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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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First 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 announced the monetary policy of the Reserve Bank for the remaining period of 2009-10 in the light of the macroeconomic developments so far. The meeting also provided a valuable opportunity for the Reserve Bank and the commercial banks to understand and appreciate each other's perspectives.

Bankers generally welcomed the Reserve Bank's policy stance. They felt that the status quo on policy rates would anchor interest rate expectations that could spur investment demand. They indicated that they are seeing signs of revival in the domestic economy and expect credit demand to pick up in the second half of the year. In this context, I emphasised the need to increase the flow of credit, particularly to agriculture and micro, small and medium enterprises. Banks were concerned that their liability structure is getting shorter with the reduction in the term structure of deposits, while the asset structure is getting elongated on account of the increasing share of long-term loans, particularly infrastructure. Several banks also indicated that the share of current and savings (CASA) deposits has been declining, which would put pressure on their net interest margins (NIM). As regards credit quality, banks were of the view that non-performing assets (NPAs) are expected to increase, particularly, in the unsecured segments, although they will remain manageable. Going forward, public sector banks emphasised the need for raising capital as risk-weighted assets expand in their asset portfolio.

Global Economy

The global economy is showing incipient signs of stabilisation, *albeit* not recovery. The pace of decline in economic activity in several major advanced economies has slowed, frozen credit markets have thawed and equity markets have begun to recover. Recent months have also witnessed industrial activity reviving in a number of emerging market economies. Notwithstanding some positive signs, the path and the time horizon for global recovery remain uncertain in the light of subdued consumption demand, increased unemployment levels and in anticipation of further contraction in global trade and private capital flows. Business and consumer confidence are yet to show definitive signs of revival but the financial sector appears to be stabilising in response to concerted actions taken by governments and central banks across the world, economic recession in the real sector persists. According to the latest assessment by the International Monetary Fund (IMF), the global economy is projected to shrink by 1.4 per cent in 2009 before recovering and expanding by 2.5 per cent in 2010. The IMF, however, upgraded the growth outlook for developing Asia citing improved prospects in China and India.

The Crisis and India

The Indian economy experienced a significant slowdown in 2008-09, in comparison with the robust growth performance in the preceding five years, largely due to the knock-on effect of the global financial crisis. India's exports contracted during eight straight months which, in turn, impacted the industrial sector and the services sector. The financial sector, however, remained relatively unaffected despite the severe stress created by the global deleveraging process, which triggered capital outflows in the second half of 2008-09.

Quick and aggressive policy responses both by the Government and the Reserve Bank mitigated the impact of the global financial crisis. The large domestic demand bolstered by the government consumption, provision of forex and rupee liquidity coupled with sharp cuts in policy rates, a sound banking sector and well-functioning financial markets helped cushion the economy from the worst impact of the crisis. There are now progressive signs of recovery in India: food stocks have increased; industrial production has turned positive; corporate performance has improved; business confidence surveys are optimistic; leading indicators show an upturn; interest rates have declined; credit off-take has picked up after May 2009; stock prices have rebounded; the primary capital market has witnessed some activity; and external financing conditions have improved. On the other hand, there are some negative signs: delayed and deficient monsoon; food price inflation; rebound in global commodity prices; continuing weak external demand; and high fiscal deficit.

Monetary Policy Action

We have adjusted the policy rates several times in the last ten months. Currently, the repo rate is at 4.75%, the reverse repo at 3.25%, and the CRR at 5%. Consistent with our current assessment of macroeconomic and monetary conditions, we have decided to keep all these rates unchanged.

Reserve Bank's Policy Thrust

The thrust of the various policy initiatives by the Reserve Bank since mid-September 2008 has been on providing ample rupee liquidity, ensuring comfortable dollar liquidity and maintaining a market environment conducive for the continued flow of credit to all productive sectors. These actions have resulted in augmentation of actual/potential liquidity of over Rs.5,61,700 crore. The liquidity situation has remained comfortable since mid-November 2008 as evidenced by the LAF window where the Reserve Bank has been absorbing nearly Rs.1,20,000 crore on a daily average basis during the current financial year. The liquidity expansion has been consistent with the Reserve Bank's stance of ensuring a policy regime that will enable credit expansion at viable rates while preserving credit quality.

Interest Rate Response from Banks

As liquidity remains ample, the competitive pressure on banks to reduce lending rates has increased. Consequently, the transmission of policy rate changes to bank lending rates has improved since the last Annual Policy Statement in April 2009. As the short-term deposits contracted earlier at high rates mature and get repriced, it opens up room for banks to further reduce their lending rates.

Government Borrowing

As a result of the disruption caused by the crisis, the Government deviated from the road map for fiscal consolidation set by the FRBM Act. The deficit indicators deteriorated sharply in 2008-09 and are projected to be even higher in 2009-10. The combined net market borrowings of the Central and State Governments in 2008-09 were nearly two and half times their net borrowings in 2007-08. These are budgeted to increase further by nearly 34 per cent in 2009-10. Management of the large market borrowing programme in a non-disruptive manner requires active liquidity management and, accordingly, the Reserve Bank indicated its intention to purchase government securities under open market operations (OMO) for an indicative amount of Rs.80,000 crore during the first half of 2009-10.

During the first half of 2009-10, net market borrowing of the Central Government through dated securities will be Rs.2,65,911 crore, of which nearly 63 per cent (Rs.1,67,911 crore) has been completed by July 27, 2009 and an additional amount of Rs.28,000 crore has been raised through de-sequestering MSS balances. The open market operations (OMO) undertaken so far have been of the order of Rs.33,439 crore, accounting for about 42 per cent of the notified amount of Rs.80,000 crore. There is, therefore, sufficient headroom available to the Reserve Bank to manage the balance borrowing smoothly. It may be noted in this context that during the first half of 2009-10, proposed OMO purchases and MSS unwinding will add primary liquidity of Rs.1,50,000 crore, which by way of monetary impact is equivalent to reduction of CRR by over 3.5 percentage points.

Growth Outlook

On current assessment, the growth projection for GDP for 2009-10 is placed at 6.0 per cent with an upward bias. This updated growth projection thus marks a slight improvement over the growth expectation of around 6.0 per cent indicated in the Annual Policy Statement. The overall macroeconomic scenario continues to be uncertain, although it is expected that the fiscal and monetary stimulus measures will supplement domestic demand in 2009-10. On balance, an uptrend in the growth momentum is unlikely before the middle of 2009-10.

Inflation Outlook

Let me now turn to the inflation prospects. WPI inflation for end-March 2010 is projected at around 5.0 per cent ─ higher than the projection of 4.0 per cent made in the Annual Policy Statement of April 2009. As anticipated, the WPI inflation turned negative in June 2009 due to the statistical base effect and not because of any contraction in demand. However, the sharp decline in WPI inflation has not been commensurately matched by a similar decline in inflation expectations. Within WPI, inflation of primary articles, particularly food articles, remains significantly positive. Moreover consumer price indices (CPIs) have remained elevated, indeed also hardened in recent months. Global commodity prices have rebounded ahead of global recovery and the uncertain monsoon outlook could further accentuate food price inflation.

Risks to Growth and Inflation Outlook

On balance, the risks to the current projections of real GDP growth and inflation for 2009-10 are on the upside. The comfortable levels of foodgrains stocks should help mitigate the risks in the event of price pressures from the supply side. The Reserve Bank will also closely monitor the level of liquidity so as to contain inflationary expectations if supply side price pressures were to rise.

Money Supply

In order to ensure that the increased Government market borrowing programme does not crowd out credit flow to the private sector, the projection of money supply (M_3) growth for 2009-10 has been raised to 18 per cent from 17 per cent indicated in the Annual Policy Statement. Consistent with this, aggregate deposits and adjusted non-food credit of commercial banks are projected to grow by 19 per cent and 20 per cent respectively. As always, these numbers are provided as indicative projections and not as targets.

Challenges on the Way Forward

There are several immediate and medium term challenges facing the economy as highlighted below:

- The first challenge is to manage the balance between the short-term compulsions of providing ample liquidity and the potential build-up of inflationary pressure on the way forward by maintaining the accommodative monetary stance till demand conditions further improve and credit flow takes hold. But we need to be ready with a roadmap to reverse the expansionary stance quickly and effectively thereafter.
- The second challenge is to manage the Government's large borrowing programme without crowding out present or potential private credit demand. Despite active liquidity management by the Reserve Bank, the large and abrupt increase in government borrowing has resulted in hardening of yields which clearly militated against the low interest rate regime that the economy requires in the current situation.
- The third challenge is to maintain policy rates and liquidity conditions conducive for spurring private investment demand, which has been dented by the crisis.
- The fourth challenge is to restore the fiscal consolidation process by laying down the roadmap. Large fiscal deficits, if continued strictly beyond the recovery period, can crowd out private investment and trigger inflationary pressures. The large government borrowing has already led to hardening of yields which have impeded monetary transmission. The Government will, therefore, need to return to a path of fiscal consolidation which will lend credibility to the fiscal stance and also give predictability to economic agents. It is also necessary to focus on the quality of fiscal adjustment even while pursuing quantitative targets.
- Finally, a big medium-term challenge is to improve the investment climate and expand the absorptive capacity of the economy by (i) moving forward with financial sector reforms to promote financial inclusion, further widen and deepen financial markets and strengthen financial institutions while factoring in the lessons of the global economic crisis; and (ii) giving a big thrust to governance reforms, without which it is difficult to inspire the trust and confidence of potential investors.

Monetary Policy Stance

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

- Manage liquidity actively so that the credit demand of the Government is met while ensuring the flow of credit to the private sector at viable rates.
- Keep a vigil on the trends and signals of inflation, and be prepared to respond quickly and effectively through policy adjustments.
- Maintain a monetary and interest rate regime consistent with price stability and financial stability supportive of returning the economy to the high growth path.

The Reserve Bank reiterates that it will maintain an accommodative monetary stance until there are definite and robust signs of recovery. This accommodative monetary stance is, however, not the steady state. On the way forward, the Reserve Bank will have to reverse the expansionary measures to anchor inflation expectations and subdue inflationary pressures while preserving the growth momentum. The exit strategy will be modulated in accordance with the evolving macroeconomic developments."

G. Raghuraj
Deputy General Manager

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