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Third Quarter Review of Monetary Policy 2009-10: Press Statement by Dr. D. Subbarao, Governor

"This morning, I had a meeting with the chiefs of major banks where we released and disseminated the Third Quarter Review of RBI's monetary policy. First a few words on the response of the banks before I give an overview of the macroeconomic situation and the Reserve Bank's policy stance.

Banks generally welcomed the Reserve Bank's policy stance. They indicated that the monetary measures announced by the Reserve Bank may not put immediate pressure on lending rates. Apart from monetary policy, discussions centred around specific issues such as (i) credit growth and monetary transmission; (ii) government market borrowing programme; (iii) infrastructure financing; and (iv) financial inclusion. Banks felt that credit growth prospects remain favourable going forward. They emphasised the need to expand their capital to sustain their lending operations in future. Banks indicated that they have reduced their lending rates responding to earlier monetary easing by the Reserve Bank. Consequently, their net interest margins have come under pressure. Non-performing assets (NPAs) are expected to increase, particularly from the restructured assets. They felt that if the government borrowings next year are large, they could put pressure on resources and interest rates as credit is expected to pick up significantly. Banks were concerned about their growing exposure to the infrastructure sector and suggested that policy intervention is required from the Government and the Reserve Bank to address the issue of the asset-liability mismatch and exposure in their balance sheets. Finally, banks assured the Reserve Bank that they share its commitment to financial inclusion and indicated that they are working on expanding banking facilities in unbanked areas.

Global Economy

The global economy is showing increasing signs of stabilisation with the Asian region experiencing a relatively stronger rebound. Global economic performance improved during the third and fourth quarters of 2009, prompting the IMF to reduce the projected rate of economic contraction in 2009 from 1.1 per cent made in October 2009 to 0.8 per cent in January 2010. The IMF has also revised the projection of global growth for 2010 to 3.9 per cent, up from 3.1 per cent. However, significant risks remain: (i) the recovery is driven largely by government spending in many economies; (ii) commodity and asset prices have risen aided by high levels of global liquidity; and (iii) emerging market economies (EMEs), which are generally recovering faster than advanced economies, are likely to face increased inflationary pressures.

Indian Economy

Growth

The Indian economy showed a degree of resilience as it recorded a better-than-expected growth of 7.9 per cent during the second quarter of 2009-10. Subsequent data releases confirm the assessment that the economy is steadily gaining momentum, though public expenditure continues to play a dominant role, and performance across sectors is uneven, suggesting that recovery is yet to become sufficiently broad-based.

In the Second Quarter Review of October 2009, we projected GDP growth for 2009-10 of 6 per cent with an upside bias. Recent movements in the indicators of real sector activity suggest that the upside bias has materialised. Assuming a near zero growth in agricultural production and continued recovery in industrial production and services sector activity, the baseline projection for GDP growth for 2009-10 is now raised to 7.5 per cent.

Looking ahead to 2010-11, our preliminary assessment of the baseline scenario is that the current growth will be sustained. We shall formally indicate our growth projection for 2010-11 in April 2010.

Inflation

For several months, rapidly rising food inflation has been a cause for concern. There are indications that the sustained increase in food prices is beginning to spill over into other commodities and services as well. The October 2009 Review projected WPI inflation for end-March 2010 of 6.5 per cent with an upside bias. The upside risk in terms of higher food prices reflecting the poor south-west monsoon has already materialised. Some additional factors such as higher global crude prices and less than expected seasonal moderation in food prices have also exerted upward pressure on inflation. Based on the latest evidence, the baseline projection for WPI inflation for end-March 2010 is now raised to 8.5 per cent.

As in the case of growth, we shall formally announce our inflation projection for 2010-11 in April 2010. However, on the assumption of a normal monsoon and global oil prices remaining around the current level, it is expected that inflation will moderate from July 2010. This moderation in inflation will depend on several factors, including the measures taken and to be taken by the Reserve Bank as a part of the normalisation process.

Money and Credit Aggregates

During the current financial year, the year-on-year growth in money supply (M₃) moderated from over 20 per cent at the beginning of the financial year to 16.5 per cent on January 15, 2010, reflecting deceleration in bank credit growth. Year-on-year non-food credit growth recovered to over 14 per cent by mid-January 2010 from the trough of around 10 per cent in October 2009. Corporates had better access to non-bank sources of funds which, to a large extent, mitigated the impact of slowdown in bank credit growth. The indicative adjusted non-food credit growth for 2009-10 is now reduced to 16 per cent from the earlier projection of 18 per cent and M₃ growth during 2009-10 has been reduced to 16.5 per cent for policy purposes from the earlier projection of 17 per cent.

Financial Markets

Financial markets continued to remain orderly and overnight money market rates remained below or close to the lower bound of the liquidity adjustment facility (LAF) rate corridor as liquidity conditions remained comfortable. Despite large government borrowings, yields remained contained due to lower credit demand, open market operations (OMO) and active liquidity management by the Reserve Bank. Equity markets are behaving in a manner consistent with global patterns.

Risk Factors

While the baseline scenario is comforting, a number of downside risks to growth and upside risks to inflation need to be recognised. These include (i) uncertainty about the pace and shape of the global recovery; (ii) the surge in oil prices, if global recovery is stronger than expected; (iii) uncertainty about the performance of the south-west monsoon in 2010; (iv) sharp increase in capital flows, above the absorptive capacity of the economy, which may complicate exchange rate and monetary management; and (v) accentuation of inflation expectations, if excess liquidity is allowed to persist in the face of a narrowing output gap. In addition, a bigger risk to both short-term economic management and to medium-term economic prospects emanates from the large fiscal deficit. As the recovery gains momentum, it is important that there is coordination in the fiscal and monetary exits. The reversal of monetary accommodation cannot be effective unless there is also a roll back of government borrowings. It is imperative, therefore, that the government returns to a path of fiscal consolidation which can begin with a phased roll back of the transitory components. Beyond that, the Government should indicate a roadmap for fiscal consolidation and also spell out the broad contours of tax policies and expenditure compression that will define this roadmap.

Monetary Policy Stance

The Reserve Bank announced the first phase of exit from the expansionary monetary policy by terminating some sector-specific facilities and restoring the statutory liquidity ratio (SLR) of scheduled commercial banks to a pre-crisis level in the Second Quarter Review of October 2009. Against the backdrop of the current global and domestic macroeconomic conditions, outlooks and risks, our policy stance is shaped by three important considerations: (i) First, a consolidating recovery should encourage us to clearly and explicitly shift our stance from 'managing the crisis' to 'managing the recovery', and it is necessary to carry forward the process of exit further; (ii) Second, even though the inflationary pressures in the domestic economy predominantly stem from the supply side, the consolidating recovery increases the risks of these pressures spilling over into a wider inflationary process; and (iii) Third, strong anti-inflationary measures may undermine the recovery which is yet to fully take hold.

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

- Anchor inflation expectations and keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments as warranted.
- Actively manage liquidity to ensure that credit demands of productive sectors are adequately met consistent with price stability.

- To maintain an interest rate environment consistent with price stability and financial stability, and in support of the growth process.

Monetary Policy Measures

Our Third Quarter Review specifies the following monetary measures:

- (i) The cash reserve ratio (CRR) of scheduled banks has been increased by 75 basis points in two stages from 5.0 per cent to 5.75 per cent of their net demand and time liabilities (NDTL). As a result of the CRR increase, about Rs.36,000 crore of excess liquidity will be absorbed from the system.
- (ii) The policy rates, both the repo rate and the reverse repo rate have been retained at their current levels.

Expected Outcome

We expect three major outcomes from the above policy action:

- i) Reduction in excess liquidity will help anchor inflationary expectations.
- ii) The recovery process will be supported without compromising price stability.
- iii) The calibrated exit will align policy instruments with the current and evolving state of the economy.

Way Forward

The Reserve Bank will continue to monitor macroeconomic conditions, particularly the price situation closely and take further action as warranted."

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