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RBI Governor announces Third Quarter Review of Annual Statement on Monetary Policy for 2006-07

Dr. Y Venugopal Reddy, Governor, Reserve Bank of India today presented the Third Quarter Review of Annual Statement on Monetary Policy for the Year 2006-07.

Highlights

- Repo Rate increased to 7.50 per cent from 7.25 per cent.
- Reverse Repo Rate, Bank Rate and Cash Reserve Ratio (CRR) kept unchanged.
- The flexibility to conduct overnight or longer term repo including the right to accept or reject tender(s) under the liquidity adjustment facility (LAF), wholly or partially is retained.
- GDP growth forecast at 8.5-9.0 per cent during 2006-07.
- Inflation to be brought down as close as possible to 5.0-5.5 per cent at the earliest, while continuing to pursue the medium-term goal of a ceiling on inflation at 5.0 per cent.
- Provisioning requirement increased to two per cent for standard assets in the real estate sector, outstanding credit card receivables, loans and advances qualifying as capital market exposure and personal loans (excluding residential housing loans).
- Provisioning requirement increased to two per cent for the banks' exposures in the standard assets category to the non-deposit taking systemically important non-banking financial companies (NBFCs).
- Risk weight increased to 125 per cent for banks' exposure to the non-deposit taking systemically important NBFCs.
- Interest rate ceiling on NRE deposits reduced from 100 basis points to 50 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity.
- Interest rate ceiling on FCNR(B) deposits reduced from LIBOR/SWAP rates to 25 basis points below LIBOR/SWAP rates for respective currency/ maturities.
- Banks are being restrained from granting fresh loans, in excess of Rs. 20 lakh, against NRE and FCNR(B) deposits and being advised not to undertake artificial slicing of the loan amount to circumvent the ceiling.
- Over the remaining part of the year, management of liquidity would receive priority in the policy hierarchy. Consequent upon the tightening of market liquidity, the impact of monetary policy is expected to be stronger than before.

- The Reserve Bank would use all policy instruments, including the CRR, to ensure the appropriate modulation of liquidity in responding to the evolving situation.

- The Reserve Bank will ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank will continue with its policy of active demand management of liquidity through open market operations (OMO) including the MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be:

    - To reinforce the emphasis on price stability and well anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
    - To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
    - To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations and the growth momentum.

Details

Domestic Developments

- Real GDP growth firmed up to 9.1 per cent in the first half of 2006-07 from 8.5 per cent in the first half of 2005-06.

- Inflation, measured by variations in the wholesale price index (WPI) on a year-on-year (Y-o-Y) basis, rose from its end-March 2006 level of 4.1 per cent to the intra-year peak of 6.1 per cent on January 6, 2007 before marginally declining to 6.0 per cent by January 13, 2007.

- Prices of primary articles registered a Y-o-Y increase of 9.3 per cent as on January 13, 2007 as compared with an increase of 5.6 per cent a year ago.

- Manufacturing inflation increased to 5.6 per cent Y-o-Y by January 13, 2007 from 1.9 per cent at the beginning of the current financial year and 2.2 per cent a year ago.

- Inflation, measured by variations in the consumer price index (CPI) for urban non-manual employees, agricultural labourers and rural labourers showed a sharp Y-o-Y increase to 6.9 per cent, 8.9 per cent and 8.3 per cent in December 2006, respectively, from 5.7 per cent, 4.7 per cent and 4.9 per cent, a year ago.

- The Y-o-Y inflation, measured by variations in the CPI for industrial workers was placed at 6.3 per cent in November 2006, higher than 5.3 per cent a year ago.

- The average price of the ‘Indian basket’ of international crude decreased to US $ 51.0 per barrel by January 25, 2007 from US $ 67.9 per barrel in July-September, 2006.

- The Y-o-Y growth in money supply (M_3) at 20.4 per cent on January 5, 2007 was higher than 16.0 per cent a year ago and above the projected trajectory of 15.0 per cent indicated in the Annual Policy Statement for 2006-07.

- The Y-o-Y growth in aggregate deposits at Rs.4,38,037 crore (22.5 per cent) was higher than that of Rs.2,85,182 crore (17.2 per cent) a year ago and was also the highest since 1993-94 on a comparable basis.

- On a Y-o-Y basis, non-food credit expanded by Rs.4,07,735 crore (31.2 per cent) as on January 5, 2007 on top of an increase of Rs.3,11,013 crore (31.2 per cent) a year ago.

- Banks' holdings of Government and other approved securities fell to 28.6 per cent of their net demand and time liabilities as on January 5, 2007 from 32.6 per cent a year ago.

- The average liquidity overhang under the LAF, MSS and Centre's surplus cash balances, which was Rs.89,786 crore in April-June, 2006 and Rs.92,354 crore in July-September, 2006 declined to Rs.84,312 crore in October-December, 2006 and further to Rs. 79,221 crore in January (up to January 23, 2007).

- Stable and orderly conditions in financial markets were interrupted by short episodes of some tightening in the overnight money market in the first half of November and the second half of December with interest rates firming up in almost all segments.

- Bank deposit rates which had increased by 25-175 basis points in October over April 2006, particularly for the longer end, rose further by 25-50 basis points in December over October 2006, and by 25-125 basis points in January 2007 across various maturities.

- The weighted average benchmark prime lending rates (BPLRs) of public sector banks increased from 10.71 per cent in March, 2006 to 11.18 per cent in June, 2006 and further to 11.58 per cent in December, 2006.

- The weighted average BPLRs of private sector banks also increased from 12.37 per cent in March to 12.80 per cent in June and 13.22 per cent in December. The weighted average BPLRs of foreign banks increased from 12.67 per cent to 12.72 per cent during the period.

- The BSE Sensex rallied with intermittent corrections to reach a high of 14,283 on January 25, 2007.

- The gross borrowings of the Central Government at Rs.1,25,000 crore (Rs.1,15,000 crore a year ago) through dated securities during 2006-07 so far (up to January 22, 2007) constituted 83.1 per cent of the budget estimates (BE) while net market borrowings at Rs.91,432 crore (Rs.83,079 crore a year ago) constituted 80.4 per cent of the BE.

External Sector

- Exports (in US dollar terms) recorded a growth of 22.0 per cent during April-December 2006 as compared with 29.9 per cent in the corresponding period of 2005. Imports rose by 24.8 per cent as compared with 37.8 per cent a year ago.

- While petroleum, oil and lubricants (POL) imports rose by 39.2 per cent during April-December 2006 (46.9 per cent a year ago), non-oil import growth decelerated to 18.7 per cent from 34.3 per cent a year ago.

- The foreign exchange reserves rose to US $ 178.1 billion by January 19, 2007 from US $ 151.6 billion at the end of March, 2006.

- The rupee appreciated by 0.8 per cent against the US dollar and by 3.4 per cent against the Japanese yen while it depreciated against euro by 5.5 per cent and against pound sterling by 10.5 per cent during the current financial year so far (up to January 25, 2007).

Global Developments

- According to the IMF's World Economic Outlook of September 2006, global real GDP growth in purchasing power parity terms is expected to accelerate to 5.1 per cent in 2006 from 4.9 per cent in 2005 but will slow down to 4.9 per cent again in 2007.

- In the US, real GDP growth was 2.0 per cent in the third quarter (July-September) as compared with 5.6 per cent and 2.6 per cent in the first and second quarters, respectively. The slowdown was mainly on account of lower residential fixed investment.

- Global growth continues to be strong but is exhibiting mixed patterns. There has been a surge in the international prices of cereals. While headline inflation has been moderating mainly on account of the decline in international crude prices, core inflation has generally remained firm.

- In the global financial markets, risks have become more diversified. The Dow Jones Industrial Average rose to an all-time intraday high on January 24, 2007.

- A number of central banks have raised their policy rates, *inter-alia*, in the UK, Euro area, Australia, China, Korea, Turkey, Saudi Arabia and Iceland. The Government and the People's Bank of China (PBC) have taken a series of measures in a bid to slow down the growth to more sustainable levels and reduce potential inflationary pressures in sensitive sectors.

- Some central banks have paused in their policy cycle, notably in the US, Canada, Japan, Malaysia and Mexico. A few central banks have eased monetary policy rates, such as in Indonesia, Brazil, Chile and Thailand.

Overall Assessment

- There are shifts underway in the patterns of global growth even while inflation expectations remain stable at present.

- There are concerns relating to the uncertainty surrounding international crude prices. While crude prices have moderated recently, geo-political risks remain. Central banks are, by and large, persisting with withdrawal of monetary accommodation.

- While risks to the outlook from the contraction in the US housing market, rising food and metal prices remain, global financial markets remain vulnerable to sudden shifts in expectations and volatility.

- Global factors, by themselves, do not seem to warrant a policy response; however, corporates and financial intermediaries need to be aware of sudden reversals in sentiment in global financial markets unrelated to economic fundamentals, especially if triggered by geo-political factors. Banks are, therefore, advised to ensure the hedging of their exposures and to undertake pre-emptive strategies to insulate their balance sheets from currency and interest rate risks.

- In India, recent developments, in particular, the combination of high growth and firming inflation, coupled with escalating asset prices and tightening infrastructural bottlenecks, have complicated the conduct of monetary policy.

- In recognition of the cumulative and lagged effects of monetary policy, the Reserve Bank began a graduated withdrawal of accommodation in mid-2003 in spite of inflation being within its tolerance band. Since September, 2004 repo/reverse repo rates have been increased by 125/150 basis points, the CRR by 100 basis points; the risk weights for housing loans from 50 per cent to 75 per cent, commercial real estate from 100 per cent to 150 per cent and consumer credit from 100 per cent to 125 per cent. Provisioning requirement for standard advances in specific sectors has been raised to 1.0 per cent.

- The stance of monetary policy has progressively shifted from an equal emphasis on price stability alongside growth to one of reinforcing price stability with immediate monetary measures and to take recourse to all possible measures promptly in response to evolving circumstances.

- Early warning signals emanating from rising inflation in an environment of high money and credit growth indicate that monetary policy is still accommodative, warranting a policy response in terms of a measured increase in interest rates to assuage demand pressures.

- There are also abiding concerns relating to the persistently high credit growth and the potential for erosion in the quality of credit so that balance sheets of banks need to be fortified against the build-up of loan delinquencies by precautionary provisioning and a greater sensitivity to underlying risks by enhancement of risk weights applied to advances to specific sectors in which banks' exposures have been rising at a fast pace.

- There are also indications that capital inflows are likely to be sustained with expansionary effects carrying potential inflationary pressures and attenuating monetary and liquidity management. Therefore, it is important to modulate inflows into non-resident deposit scheme which have recorded sizeable increases during the year so as to ensure effective liquidity management.

Stance of Monetary Policy

- Real GDP growth for 2006-07 is expected to be 8.5-9.0 per cent as compared with 8.0 per cent projected in the Mid-Term Review, and 7.5-8.0 per cent in the Annual Policy Statement and the First Quarter Review.

- The objective of the policy measures being undertaken at the current juncture would be to bring inflation as close as possible to the stated range of 5.0-5.5 per cent at the earliest, while continuing to pursue the medium-term goal of a ceiling on inflation at 5.0 per cent.

- The probability of current levels of international crude prices being maintained is high, though some geopolitical risks remain.

- The conduct of monetary policy is currently confronted with three important issues: first, demand pressures appear to have intensified, reflected in rising inflation, high money and credit growth, elevated asset prices, strains on capacity utilisation, some indications of wage pressures and widening of the trade deficit; second, there are increased supply-side pressures in evidence from prices of primary articles; and third, monetary policy will have to contend with the lagged response of productive capacity and infrastructure to the ongoing expansion in investment.

- Bank credit continues to grow at a rapid pace for the third year in succession and the rates of growth are clearly excessive, warranting measures to moderate growth even after accounting for the relatively low level of credit penetration in our country and the structural transformation of the economy that is underway.

- The continued high credit growth in the real estate sector, outstanding credit card receivables, loans and advances qualifying as the capital market exposure and personal loans, is a matter of concern. It has, therefore, become imperative to increase the provisioning requirement for these standard assets (excluding residential housing loans) to two per cent from one per cent.

- Further, it has been decided to increase the provisioning requirement for the banks' exposures in the standard assets category to the non-deposit taking systemically important non-banking financial companies (NBFCs) to two per cent from 0.4 per cent as also the risk weight for the banks' exposure to such NBFCs to 125 per cent from 100 per cent.

- There is merit in moderating additions to liquidity from large capital inflows and hence, it has been decided to reduce the interest rate ceiling on NRE deposits from 100 basis points to 50 basis points above LIBOR/SWAP rates for US dollar of corresponding maturity, and also to reduce the interest rate ceiling on FCNR(B) deposits from LIBOR/SWAP rates to 25 basis points below LIBOR/SWAP rates for respective currency/ maturities.

- In order to avoid upward pressure on asset prices in sensitive sectors through utilisation of these facilities, banks are being restrained from granting fresh loans, in excess of Rs. 20 lakh, against the NRE and FCNR(B) deposits and also being advised not to undertake artificial slicing of the loan amount to circumvent the ceiling.

- Over the remaining part of the year, management of liquidity would receive priority in the policy hierarchy. Consequent upon the tightening of market liquidity, the impact of monetary policy is expected to be stronger than before.

- The Reserve Bank would use all policy instruments, including the CRR, to ensure the appropriate modulation of liquidity in responding to the evolving situation; and to ensure the maintenance of price stability.

- The Reserve Bank will ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, particularly for productive purposes, consistent with the objective of price and financial stability. Towards this end, the Reserve Bank will continue with its policy of active demand management of liquidity through open market operations (OMO) including the MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy in the period ahead will be:

    - To reinforce the emphasis on price stability and well anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.

    - To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.

    - To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations and the growth momentum.

Monetary Measures

- Repo Rate under the LAF is increased by 25 basis points from 7.25 per cent to 7.50 per cent with immediate effect.
- The Reserve Bank retains the option to conduct overnight repo or longer term repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility 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.
- Reverse Repo Rate and Bank Rate have been kept unchanged at 6.0 per cent.
- CRR has been kept unchanged at 5.5 per cent.

The Annual Policy Statement for the year 2007-08 will be announced on April 24, 2007.

Alpana Killawala
Chief General Manager

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