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RESERVE BANK OF INDIA

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Annual Policy Statement for the Year 2010-11: Press Statement by Dr. D. Subbarao, Governor

"This morning, I had a meeting with the chiefs of major banks where we announced the Reserve Bank's monetary policy for 2010-11. We had consulted with a wide array of stakeholders in the run up to this policy and took their views on board. Let me briefly summarise the main points of our discussion with the banks before I spell out the Reserve Banks' policy stance.

Meeting with Banks

Banks welcomed the Reserve Bank's policy stance. They agreed that the monetary measures announced by the Reserve Bank today were appropriate given the growth-inflation dynamics. Apart from monetary policy, discussions centred around three specific issues: (i) government market borrowing programme; (ii) financial inclusion; and (iii) infrastructure financing. Banks indicated that the programmed government borrowings may not crowd out private sector demand given the projected level of resources in the system. Banks assured the Reserve Bank that they share their commitment to financial inclusion and indicated that they will work innovatively to promote financial inclusion. Banks were concerned about their growing exposure to the infrastructure sector. Although they welcomed the measures initiated by the Reserve Bank to promote infrastructure financing by banks, they indicated that there is a need to develop alternative sources for financing to supplement the efforts of the banking sector.

Global Context

This monetary policy for 2010-11 is set against a rather complex economic backdrop. Although the situation is more reassuring than it was a quarter ago, uncertainty about the shape and pace of global recovery persists. Private spending in advanced economies continues to be constrained and inflation remains generally subdued making it likely that fiscal and monetary stimuli in these economies will continue for an extended period. Emerging market economies (EMEs) are significantly ahead on the recovery curve, but some of them are also facing inflationary pressures. This has prompted central banks in some EMEs to begin phasing out their accommodative monetary policies.

Indian Economy

Growth

In India, economic recovery, which began around the second quarter of 2009-10, has since shown sustained improvement. Industrial recovery has become more broad-based and is expected to take firmer hold on the back of rising domestic and external demand. After a continuous decline for nearly a year, exports and imports have expanded since October/November 2009. Flow of resources to the commercial sector from both bank and non-bank sources has picked up. Surveys by the RBI as well as others suggest that business optimism has improved. On balance, under the assumption of a normal monsoon and sustained good performance of the industry and services sectors, for policy purposes, the Reserve Bank projects real GDP growth for 2010-11 at 8.0 per cent with an upside bias.

Inflation

The developments on the inflation front are, however**,** worrisome. Headline wholesale price index (WPI) inflation accelerated from 1.5 per cent in October 2009 to 9.9 per cent by March 2010. There has been a significant change in the drivers of inflation in recent months. What was initially a process driven by food prices has now become more generalised. This is reflected in non-food manufactured products inflation rising from (-) 0.4 per cent in November 2009 to 4.7 per cent in March 2010.

Going forward, three major uncertainties cloud the outlook for inflation. First, the prospects of the monsoon in 2010-11 are not yet clear. Second, crude prices continue to be volatile. Third, there is evidence of demand side pressures building up. On balance, keeping in view domestic demand-supply balance and the global trend in commodity prices, the baseline projection for WPI inflation for March 2011 is placed at 5.5 per cent.

Monetary Aggregates

Keeping in view the need to balance the resource demand to meet credit offtake by the private sector and government borrowings, monetary projections have been made consistent with the growth and inflation outlook. For policy purposes, money supply (M_3) growth for 2010-11 is placed at 17.0 per cent. Consistent with this, aggregate deposits of scheduled commercial banks (SCBs) are projected to grow by 18.0 per cent. The growth in non-food credit of SCBs is placed at 20.0 per cent. As always, these numbers are provided as indicative projections and not as targets.

Financial Markets

The overall liquidity remained in surplus though it declined towards the end of the year consistent with the monetary policy stance. Overnight interest rates generally stayed close to the lower bound of the LAF rate corridor. The large market borrowing by the Government put upward pressure on the yields on government securities which was contained by active liquidity management by the Reserve Bank.

Market Borrowings

The Union Budget for 2010-11 has begun the process of fiscal consolidation and the net market borrowing requirement of the Central Government in 2010-11 is budgeted lower than that in the previous year. However, fresh issuance of securities in 2010-11 will be 36 per cent higher than last year. Managing the borrowing is going to be more challenging than in last year for three main reasons.

First, the option for liquidity management through OMO and MSS which we used extensively last year will be limited this year.

Second, private credit demand will pick up, making crowding out a potential possibility.

Finally, inflation pressures are stronger.

Regardless, the Reserve Bank will ensure that credit requirement of both the government and the private sector are met.

Risk Factors

Let me turn to risk factors. While the indicative projections of growth and inflation for 2010-11 may appear reassuring, we need to recognise the major downside risks to growth and upside risks to inflation:

- The prospects of sustaining the global recovery hinge strongly on the revival of private demand which continues to be weak in major advanced economies. While recovery in India is expected to be driven predominantly by domestic demand, a sluggish and uncertain global environment can have an adverse impact.
- If the global recovery gains momentum, commodity and energy prices may harden further which could add to inflationary pressures.
- Any unfavourable monsoon rainfall pattern could exacerbate food inflation, and could also impose a fiscal burden and dampen rural consumer and investment demand.
- The continued accomodative monetary policy in advanced economies is expected to trigger large capital flows into the EMEs, including India. This will pose a challenge for exchange rate and monetary management.

A few comments on the exchange rate management. Our exchange rate policy is not guided by a fixed or pre-announced target or band. Our policy has been to retain the flexibility to intervene in the market to manage excessive volatility and disruptions to the macroeconomic situation. Recent experience has underscored the issue of large and often volatile capital flows influencing exchange rate movements against the grain of economic fundamentals and current account balances. There is, therefore, need to be vigilant against the build-up of sharp and volatile exchange rate movements and its potentially harmful impact on the real economy.

Monetary Policy Stance

The monetary policy response in India since October 2009 has been calibrated to India's specific macroeconomic conditions. In the wake of the global economic crisis, the Reserve Bank pursued an accommodative monetary policy beginning mid-September 2008. This policy instilled confidence in market participants, mitigated the adverse impact of the global financial crisis on the economy and ensured that the economy started recovering ahead of most other economies. However, in view of the rising food inflation and the risk of it impinging on inflationary expectations, the Reserve Bank began the process of exit from the expansionary monetary policy beginning October 2009.

Our monetary policy stance for 2010-11 has been guided by the following three considerations. First, despite the increase of 25 basis points each in the repo rate and the reverse repo rate in mid-March 2010, our real policy rates are still negative. With the recovery now firmly in place, we need to move in a calibrated manner in the direction of normalising our policy instruments. Second, the current episode of inflation, which was triggered by supply side factors, is developing into a wider inflationary process. Demand side pressures are now clearly discernible. There is, therefore, need to ensure that demand side inflation does not become entrenched. The third consideration that informed our monetary policy stance is the need to balance the monetary policy imperative of absorbing liquidity and ensuring that credit is available to both the Government and the private sector.

Against this background, the stance of monetary policy is intended to:

- Anchor inflation expectations, while being prepared to respond appropriately, swiftly and effectively to further build-up of inflationary pressures.
- Actively manage liquidity to ensure that the growth in demand for credit by both the private and public sectors is satisfied in a non-disruptive way.
- Maintain an interest rate regime consistent with price, output and financial stability.

Monetary Policy Measures

Our Monetary Policy Statement 2010-11 specifies the following monetary measures:

i) The repo rate has been raised by 25 basis points from 5.0 per cent to 5.25 per cent with immediate effect.

ii) The reverse repo rate has been raised by 25 basis points from 3.5 per cent to 3.75 per cent with immediate effect.

iii) The cash reserve ratio (CRR) of scheduled banks has been raised by 25 basis points from 5.75 per cent to 6.0 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning April 24, 2010.

Expected Outcome

We expect four major outcomes from the above policy action:

i) Inflation will be contained and inflationary expectations will be anchored.

ii) The recovery process will be sustained.

iii) Government borrowing requirements and the private credit demand will be met.

iv) Policy instruments will be further aligned in a manner consistent with the 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.

Developmental and Regulatory Policies

Let me now turn to development and regulatory issues. Over the last several years, the Reserve Bank has undertaken wide ranging financial sector reforms to improve financial intermediation and maintain financial stability. This process has now become more intensive with a focus on drawing appropriate lessons from the global financial crisis and putting in place a regulatory regime that is alert to possible build-up of financial imbalances. The Reserve Bank will further its efforts to improve the efficiency of the financial sector and financial markets while maintaining financial stability. Simultaneously, the Reserve Bank will vigorously pursue the financial inclusion agenda.

I will highlight a few actions we have taken or plan to take in these areas:

Financial Stability

- Publishing the Financial Stability Report on a half-yearly basis. The first report released on March 25, 2010 found that the overall risk to financial stability was limited.

Interest Rates

- Mandating banks to switch over to the system of Base Rate from July 1, 2010 to facilitate better pricing of loans, enhance transparency in lending rates and improve the assessment of monetary policy transmission.

Financial Market Products

- Introducing Interest Rate Futures on 5-year and 2-year notional coupon bearing securities and 91-day Treasury Bills.
- Permitting the recognised stock exchanges to introduce plain vanilla currency options on spot US Dollar/Rupee exchange rate for residents.
- Introducing a reporting platform for secondary market transactions in CDs and CPs.
- Setting up a Working Group to work out the modalities for an efficient, single-point reporting mechanism for all OTC interest rate and forex derivative transactions.

Credit Delivery and Financial Inclusion

- Permitting banks to engage any individual as banking correspondents (BCs) subject to banks' comfort level and their carrying out suitable due diligence.
- Discussing with individual banks their Financial Inclusion Plans (FIPs) and monitoring their implementation.
- Mandating banks not to insist on collateral securities in case of loans up to Rs.10 lakhs as against the present limit of Rs.5 lakhs extended to all units in the MSEs sector.
- Urging banks to keep in view the recommendations made by the High Level Task Force constituted by the Government of India for increasing the flow of credit to the MSE sector, particularly to micro enterprises. The Reserve Bank will monitor the performance of banks in this regard.
- Constituting a Committee to gather information on the working of grassroot level rural co-operatives for assessing their potential to contribute to financial inclusion.
- Setting up a Committee for studying the advisability of granting new urban co-operative banking licences.
- Allowing well-managed UCBs to set up off-site ATMs without seeking approval through the annual business plans.

Regulatory Measures

- Preparation of a discussion paper on the mode of presence of foreign banks through branch or wholly owned subsidiary by September 2010.
- Putting out a discussion paper marshalling the international practices, Indian experience and also the extant ownership and governance guidelines for considering additional banking licences to private sector players by end-July 2010.

- Constituting a Working Group to recommend a roadmap for the introduction of a holding company structure.
- Treating annuities under build-operate-transfer (BOT) model in respect of road/highway projects and toll collection rights in some situations as tangible securities subject to certain conditions.
- Allowing securitisation companies/reconstruction companies (SCs/RCs) to acquire the assets either in their own books or directly in the books of the trusts set up by them.
- Issuing comprehensive guidelines based on Financial Stability Board (FSB) principles on sound compensation practices by end-June 2010.
- Entering into bilateral MoU with overseas supervisory authorities within the existing legal provisions, consistent with the Basel Committee on Banking Supervision (BCBS) principles.
- Treating Core Investment Companies (CICs) having an asset size of Rs.100 crore and above as systemically important core investment companies. Such companies be required to register with the Reserve Bank.

Customer Service

- Setting up a Committee to look into banking services rendered to retail and small customers.
- Further strengthening the mechanism for implementing the Reserve Bank’s guidelines on customer service, through on-site and off-site inspections.
- Requiring banks to devote exclusive time in a Board meeting once every six months to review and deliberate on customer service."

G. Raghuraj
Deputy General Manager

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