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RESERVE BANK OF INDIA

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई 400001
DEPARTMENT OF COMMUNICATION, Central Office, S.B.S. Marg, Mumbai 400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 2270 3279

वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

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

"This morning, the Reserve Bank released its Second Quarter Review of Monetary Policy for 2010-11. At the heart of the policy was a further increase in the repo and reverse repo rates by 25 basis points each. Accordingly, the repo rate stands raised to 6.25 per cent and the reverse repo rate to 5.25 per cent. The cash reserve ratio (CRR) has been left unchanged at 6 per cent of net demand and time liabilities (NDTL) of banks.

2. With this increase, since we started reversing the monetary policy stance in March 2010, the repo rate has increased by 150 basis points and the reverse repo by 200 basis points.

Considerations Behind Policy Move

3. As always, we had taken into account both global and domestic macroeconomic situation in calibrating this policy move. In particular, we were guided by three considerations.

i) Domestic growth drivers are robust which should help absorb to a large extent the negative impact of any slowdown in global recovery.

ii) Inflation and inflationary expectations remain high as both demand side and supply side factors are at play. Given the spread and persistence of inflation, demand-side inflationary pressures need to be contained and inflationary expectations anchored.

iii) Even though a liquidity deficit is consistent with our anti-inflation stance, it needs to be contained within a reasonable limit to ensure that economic activity is not disrupted.

Global Outlook

4. To start with, a brief comment on the global economy. The fragile and uneven nature of the recovery and large unemployment in advanced economies raise concerns about the sustainability of the global turn around. The slowing momentum of recovery has prompted the central banks of some advanced economies to initiate (or consider initiating) a second round of quantitative easing to further stimulate private demand. While the ultra loose monetary policy of advanced economies may benefit the global economy in the medium-term, in the short-term it will trigger further capital inflows into emerging market economies (EMEs) and put upward pressure on global commodity prices.

Indian Economy

Growth

5. Turning to domestic outlook, the economy is operating close to the trend growth rate, driven mainly by domestic factors. The normal South-West monsoon and its delayed withdrawal have boosted the prospects of both *kharif* and *rabi* agricultural production which should also stimulate rural demand. Most industrial and service sector indicators also point towards sustained growth.

6. Taking into account the good performance of the agriculture sector, and a range of indicators of industrial production and service sector activity, the baseline projection of real GDP growth for 2010-11, for policy purposes, is retained at 8.5 per cent.

Inflation

7. Let me now move to the vital issue of inflation conditions. Notwithstanding some moderation in recent months, headline inflation remains significantly above its medium-term trend, and well above the comfort zone of the Reserve Bank. Food inflation has not shown the expected post-monsoon moderation and has remained persistently elevated for over an year now, reflecting in part the structural demand-supply mismatches in several commodities. This has elevated inflation expectations. The risks of expectations spilling over into prices of other commodities are significant when the economy is growing close to trend. That could potentially offset the recent moderation.

8. Even as non-food manufacturing inflation has moderated, it remains above its medium-term trend. The new WPI series released in September 2010 is a better representative of commodity price levels with an updated base (2004-05=100) and wider coverage of commodities. When we compare the old and new WPI series, inflation at the aggregate level over the medium-term is similar under both series, but there are differences at a disaggregated level. Inflation in primary articles, especially food articles, in the new series has been significantly higher than in the old series, whereas for manufactured products, it has been somewhat lower.

9. Going forward, the inflation outlook will be shaped by three factors: (i) the evolution of food price inflation; (ii) global commodity prices; and (iii) demand pressures stemming from sustained growth amidst tightening capacity constraints in many industries.

10. On balance, inflation is expected to moderate from the present elevated level, reflecting in part, some easing of supply constraints and concerted policy action. In its July Review, the Reserve Bank made a baseline projection of WPI inflation for March 2011 of 6 per cent under the old series of WPI. The baseline projection of WPI inflation for March 2011 has been placed at 5.5 per cent under the new series. This is equivalent to 6 per cent under the old series. Effectively, this means that the Reserve Bank's inflation projection remains unchanged from that made in its July 2010 Review.

Monetary and Liquidity Aggregates

11. The overall liquidity situation has been in the news over the last few weeks. Let me explain the evolving situation and the underlying dynamics.

12. The present tight liquidity is a result of both structural and frictional factors. On the structural side, the deposit growth rate of the banking system has been sluggish even as the credit growth improved. On the frictional side, government cash balances had built up as a result of more than anticipated tax receipts. On top of it, there were large capital outflows on account of refund of over-subscription of Coal India IPO.

13. Tight liquidity conditions are admittedly desirable from the viewpoint of inflation management, but there are legitimate concerns about the deficit as the injection through the LAF window had become too large in recent weeks, in excess of the Reserve Bank's comfort zone of (+/-) 1 per cent of NDTL

14. With a view to alleviating the frictional liquidity pressure, the Reserve Bank decided to conduct a second LAF (SLAF) on a daily basis and also allowed banks to avail additional liquidity support under the LAF to the extent of up to 1 per cent of their NDTL up to November 4, 2010. In order to address the structural liquidity problem, earlier today, the Reserve Bank announced an OMO for purchase of government securities amounting to ₹12,000 crore.

15. In view of the current assessment of the growth-inflation dynamics, It is expected that monetary aggregates will evolve along the projected trajectory indicated in our July Review. Accordingly, for policy purposes, we have retained the earlier projections of money supply (M_3) at 17 per cent and of non-food bank credit growth at 20 per cent. As always, these numbers are indicative projections and not targets.

External Sector

16. Let me now move to external sector management which has assumed a lot of importance in the recent period owing to global developments. The current account deficit in the balance of payments widened in the first quarter of 2010-11. If the current trend persists, the current account deficit as a percentage of GDP for the full year will be significantly higher than in last year. It is generally perceived that a current account deficit above 3 per cent of GDP is difficult to sustain over the medium-term. The challenge, therefore, is to rein in the deficit over the medium-term and finance it in the short-term. The medium-term task has to receive policy focus from both the Government and the Reserve Bank. The short term task is to see that the current account is fully financed while ensuring that capital flows are not far out of line with the economy's absorptive capacity and that the component of long-term and stable flows in the overall capital flows is high.

Capital Flows

17. In the context of today's increases in policy rates, let me now turn to another important issue. It has often been argued that the widening of interest rate differential between the domestic and international markets will result in increased debt-creating capital flows. While it is true that large interest rate differential makes investment in domestic debt instruments and external borrowings by domestic entities more attractive, we need to keep in view three aspects in the Indian context. First, the economy's capacity to absorb capital flows has expanded as reflected in the widening of the current account deficit. Second, despite the already large differential between domestic and international interest rates, capital flows in the recent period have been predominantly in the form of portfolio flows into the equity market. This suggests that the interest rate differential is not the only factor that influences capital flows. Third, in line with our policy of preferring equity to debt-creating flows, we still maintain some controls in respect of debt flows.

Risk Factors

18. Let me indicate some of the important risks to the growth and inflation outlook.

- First, the main downside risk to growth emanates from the prospects of a prolonged, slow and halting recovery in advanced economies which would adversely affect the growth performance of EMEs, including India.
- Second, inflationary pressures may accentuate due to the structural component in food inflation while demand side pressures may accentuate due to capacity constraints in many industries and rising global commodity prices.
- Third, given the weak recovery, some advanced economies are in the process of resorting to another round of quantitative easing that could trigger capital flows into EMEs, including India. Large capital flows beyond the absorptive capacity of

the economy could pose a major challenge for exchange rate and monetary management.

- Fourth, the widening of the current account deficit raises concerns given the uncertainty associated with international capital flows.
- Fifth, asset prices in India, as in many other EMEs, have risen sharply in a short time which is a cause for concern.

Monetary Policy Stance

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

- Contain 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.
- Actively 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

20. Today's monetary policy actions are expected to:

- Sustain the anti-inflationary thrust of recent monetary actions and outcomes in the face of persistent inflation risks.
- Rein in rising inflationary expectations which may be aggravated by the structural nature of food price increases.
- Be moderate enough not to disrupt growth.

21. Let me reiterate that the exit from expansionary monetary policy since October 2009 has been calibrated on the basis of India's specific growth-inflation dynamics in the broader context of persistent global uncertainty. The Reserve Bank will continue to closely monitor both global and domestic macroeconomic conditions. We will take action as warranted with a view to mitigating any potentially disruptive effects of lumpy and volatile capital flows and sharp movements in domestic liquidity conditions, consistent with the broad objectives of price and output stability.

22. Based purely on current growth and inflation trends, the Reserve Bank believes that the likelihood of further rate actions in the immediate future is relatively low. However, in an uncertain world, we need to be prepared to respond appropriately to shocks that may emanate from either global or domestic environment.

Developmental and Regulatory Polices

23. Let me now turn to developmental and regulatory issues. The thrust of the regulation by the Reserve Bank in recent years has not only been on strengthening the financial system, but also on developing financial markets, promoting financial inclusion, improving credit delivery, especially to the SME sector, improving customer service and strengthening the payment and settlement systems. The Reserve Bank, therefore, will continue to pursue reforms in these areas so as to enhance the efficiency and stability of the financial system.

24. I will highlight a few measures, we have taken or plan to take in these areas.

Financial Stability

- Releasing the second financial stability report in December 2010. Going forward, financial stability report will be published in June and December every year.

Interest Rates

- Preparing a discussion paper, which will delineate the pros and cons of deregulating the savings bank deposits interest rate.

Financial Market Products

- Permitting settlement of repo in corporate bonds on a T+0 basis in addition to the existing T+1 and T+2 basis.

Credit Delivery and Financial Inclusion

- Allowing regional rural banks (RRBs) to open branches in tier 3 to tier 6 centres as identified in the Census 2001(with population up to 49,999), subject to fulfilling certain conditions.
- Opening sub-offices of the Reserve Bank in the remaining six states of the North East, *viz*., Arunachal Pradesh, Nagaland, Manipur, Mizoram, Tripura and Meghalaya, in a phased manner.
- Initiating several measures to strengthen the role of urban co-operation banks (UCBs) such as:
  - (i) extending area of their operations;
  - (ii) liberalising branch licensing policy for well managed and financially sound UCBs;
  - (iii) allowing well managed and financially sound UCBs to engage business correspondents (BCs)/business facilitators (BFs);
  - (iv) allowing licensed UCBs the facility of INFINET membership, current and SGL accounts with the Reserve Bank; and
  - (v) allowing RTGS membership to well managed and financially sound UCBs having a minimum net worth of ₹ 25 crore.

Regulatory Measures

- Prescribing the loan to value (LTV) ratio of not exceeding 80 per cent in respect of housing loans hereafter.
- Increasing the risk weight for residential housing loans of ₹ 75 lakh and above, irrespective of the LTV, to 125 per cent.
- Increase the standard asset provisioning by commercial banks for all housing loans with teaser rates to 2 per cent.
- Stipulating prudential limits to regulate the investments of banks in companies engaged in forms of business other than financial services. Banks will be required to review their investments in such companies and be compliant with the guidelines as per the roadmap to be laid down.
- Implementing the recommendations of the Internal Group on Supervision of Financial Conglomerates (FCs) on (i) capital adequacy for FCs; and (ii) intra-group transactions and exposures in FCs.
- Taking appropriate steps to fully align the corporate governance practices in banks in India with the principles enunciated by the Basel Committee on Banking Supervision (BCBS).
- Issuing final guidelines on compensation practices by banks by end-December 2010.
- Putting the draft guidelines on licensing of new banks in public domain by end-January 2011 for public comments.

Institutional Measures

- Increasing the threshold limit for real time gross settlement system (RTGS) transactions from the present limit of ₹ 1 lakh to ₹ 2 lakh.
- Accepting the report of the Group on next generation RTGS.
- Planning the next roll out of cheque truncation system in March 2011 at Chennai.

Discussions with banks

25. Banks welcomed the Reserve Bank’s policy stance. They agreed that the monetary measures announced by the Reserve Bank today were appropriate in the current domestic growth-inflation dynamics. Apart from monetary measures, discussions with banks focused on four specific issues, *i.e.*, (i) liquidity situation; (ii) housing credit, price and risk; (iii) customer service; and (iv) external sector management. While appreciating the liquidity easing measurers announced recently, banks indicated that steps are required to ease structural liquidity. Welcoming the stipulation of the loan to value ratio and increased risk weight in housing loans, some banks felt that the practice of offering lower interest rates in the initial period of housing loans cannot be equated with teaser loans as the risk in such loans is not different from those offered at floating rate loans. Banks reiterated that they will continue to strive for improved customer service. Banks shared the Reserve Bank’s concern that the component of stable capital flows in the overall flows should be increased to address the concerns of financing the widening current account deficit."

Ajit Prasad
Assistant General Manager

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