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Third Quarter Review of Monetary Policy 2010-11
Press Statement by Dr. D. Subbarao, Governor

"This morning, the Reserve Bank released its Third Quarter Review of Monetary Policy for 2010-11. Based on an assessment of the current macroeconomic situation, we decided to:

- increase the repo and reverse repo rates by 25 basis points (bps) each. Accordingly, the repo rate stands at 6.5 per cent and the reverse repo rate at 5.5 per cent;
- retain the cash reserve ratio (CRR) at 6 per cent of net demand and time liabilities (NDTL) of banks.

2. With the increases announced today, since mid-March 2010, the Reserve Bank has cumulatively increased the repo rate by 175 bps and the reverse repo rate by 225 bps. Additionally, the CRR was increased by 100 bps. Banks have responded to this calibrated tightening by raising their deposit and lending rates, suggesting strong monetary policy transmission.

3. In addition to changes in the policy rates, we made some decisions to manage the current liquidity situation. We decided to extend the two special measures currently in operation, viz.:

- the additional liquidity support to scheduled commercial banks under the liquidity adjustment facility (LAF) to the extent of up to one per cent of their NDTL; and
- a daily second LAF up to April 8, 2011.

Considerations Behind the Policy Move

4. Let me now explain the considerations that guided our monetary policy stance for the remaining period of 2010-11:

i) Inflation is clearly the dominant concern. Even as the rate itself remains unacceptably high, the reversal in the direction of inflation is striking. Primary food articles inflation has risen again sharply. Non-food articles inflation and fuel inflation are already at elevated levels. Non-food manufacturing inflation has remained sticky. There are signs of food and fuel price increases spilling over into generalised inflation.

ii) Second, there has been a sharp rise in global commodity prices which has heightened upside risks to domestic inflation.

iii) Third, growth has moved close to its pre-crisis trajectory even in the face of an uncertain global recovery.

iv) Fourth, the uncertainty with regard to global recovery has reduced.

Global Outlook

5. Let me now give you a brief overview of the global economy. Advanced economies are showing firmer signs of sustainable recovery. Although uncertainty continues in the Euro area, there is an overall improvement in global growth prospects. However, inflation has edged up in major advanced economies even as a large slack persists, owing mainly to increase in food and energy prices. Whereas signs of inflation in the advanced countries are only incipient, many emerging market economies have been facing strong inflationary pressures, reflecting higher international commodity prices and rising domestic demand pressures. Significantly, food, energy and commodity prices are widely expected to harden during 2011, driven by a combination of supply constraints and rising global demand, as the advanced economies consolidate their recovery. This suggests that inflation could be a global concern in 2011.

The Indian Economy

Growth

6. Turning to the domestic macroeconomic situation, the 8.9 per cent GDP growth in the first half of 2010-11 suggests that the economy is operating close to its trend growth rate, powered mainly by domestic factors. The *kharif* harvest has been good and *rabi* prospects look promising. Good agricultural growth has boosted rural demand. Export performance in recent months has been encouraging.

7. With the risks to growth in 2010-11 being mainly on the upside, the baseline projection of real GDP growth is retained at 8.5 per cent but with an upside bias.

Inflation

8. Moving on to the inflation situation, the moderation in headline inflation observed between August and November 2010 was along the projected trajectory of the Reserve Bank. This trend, however, reversed when WPI inflation (year-on-year) moved up from 7.4 per cent in November 2010 to 8.4 per cent in December 2010, due mainly to sharp increase in the prices of vegetables, mineral oils and minerals.

9. While the current spike in food prices is expected to be transitory, inflation stemming from structural demand-supply mismatches in several non-cereal food items such as pulses, oilseeds, eggs, fish, meat and milk is likely to persist till supply response kicks in. Non-food manufacturing inflation also remains above its medium-term trend of 4 per cent.

10. Going forward, the inflation outlook will be shaped by three factors: (i) on how the food price situation, both domestic and global, evolves; (ii) how global commodity prices behave; and (iii) the extent to which demand side pressures may manifest.

11. We have raised the baseline projection of WPI inflation for March 2011 from 5.5 per cent to 7.0 per cent. This upward revision was based on several considerations. First, the upside risks to inflation, as mentioned in the mid quarter review of December 2010, have materialised as reflected in the increase in prices of metals and non-administered fuel. Second, there have been some transitory supply shocks which triggered a sharp increase in vegetable prices. Third, petroleum and

aviation turbine fuel prices went up in early January which will add 9 bps to WPI inflation. While the impact of transitory factors is expected to dissipate, price pressures on account of demand-supply imbalances in respect of some commodities will persist.

Monetary and Liquidity Conditions

12. While the year-on-year money supply (M_3) growth at 16.5 per cent in December 2010 was close to the indicative projection of 17.0 per cent, non-food credit growth at 24.4 per cent was much above the indicative projection of 20.0 per cent. Credit expansion in the recent period has been rather sharp, far outpacing the expansion in deposits. Rapid credit growth without a commensurate increase in deposits is not sustainable.

13. Tight liquidity conditions persisted throughout the third quarter of 2010-11. While the overall liquidity in the system has remained in deficit consistent with the policy stance, the extent of tightness is beyond the comfort zone of the Reserve Bank, *i.e.*, (+)/(-) one per cent of NDTL of banks. Above-normal government cash balances contributed to the frictional component of liquidity deficit. However, the widening difference between credit and deposit growth rates coupled with high currency growth accentuated the structural liquidity deficit.

14. The Reserve Bank instituted a number of measures to mitigate the liquidity deficit such as: (i) reduction in the statutory liquidity ratio (SLR) of scheduled commercial banks (SCBs) by one percentage point; (ii) conducting open market operation (OMO) purchase of government securities of the order of over ₹67,000 crore; (iii) additional liquidity support to SCBs under the LAF; and (iv) introduction of a second LAF window on a daily basis.

15. While the Reserve Bank will endeavour to provide liquidity to meet the productive credit requirements of a growing economy, it is important that credit growth moderates to conform broadly to the indicative projection. This will prevent any further build-up of demand side pressures. Accordingly, the projection for 2010-11 of M_3 growth has been retained at 17 per cent and that for non-food credit growth at 20 per cent. The Reserve Bank will constantly monitor the credit growth and, if necessary, engage with banks which show an abnormal incremental credit-deposit ratio.

External Sector

16. A brief, *albeit* important, comment about the external sector. In the first half of 2010-11, the current account deficit (CAD) expanded to 3.7 per cent of GDP from 2.2 per cent in the corresponding period of last year. Subsequent trade data indicate that exports have grown faster than imports which will improve the CAD. For the year as a whole, we estimate that the CAD will be close to 3.5 per cent of GDP.

Risk Factors

17. Now let me highlight the risks to our growth and inflation projections:

- Food inflation has remained at an elevated level for about two years and the prospect of it spilling over to the general inflation process is rapidly becoming a reality.
- Imports as a means to supplement domestic availability for many commodities will become less of an option as global growth consolidates

and capacity utilisation increases. This may accentuate demand side pressures.

- The estimated current account deficit of 3.5 per cent of GDP for 2010-11 is not sustainable.
- On top of the level of CAD which is a risk, the financing of CAD is an additional risk. Should global recovery be faster than expected, it may also have implication for the financing of CAD.
- The recent improvement in the fiscal situation owes largely to one-off revenues generated from spectrum auctions and disinvestment proceeds. However, the commodity price developments pose significant risks for fiscal consolidation in the year ahead. The efficacy of further fiscal adjustment will be influenced by the firming trend in commodity prices and the extent to which Government will allow this to pass through to consumers.
- The combined risks from inflation, CAD and fiscal situation contribute to an increase in uncertainty about economic stability that consumers and investors have to deal with.

Monetary Policy Stance

18. The current stance of monetary policy is intended to:

- Contain the spill-over of high food and fuel inflation into generalised inflation and anchor inflationary expectations, while being prepared to respond to any further build-up of inflationary pressures.
- Maintain an interest rate regime consistent with price, output and financial stability.
- Manage liquidity to ensure that it remains broadly in balance, with neither a surplus diluting monetary transmission nor a deficit choking off fund flows.

Expected Outcomes

19. Today's policy actions are expected to:

- Contain the spill-over from rise in food and fuel prices to generalised inflation.
- Rein in rising inflationary expectations, which may be aggravated by the structural and transitory nature of food price increases.
- Be moderate enough not to disrupt growth.
- Continue to provide comfort to banks in their liquidity management operations.

Guidance

20. Let me now give you some guidance. Current growth and inflation trends clearly warrant that we persist with the anti-inflationary monetary stance. Looking beyond 2010-11, the Reserve Bank expects the domestic growth momentum to stabilise. Inflation is expected to moderate from the first quarter of 2011-12, but several upside risks are already visible. The monetary stance will be determined by how these factors impact the overall inflationary scenario.

Discussions with Banks

21. At today's meeting with bank CEOs where the policy was released, banks welcomed the Reserve Bank's policy stance. They shared the Reserve Bank's concerns about inflation and agreed that the monetary measures and guidance about the stance announced by the Reserve Bank today were appropriate in the current domestic growth-inflation scenario. Apart from monetary measures, discussions with banks centred on: (i) inflation dynamics; (ii) credit growth and asset liability management; and (iii) liquidity management and market borrowing situation. Banks felt that there was a need to step up investment in agricultural infrastructure and focus on better supply chain management. In this context, Indian Banks' Association (IBA) will prepare a Discussion Paper to examine what banks could do to improve finance to enhance productivity and diversification in the agriculture sector. While welcoming the extension of additional liquidity support facility and the second LAF up to April 8, 2011, banks felt that the liquidity situation was still tight and there was a need to inject primary liquidity by the Reserve Bank. Banks indicated that they would endeavour to align the credit growth rate with that of the deposit growth rate. With a view to addressing asset liability mismatches, banks felt that there was a need to look into innovative solutions for financing the infrastructure sector – a major source of asset liability mismatch. In particular, they suggested that there was a need to incentivise raising of long-term resources by banks through appropriate fiscal measures. The recommendations of the Malegam Sub-Committee on the micro-finance sector were also discussed in the meeting."

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