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RESERVE BANK OF INDIA

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Governor, Dr. D. Subbarao's Press Statement on Stance of Monetary Policy for the Remaining Period of 2008-09

"This Mid-Term Monetary Policy Review of the Reserve Bank of India is set in the context of several complex and compelling policy challenges. The global financial system is in a crisis of unprecedented dimensions. Across the world, there have been severe disruptions in money markets, sharp declines in stock markets and extreme risk aversion in financial markets. Governments, central banks and financial regulators around the world are responding to the crisis with aggressive, radical and unconventional measures to restore confidence and stabilize the markets.

2. India's financial sector is stable and healthy. Indian banks do not have direct financial exposure to the US sub-prime assets. Foreign subsidiaries and foreign branches of Indian banks have suffered some mark-to-market losses on financial instruments due to the general widening of credit spreads. These losses are modest relative to the size of their business. Adequate provisioning has been made for these. The overall capital adequacy ratio of commercial banks in India is 12.7 per cent, well above the regulatory minimum of 9 per cent and the Basel Accord requirement of 8 per cent. Furthermore, the regulatory mandate of 25 per cent as SLR and 6.5 per cent as CRR provides an inherent strength to the Indian banks. The most prominent symptom of the problem in the financial sectors of advanced countries has been the freezing up of inter-bank markets. On the contrary, the inter-bank market in India has been functioning in an orderly manner.

3. Nevertheless, the global developments have had indirect, knock-on effects on domestic financial markets. Money markets have experienced unusual tightening of liquidity in recent weeks as a result of global developments which were amplified by transient local factors such as advance tax payments. The foreign exchange market has experienced pressure on account of FII portfolio outflows and the enhanced foreign exchange requirements of oil and fertiliser companies. Constraints in access to external financing as also repricing of risks and higher spreads resulted in additional demand from corporates for domestic bank credit with attendant hardening of interest rates across the spectrum.

4. In the wake of the stress on our financial markets as a result of the global financial crisis, the Reserve Bank announced a series of measures starting mid-September 2008 to ease both domestic and foreign exchange liquidity. The following are the more important ones:

- CRR was reduced by a cumulative 250 basis points effective from the fortnight beginning October 11.
- As an *ad hoc* and temporary measure, banks have been allowed to avail of additional liquidity support under the LAF up to one per cent of their net demand and time liabilities (NDTL).

- A special 14-day repo facility for an amount of Rs.20,000 crore has been instituted to alleviate liquidity stress faced by mutual funds, and banks have been allowed access to a special LAF window up to an additional 0.5 per cent of NDTL exclusively for this purpose.

- Reserve Bank provided an advance of Rs.25,000 crore to financial institutions under the Agricultural Debt Waiver and Debt Relief Scheme pending release of money by the Government.

- The interest rate ceilings on FCNR (B) and NR(E)RA term deposits were increased by 100 basis points each.

- The Reserve Bank also announced that it would institute special market operations to meet the foreign exchange requirements of public sector oil market companies against oil bonds when they become available.

5. In order to alleviate the pressures on domestic credit markets brought on by the indirect impact of the global liquidity constraints and, in particular, to maintain financial stability, it was decided on October 20, 2008 to reduce the repo rate under the Liquidity Adjustment Facility (LAF) by 100 basis points to 8.0 per cent with immediate effect.

6. The measures indicated above have substantially eased the liquidity stress in domestic financial markets. The total liquidity support provided through reductions in the CRR, the temporary accommodation under the SLR and the advance under the agricultural debt relief scheme is of the order of Rs.1,85,000 crore. In the inter-bank call money market, rates have softened from well above the repo rate to a level just above the reverse repo rate. The LAF window saw a mode reversal from a net injection of over Rs.90,000 crore on October 1, 2008 to a net absorption through reverse repos of over Rs.35,000 crore on October 23, 2008. Yields in the benchmark 10 year G-Secs dropped from 8.3 per cent on October 3, 2008 to 7.58 per cent on October 23, 2008. It is expected that the cut in the repo rate effected on October 20, 2008 will further ease the constraints in money and credit markets.

7. The task of monetary policy has always centred around managing a judicious balance between price stability, sustaining the growth momentum and maintaining financial stability. The relative emphasis across these objectives has varied from time to time depending on the underlying macroeconomic conditions. Prudent regulatory surveillance and effective supervision have ensured that our financial sector has been and continues to be robust. The global financial turmoil has, however, reinforced the importance of putting special emphasis on preserving financial stability. At the same time, inflation, which is still in double digits and moderation in growth continue to be critical policy concerns. Consequently, the central task for the conduct of monetary policy has become more complex than before, with increasing priority being given to financial stability. The current challenge, accordingly, is to strike an optimal balance between preserving financial stability, maintaining price stability, anchoring inflation expectations, and sustaining the growth momentum.

8. The global downturn may be deeper, and the recovery longer, than expected earlier. Consequently, the adverse implications through trade and financial channels for emerging economies, including India, have amplified. These adverse developments are overlaid on the moderation of growth in industry and services sectors in the first half of 2008-09. Taking these developments and prospects into account, the Reserve Bank has revised the projection of overall real GDP growth for 2008-09 to a range of 7.5-8.0 per cent.

9. Globally, pressures from commodity prices, including crude, appear to be abating, though they continue to rule at elevated levels. Domestically, prices of food articles are moderating and the beneficial effects of the south-west monsoon should enable a further easing in the coming months. There are also incipient signs of some softening in prices of manufactured goods. Keeping in view the supply management measures taken by the Government and the lagged demand response to the monetary policy measures taken by the Reserve Bank over the last one year, RBI maintains its earlier projection of inflation of 7.0 per cent by end-March 2009.

10. Non-food credit has posted a growth of 29 per cent on a year-on-year basis as of October 10, 2008 which is well beyond the projected level of 20 per cent for 2008-09. Banks should continue to lend for productive purposes and, in particular, permit drawals of sanctioned limits, guided as always by their commercial judgment. It will be in order for banks to consider restructuring the dues of small and medium enterprises on merits. At the same time, they should pay attention to maintaining credit quality. In pursuit of this objective, banks should focus on stricter credit appraisals on a sectoral basis, monitor loan to value ratios and calibrate their credit portfolio in tune with their asset-liability projections. The Reserve Bank will monitor the rate of credit growth and credit quality closely and will, as necessary, engage with select banks which are outliers on the norms.

11. India's balance of payments continues to reflect strength and resilience in a highly unsettled international environment. In the capital account, sustained FDI inflows and higher NRI flows have partly off-set the impact of the FII outflows. Overall, during 2008-09, the current account deficit may be higher and net capital flows lower than during last year, but it is expected that net capital flows would meet the external financing requirements.

12. Given the uncertain global financial situation, monitoring and maintenance of domestic financial stability warrants continuous attention. The Reserve Bank will maintain a close vigil on the entire financial system to prevent pressures building up in the financial markets. This will include enhancing liquidity if pressures persist. This could also mean curtailing liquidity if the recent liquidity easing measures are seen to have injected excess liquidity, thereby stoking inflationary pressures.

13. The global financial situation, described as the worst since the Great Depression, continues to be uncertain and unsettled. No country can remain unscathed in a crisis of this proportion. This is uncharted territory and experience to date has evidenced the need to go beyond standard or conventional solutions. The Reserve Bank has endeavoured to be proactive, and has taken measures to manage the rapid developments and ease pressures stemming from the global crisis. The Reserve Bank reiterates that it is confident of managing the situation and of minimising the adverse impact of the global crisis on the Indian economy. Our financial system is healthy and resilient, and our economic fundamentals are strong. Once the global situation is stabilised, and calm and confidence are restored, we will return to our higher growth trajectory.

14. Based on the above overall assessment of the macroeconomic situation, the stance of monetary policy for the rest of 2008-09 will be as follows:

- Ensure a monetary and interest rate environment that optimally balances the objectives of financial stability, price stability and well-anchored inflation expectations, and growth;

- Continue with the policy of active demand management of liquidity through appropriate use of all instruments including the CRR, open market operations (OMO), the MSS and the LAF to maintain orderly conditions in financial markets;

- In the context of the uncertain and unsettled global situation and its indirect impact on the domestic economy in general and the financial markets in particular, closely and continuously monitor the situation and respond swiftly and effectively to developments, employing both conventional and unconventional measures;

- Emphasise credit quality and credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

15. Against the backdrop of recent global and domestic developments and in the light of measures taken by the Reserve Bank over the last month, we have kept the Bank Rate, the repo rate and the reverse repo rate under the LAF and the cash reserve ratio (CRR) unchanged for the present. The Reserve Bank is closely and continuously monitoring the evolving macroeconomic and financial conditions, globally and domestically, and will respond to evolving circumstances proactively and swiftly."

G. Raghuraj
Deputy General Manager

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