payment situation remains stable.

41. 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. As capital inflows during 2007-08 were far in excess of the normal absorptive capacity of the economy, there was substantial accretion to foreign exchange reserves by US $ 110.5 billion. The foreign exchange reserves declined by US $ 23.4 billion from US $ 309.7 billion as at end-March 2008 to US $ 286.3 billion by end-September 2008 largely reflecting valuation effects. Excluding valuation effects, the decline was US $ 2.5 billion. Between October 2008 and January 16, 2009 foreign exchange reserves declined by US $ 34.1 billion to US $ 252.2 billion, including valuation effects. India's current level of foreign exchange reserves remains comfortable.

Overall Outlook

42. At the heart of the global financial crisis lie the non-functional and frozen financial markets. In sharp contrast to their international counterparts, the financial system in India has been resilient and stable. Barring some tightness in liquidity during mid-September to early October, the money, foreign exchange and government securities markets have been orderly as reflected in market rates, spreads and transaction volumes relative to those observed during normal times. India's banking system remains healthy, well-capitalised, resilient and profitable. Credit markets have been functioning well and banks have been expanding credit, notwithstanding the perceptions in some quarters of lack of adequate credit from the banks to the commercial sector.

43. Over the last five years, India clocked 8.8 per cent average annual growth, driven largely by domestic consumption and investment even as the share of net exports rose. While the benign global environment, easy liquidity and low interest rates helped, at the heart of India's growth have been its growing entrepreneurial spirit and rise in productivity. These fundamental strengths continue to be in place. Nevertheless, the global crisis will dent India's growth trajectory as investments and exports slow. Clearly, there is a period of painful adjustment ahead of us. However, once the global economy begins to recover, India's turnaround will be sharper and swifter, backed by our strong fundamentals and

the untapped growth potential. Meanwhile, the challenge for the Government and the Reserve Bank is to manage the adjustment with as little pain as possible.

II. Stance of Monetary Policy

44. Since September 2008, international developments have largely circumscribed domestic policy responses. There have been severe disruptions in the international money and foreign exchange markets since September 2008. Policymakers in governments, central banks and in other regulating agencies of financial institutions around the world responded to the crisis with aggressive, radical and unconventional measures to restore calm and confidence in financial markets and bring them back to normalcy. The immediate challenge was to maintain financial stability, which moved up in the hierarchy of objectives.

Earlier Policy Measures

September 2008

45. Global financial crisis also had spillover effects on financial markets in India causing an unusual tightening of liquidity in mid-September, which was compounded by transient local factors such as advance tax payments. The domestic equity market was severely affected by the global meltdown of asset prices. The foreign exchange market also came under pressure. Access to external financing was constrained following re-pricing of risks and higher credit spreads. Responding to the evolving situation, the Reserve Bank announced the following measures on September 16, 2008:

- A firm assurance to meet any demand-supply gaps of foreign exchange in the domestic foreign exchange market.
- A second LAF was re-introduced on a daily basis.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were increased by 50 basis points each to LIBOR/swap rates *minus* 25 basis points and LIBOR/swap rates *plus* 50 basis points respectively.
- As a temporary measure, scheduled banks were allowed to avail of additional liquidity support under the LAF to the extent of up to one per

cent of their net demand and time liabilities from their SLR portfolio and seek waiver of penal interest.

October 2008

46. Liquidity conditions tightened further in October 2008 as contagion from the US financial crisis spread to Europe and Asia. Many central banks took co-rdinated actions to infuse liquidity in their jurisdictions. In addition, in order to enhance dollar liquidity, the US Fed provided currency swap lines to select central banks. Financial markets in Asia and Australia were also severely affected. The call money rate in the domestic market touched a peak of 19.8 per cent on October 10, 2008 with LAF repo volume crossing Rs.90,000 crore during the early part of October 2008. In view of persisting uncertainty in global financial markets and its impact on India and continuing shortage of liquidity reflected in repo volume, the following measures were taken by the Reserve Bank in October 2008:

- The CRR was reduced by 250 basis points from 9.0 per cent to 6.5 per cent effective from the fortnight beginning October 11, 2008.
- A 14-day special repo facility for a notified amount of Rs.20,000 crore was instituted to alleviate liquidity stress faced by mutual funds, and banks were allowed temporary use of SLR securities for collateral purposes by an additional 0.5 per cent of NDTL exclusively for this purpose.
- Commercial banks and all-India term lending and refinancing institutions were allowed to lend against and buy back certificates of deposit (CDs) held by mutual funds.
- The Reserve Bank temporarily provided a sum of Rs.25,000 crore as the first instalment under the Agricultural Debt Waiver and Debt Relief Scheme to scheduled banks and NABARD immediately, pending Parliamentary sanction and consequent release of funds by the Central Government.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were increased further by 50 basis points each to LIBOR/swap rates *plus* 25 basis points and LIBOR/swap rates *plus* 100 basis points respectively.

- Banks were permitted to borrow funds from their overseas branches and correspondent banks to the extent of 50 per cent of their unimpaired Tier-I capital or US $ 10 million, whichever is higher.
- The Reserve Bank announced that it would institute special market operations to meet the foreign exchange requirements of public sector oil marketing companies against oil bonds when they become available.
- On October 20, 2008 the repo rate under the LAF was reduced by 100 basis points to 8.0 per cent.
- The systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) were permitted to raise short-term foreign currency borrowings.

47. On the eve of announcement of the Mid-Term Review, external commercial borrowings (ECBs) up to US $ 500 million per borrower per financial year were permitted for rupee expenditure and/or foreign currency expenditure for permissible end-uses under the automatic route. Further, the all-in-cost ceiling for ECBs of average maturity period of three years and up to five years was raised to 300 basis points, and over five years, to 500 basis points above 6-month LIBOR.

November 2008

48. Global financial conditions continued to remain uncertain and unsettled. Early signs of a global recession were evident by late October. Globally, commodity prices, including crude, began to abate which reduced domestic inflationary pressures. On the growth front, it was important to ensure that credit requirements for productive purposes were adequately met so as to support the growth momentum of the economy. Accordingly, the following measures were taken on November 1, 2008:

- The repo rate under the LAF was reduced by 50 basis points to 7.5 per cent with effect from November 3, 2008.
- The CRR was reduced by 100 basis points from 6.5 per cent to 5.5 per cent of NDTL.

- The statutory liquidity ratio (SLR), which was relaxed on a temporary basis earlier, was made permanent and reduced to 24 per cent of NDTL effective November 8, 2008.
- In order to provide further liquidity comfort, a special refinance facility for scheduled commercial banks (excluding RRBs) up to 1.0 per cent of each bank's NDTL as on October 24, 2008 was introduced under Section 17(3B) of the Reserve Bank of India Act, 1934 up to a maximum period of 90 days.
- On October 15, 2008 the Reserve Bank introduced a 14-day special repo facility allowing banks to avail additional liquidity support exclusively for the purpose of meeting the liquidity requirements of mutual funds to the extent of 0.5 per cent of their NDTL. Subsequently, this facility was extended for NBFCs and the relaxation in the maintenance of the SLR was enhanced to the extent of up to 1.5 per cent of their NDTL.
- Buy-back of MSS dated securities was announced to provide another avenue for injecting liquidity to be calibrated with the market borrowing programme of the Government of India.

49. On November 7, 2008 Indian public and private sector banks that have foreign branches or subsidiaries were provided a forex swap facility of tenor up to three months with the Reserve Bank. Further, for funding the swap, banks were allowed to borrow under the LAF for the corresponding tenor at the prevailing repo rate.

50. There were indications that the global slowdown was deepening with a larger than expected impact on the domestic economy, particularly for the medium and small industry sector and export-oriented units. In the context of these developments, further augmenting rupee and forex liquidity, and strengthening and improving credit delivery mechanisms were needed for sustaining the growth momentum. Accordingly, the following measures were taken on November 15, 2008:

- The special term repo facility introduced for the purpose of meeting the liquidity requirements of MFs and NBFCs, was extended till end-March 2009. Banks can avail of this facility either on an incremental basis or on a rollover basis within the entitlement of up to 1.5 per cent of their NDTL.

- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were further raised by 75 basis points each to LIBOR/swap rates *plus* 100 basis points and LIBOR/swap rates *plus* 175 basis points respectively.
- Housing finance companies (HFCs) registered with the National Housing Bank (NHB) were permitted to raise short-term foreign currency borrowings under the approval route.
- The Reserve Bank permitted Indian corporates to prematurely buy back their FCCBs at prevailing discounted rates.
- The period of entitlement of the first slab of pre-shipment rupee export credit was extended from 180 days to 270 days.
- The aggregate limit of export credit refinance (ECR) facility for scheduled banks (excluding RRBs) was enhanced from 15 per cent to 50 per cent of the outstanding export credit eligible for refinance.
- SIDBI and the NHB were allocated Rs. 2000 crore and Rs.1000 crore respectively against banks' estimated shortfall in priority sector lending in March 2009.
- Banks were encouraged to use the special refinance facility under Section 17(3B) of the Reserve Bank of India Act, 1934 for the purpose of lending to micro and small enterprises.
- The provisioning requirements for all types of standard assets were reduced to a uniform level of 0.40 per cent, except in the case of direct advances to the agricultural and SME sectors which continue to attract provisioning of 0.25 per cent, as hitherto.
- Risk weights on banks' exposures to all unrated claims on corporates, claims secured by commercial real estate and claims on NBFCs-ND-SI were reduced to 100 per cent from 150 per cent.

51. On November 28, 2008 the Reserve Bank announced the following measures for liquidity management and improving credit flows:

- The special refinance facility under Section 17(3B) of the Reserve Bank of India Act, 1934 introduced on November 1, 2008 was extended up to June 30, 2009.
- The special term repo facility was expanded to enable banks to accommodate the funding needs of HFCs. The facility was extended up to June 30, 2009.
- The forex swap facility of tenor up to three months was extended up to June 30, 2009.
- The period of entitlement of the first slab of post-shipment rupee export credit was extended from 90 days to 180 days.

December 2008

52. The global outlook deteriorated further during December 2008. There were indications that the recession would be deeper and the recovery longer than anticipated earlier. There was also increasing evidence of slackening of domestic economic activity. The available data indicated that the demand for bank credit started moderating despite comfortable liquidity. The reduction in prices of petrol and diesel announced on December 5, 2008 further eased inflationary pressures. To improve the credit flow to productive sectors at viable costs so as to sustain the growth momentum, the Reserve Bank took the following measures on December 6 and 11, 2008:

- The repo rate was reduced under the LAF by 100 basis points from 7.5 per cent to 6.5 per cent and the reverse repo rate by 100 basis points from 6.0 per cent to 5.0 per cent, effective December 8, 2008.
- A refinance facility was introduced for SIDBI, NHB and EXIM Bank for Rs. 7,000 crore, Rs.4,000 crore and Rs.5,000 crore respectively. This facility will be available up to March 31, 2010.
- Authorised Dealers Category-I banks were permitted to consider applications for premature buy-back of FCCBs from their customers.
- Loans granted by banks to HFCs for on-lending for housing up to Rs.20 lakh per dwelling unit were classified under priority sector.
- Commercial real estate exposures restructured up to June 30, 2009 were allowed to be treated as standard assets. As a one-time

measure, the second restructuring done by banks of exposures (other than exposures to commercial real estate, capital market exposures and personal/consumer loans) up to June 30, 2009 was also made eligible for concessional regulatory treatment.

- The prescribed interest rate as applicable to post-shipment rupee export credit (not exceeding BPLR minus 2.5 percentage points) was extended to overdue bills up to 180 days.

January 2009

53. While domestic financial markets continued to function in an orderly manner, India's growth trajectory was impacted both by the global financial crisis and the follow-on global economic downturn. This impact turned out to be deeper and wider than earlier anticipated. Concurrently, because of fall in global commodity prices coupled with supply and demand management measures at home, headline inflation was on the decline. Even as some public sector and private sector banks had cut lending rates in response to the Reserve Bank's monetary policy stance, concerns over rising credit risk together with the slowing of economic activity appeared to have moderated credit growth. Accordingly, in order to stimulate growth, the Reserve Bank took the following further measures on January 2, 2009:

- The repo rate under the LAF was reduced by 100 basis points from 6.5 per cent to 5.5 per cent with effect from January 5, 2009.
- The reverse repo rate under the LAF was reduced by 100 basis points from 5.0 per cent to 4.0 per cent with effect from January 5, 2009.
- The CRR was reduced from 5.5 per cent to 5.0 per cent of NDTL effective from the fortnight beginning January 17, 2009.

54. The Government has announced the setting up of a special purpose vehicle (SPV) for addressing the temporary liquidity constraints of systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI). The mechanism would be as follows: The SPV would issue government guaranteed securities to the Reserve Bank. The SPV will, in turn, use the funds to acquire only investment grade commercial papers and non-convertible debentures of the NBFCs. During its appraisal, the SPV will ensure that the

NBFCs use the money only for addressing liquidity constraints and not for business expansion. The total support from the Reserve Bank will be limited to Rs.20,000 crore with an option to raise it by a further Rs.5,000 crore. The facility will be available for a limited period to address current liquidity concerns of NBFCs.

Liquidity Impact

55. The cumulative reduction in the CRR by 400 basis points since mid-September 2008 released additional Rs.1,60,000 crore of primary liquidity. Unwinding of MSS has released primary liquidity of a little over Rs.63,000 crore. Further, potential liquidity has been made available through various refinance facilities for banks and financial institutions to the tune of Rs.80,000 crore. The term repo facility gives an additional potential liquidity of Rs.60,000 crore. The SPV for NBFC will augment potential liquidity by another Rs.25,000 crore. In sum, the actions of the Reserve Bank since mid-September 2008 have resulted in augmentation of actual/potential liquidity of over Rs.3,88,000 crore. In addition, the permanent reduction in SLR by 1.0 per cent of NDTL has made available liquid funds of the order of Rs.40,000 crore for the purpose of credit expansion (Table 13).

Table 13: Actual/Potential Release of Primary Liquidity since mid-September 2008

Measure/Facility		Amount (Rs.crore)
1.	Cash Reserve Ratio (CRR) Reduction	1,60,000
2.	MSS Unwinding	63,045
3.	Term Repo Facility	60,000
4.	Increase in Export Credit Refinance	25,500
5.	Special Refinance Facility for SCBs (Non-RRB)	38,500
6.	Refinance Facility for SIDBI/NHB/EXIM Bank	16,000
7.	Liquidity Facility for NBFCs through SPV	25,000
Total (1 to 7)		**3,88,045**

Memo: Statutory Liquidity Ratio (SLR) Reduction 40,000

56. The liquidity situation has improved significantly following several measures taken by the Reserve Bank. The overnight call money rate, which

generally hovered above the repo rate during September-October 2008, has softened considerably and has moved towards the lower bound of the LAF corridor since early November 2008. Other money market rates such as discount rate of CDs, CPs and CBLO rate softened in tandem with the overnight call money rate. The yield on 10-year government securities has remained below 6 per cent since mid-December 2008. The LAF window has been generally in an absorption mode since mid-November 2008. The liquidity problem faced by mutual funds appears to have eased considerably. Many commercial banks have reduced their benchmark prime lending rates since mid-November 2008.

Growth Projection

57. The Reserve Bank's Mid-Term Review of October 2008 had estimated real GDP growth for 2008-09 in the range of 7.5–8.0 per cent. Since then the outlook on real GDP growth has been affected further and the downside risks to growth have amplified because of slowdown of industrial activity and weakening of external demand as reflected in decline in exports. Services sector activities are likely to further decelerate in the second half of 2008-09. Keeping in view the slowdown in industry and services and with the assumption of normal agricultural production, the projection of overall real GDP growth for 2008-09 is revised downwards to 7.0 per cent with a downward bias.

Inflation Projection

58. Pressures on commodity prices have abated markedly around the world, reflecting slump in global demand. The sharp decline in crude oil prices together with the slide in prices of metals, foodgrains and cement has influenced inflation expectations in most parts of the world. In the domestic market, inflation in terms of the wholesale price index is already below 7.0 per cent, which was projected earlier for end-March 2009. While prices of manufactured products and of the fuel group have declined in line with international trends, inflation on account of primary articles still remains at the double digit level, reflecting sustained price pressures, particularly on food articles. As per current assessment, the inflation rate is expected to moderate further in the last quarter of 2008-09. Keeping in view the global trend in commodity prices and the domestic demand-supply balance, WPI inflation is now projected to decelerate to below 3.0 per cent by end-March 2009.

59. Notwithstanding the projected decline in headline WPI inflation, it needs to be noted that consumer price inflation is yet to moderate and the decline in inflation expectations has not been commensurate with the sharp fall in WPI inflation. Even within aggregate WPI inflation, the primary articles inflation is still in double digits. Similarly, WPI inflation excluding food and fuel remains higher this year as compared with the previous year. In view of the divergent movement of various price indices and their components, and overall increase in global economic uncertainties, an assessment of underlying inflation for policy purposes becomes inherently complex. With WPI inflation having moderated significantly, consumer price inflation would also decline, though with a lag. Towards its policy endeavour of ensuring price stability with well-anchored inflation expectations, the Reserve Bank will take into account the behaviour of all the price indices and their components.

60. The conduct of monetary policy would continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent becomes the medium-term objective, consistent with India's broader integration into the global economy and with the goal of maintaining self-accelerating growth over the medium-term. However, it is recognised that the headline WPI inflation could fall well below 3.0 per cent in the short-run partly because of the statistical reason of high base, and the global trends caused by exceptionally high oil and commodity prices in early 2008.

Monetary Projection

61. Monetary and credit aggregates continue to expand at a higher rate than projected in the Annual Policy Statement of April 2008. The liquidity overhang built-up in recent years due to unprecedented surge in capital inflows, however, is gradually diminishing. The Reserve Bank is committed to provide adequate liquidity for all productive activities on a continuous basis. As the upside risks to inflation have declined, monetary policy has been responding to slackening economic growth in the context of significant global stress. Accordingly, the projection of money supply (M_3) growth for 2008-09 is raised to 19.0 per cent from 16.5-17.0 per cent earlier. Consistent with this, the aggregate deposit growth for 2008-09 is revised to 19.0 per cent from 17.0 per cent earlier. The projection of growth of adjusted non-food credit, including investment in

bonds/debentures/shares of public sector undertakings and private corporate sector and CP, for 2008-09 is revised to 24.0 per cent from 20.0 per cent earlier. As always, these numbers are provided as indicative projections and not as targets.

Overall Assessment

62. As indicated earlier, India has been affected by the global financial crisis through the financial and real channels. There is considerable dismay about why this should be the case when, in fact, India's financial system is sound and healthy, and its merchandise exports constitute only 13.5 per cent of GDP. The answer clearly is that India has rapidly integrated into the global system and has linkages with the rest of the world not just through trade channels, but also through two-way movements of capital and finance. As an integral part of a globalising world, India cannot be expected to remain immune to a global crisis of this nature and magnitude; and in responding to the crisis, India has to share the uncertainty on the way forward just like the rest of the world.

63. Both the Government and the Reserve Bank have acted to protect the economy from the adverse impact of the crisis. While the Government has announced two major fiscal stimulus packages, the endeavour of the Reserve Bank has been to provide ample rupee liquidity, ensure comfortable dollar liquidity and maintain a monetary policy environment conducive for the continued flow of credit to productive sectors. Towards this endeavour, the Reserve Bank has adopted both conventional measures such as, for example, reduction of the CRR, as well as unconventional measures such as, for example, the dollar swap facility for banks.

64. Measures aimed at expanding rupee liquidity included significant reduction in the CRR, a special repo window under the LAF for banks for on-lending to non-banking financial companies, housing finance companies and mutual funds, and a special refinance facility that banks can access without any collateral. The Reserve Bank is also unwinding the MSS securities roughly synchronised with the government borrowing programme in order to manage liquidity. In addition, an SPV is being set up to provide liquidity support to NBFCs.

65. Measures aimed at managing forex liquidity include upward adjustment of the interest rate ceilings on the FCNR(B) and NR(E)RA deposits, substantial

relaxation of the ECB regime, allowing NBFCs/HFCs access to foreign borrowing and allowing corporates to buy back FCCBs to take advantage of the discount in the prevailing depressed global markets. The Reserve Bank has also instituted a rupee-dollar swap facility for banks with overseas branches to give them comfort in managing their short-term funding requirements.

66. Measures to encourage flow of credit to sectors that are coming under pressure include extension of the period of pre-shipment and post-shipment credit for exports, expansion of the refinance facility for exports, counter-cyclical adjustment of provisioning norms for all types of standard assets barring some exceptions, reduction of risk weights on banks' exposure to certain sectors which had been increased earlier counter-cyclically, and expansion of the lendable resources available to the Small Industries Development Bank of India, the National Housing Bank and the Export-Import Bank of India.

67. To improve the flow of credit to productive sectors at viable costs so as to sustain the growth momentum, the Reserve Bank signalled a lowering of the interest rate structure by significantly reducing both its key policy rates – the repo rate and the reverse repo rate. The SLR has also been reduced by one percentage point releasing funds to banks for credit deployment.

68. In the context of tightening liquidity in the recent period, the major challenge for the Reserve Bank has been to infuse liquidity in the system and assure the markets that it will continue to maintain a comfortable liquidity position. Accordingly, the policy actions of the Reserve Bank since mid-September 2008 have resulted in the augmentation of active/potential liquidity in the system of over Rs.3,88,000 crore. The Reserve Bank has also assured market participants that it will endeavour to maintain the overnight money market rates within the LAF corridor. The Reserve Bank will continue to pursue this stance of ensuring ample liquidity in the market and maintaining the overnight money market rates within the LAF corridor. In order to do so, the Reserve Bank will, as in the past, employ both conventional and unconventional measures.

69. The Reserve Bank has acted aggressively and pre-emptively on monetary policy accommodation, particularly through interest rate cuts in terms of both magnitude and pace. In the space of just one quarter, the repo rate has been reduced from 9.0 per cent to 5.5 per cent and the reverse repo rate from 6.0 per

cent to 4.0 per cent, thereby bringing down both of them to historically lowest levels. The transmission of the policy interest rate signal has been effective in the money and government securities markets; however, the transmission in the credit market has so far been subdued. Most banks have reduced lending and deposit rates to some extent, but a few have yet to do so. In the Reserve Bank's view, the policy easing done by it in the last few months allows for considerable room for banks to respond more actively to the policy cues.

70. As indicated earlier, the demand for credit from the banking sector has increased as other sources of funds to the commercial sector have shrunk. Available information (as on January 23, 2009) suggests that the total flow of resources to the commercial sector from all sources, estimated at about Rs.4,85,000 crore during the fiscal year 2008-09 so far, has been lower than about Rs.4,99,000 crore in the corresponding period of the previous year. While bank credit has substituted for the shortfall in other sources of funds to some extent, a complete substitution has so far not taken place.

71. Given the uncertain outlook of resource availability from both external and non-bank domestic sources, the Reserve Bank has raised its indicative projection of total flow of credit from the banking sector to the commercial sector to 24.0 per cent for 2008-09 from 20.0 per cent envisaged in the Annual Policy Statement. With a view to enabling banks to sustain the current level of credit flow alongside an enhanced government market borrowing programme, the Reserve Bank's monetary operations will be conducted so as to be consistent with the revised indicative money supply projection of 19.0 per cent for 2008-09, higher than the 16.5-17.0 per cent envisaged in the Annual Policy Statement.

72. To arrest the moderation in economic growth, it is critical that banks expand the flow of credit to productive sectors of the economy and do so at viable rates. At the same time, banks should monitor their loan portfolios and take early action to prevent delinquencies down the road, and safeguard the gains of the last several years in improving asset quality. The Reserve Bank appreciates that risk management is a difficult task in normal circumstances; it is even more challenging in an environment of uncertainty and downturn. Towards this shared endeavour of maintaining the flow of credit to productive sectors, the

Reserve Bank will take calibrated monetary policy actions as necessary and at the appropriate time.

73. Although the origins of the crisis are common around the world, the crisis has impacted different economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector. In emerging economies, the transmission of external shocks to domestic vulnerabilities has typically been from the real sector to the financial sector. Countries have responded to the crisis depending on their specific country circumstances. In particular, while policy responses in advanced economies have had to contend with both the financial crisis and recession, in India, the policy response has been predominantly driven by the need to arrest moderation in economic growth. Our ability to respond has been facilitated by the continued smooth functioning of our financial markets and the well-capitalised and healthy banking system. Thus, even as policy responses across countries are broadly similar, their precise design, quantum, sequencing and timing have varied. This has been the case with India too. While we have certainly studied and evaluated measures taken by other central banks around the world, we have calibrated and designed our responses keeping in view India's specific economic context.

Policy Stance

74. Keeping in view the above assessment of the global scenario and domestic economy, particularly the outlook on growth and inflation, the stance of monetary policy for the rest of 2008-09 will be as follows:

- Provision of comfortable liquidity to meet the required credit growth consistent with the overall projection of economic growth.
- Respond swiftly and effectively with all possible measures as warranted by the evolving global and domestic situation impinging on growth and financial stability.
- Ensure a monetary and interest rate environment consistent with price stability, well-anchored inflation expectations and orderly conditions in financial markets.

75. Given the uncertain outlook on the global crisis, it is difficult to precisely anticipate every development. The Reserve Bank will continue to maintain vigil, monitor domestic and global developments, and take swift and effective action to minimise the impact of the crisis and restore the economy to its potential growth path with price stability. The response to the Reserve Bank's policy actions over the last several months is still unfolding. As demonstrated in the recent past, the Reserve Bank will act swiftly and decisively as and when evolving external and domestic conditions so warrant.

III. Monetary Measures

Bank Rate

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

Repo Rate/Reverse Repo Rate

77. The repo rate under the LAF has been kept unchanged at 5.5 per cent.

78. The reverse repo rate under the LAF has been kept unchanged at 4.0 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, if deemed fit, 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 kept unchanged at 5.0 per cent of NDTL.

Liquidity Facilities

82. The Reserve Bank has allowed banks to avail liquidity support under the LAF for the purpose of meeting the funding requirements of mutual funds (MFs), non-banking financial companies (NBFCs) and housing finance companies (HFCs) through relaxation in the maintenance of SLR up to 1.5 per cent of their NDTL.

Second, a special refinance facility for scheduled commercial banks (excluding RRBs) was provided by the Reserve Bank on November 1, 2008 under Section 17 (3B) of the RBI Act, 1934 up to 1.0 per cent of each bank's NDTL as on October 24, 2008. Both these facilities are currently available up to June 30, 2009. In order to ensure that banks continue to have flexibility in their liquidity management operations in the current market conditions, it has been decided:

- To extend both the refinance facilities up to September 30, 2009.

Annual Policy Statement 2009-10

83. The Annual Policy Statement for 2009-10 will be announced on April 21, 2009.

Mumbai
January 27, 2009