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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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Second 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 discussed recent economic developments and where I announced the Second Quarter Review of the Reserve Bank's Monetary Policy for 2009-10. In the run up to this policy review, we consulted with a wide array of stakeholders and took their views on board.

Banks generally welcomed the Reserve Bank's policy stance. They agreed with the Reserve Bank's emphasis on credit flows, particularly to agriculture and micro, small and medium enterprises to support the revival of growth. They indicated that while underlying economic activity has picked up, credit demand remains muted because the access of financing from external and domestic non-bank sources has eased significantly. Banks felt that credit growth prospects remain favourable going forward. Apart from credit offtake, discussion centred around specific issues such as the new liberalised policy on branch authorisation, changes in provisioning norms, infrastructure financing, currency management, priority sector lending certificates (PSLCs), and the recommendations of the Working Group on BPLR. Banks welcomed the liberalised policy on branch authorisation, which together with the liberalised business correspondents model, according to them, should promote financial inclusion and increase credit flow. As regards infrastructure financing by banks, the view was that while banks have a role in infrastructure financing, eventually it should be done through the corporate bond market with participation by long-term institution investors. Banks recognised the role of take-out financing and indicated that they are working with India Infrastructure Finance Company Ltd. (IIFCL) on this issue. While banks welcomed the move to increase the provisioning requirement on commercial real estate exposures, they suggested certain modifications in the calculation of the provisioning cover and requested for more time. The Reserve Bank emphasised the importance of using modern technology, including note sorting machines. There was a general feeling that the merits and demerits of PSLCs need to be carefully examined. Banks were urged to generate the debate through seminars and workshops on the recommendations of the Working Group on BPLR.

Global Economy

There has been a discernable improvement in the global economy since the last review in July 2009. The recovery is underpinned by output expansion in emerging market economies, particularly in Asia. World output improved in the second quarter, manufacturing activity has picked up, trade is recovering, financial market conditions are improving, and risk appetite is returning. A sharp recovery in equity markets has enabled banks to raise capital to repair their balance sheets. There are concerns, however, that the recovery is fragile. Even as output is reviving, unemployment is expected to increase to over 10 per cent. Investment is also expected to remain weak due to ruptured balance sheets, excess capacity and financing constraints. Bank collapses are continuing. World trade still remains below its level a year ago. On balance, while global economic prospects have improved, uncertainties remain about the pace and sustainability of economic recovery.

Indian Economy

In India, too, there are definitive indications of the economy attaining the 'escape velocity' and reverting to the growth track. This is despite the continuing contraction in exports and the worst drought since 1972. The performance of the industrial sector has improved markedly in recent months. Domestic and external financing conditions are on the upturn. Capital inflows have revived. Activity in the primary capital market has picked up and funding from non-bank domestic sources has eased. Liquidity conditions have remained easy and interest rates have softened in the money and credit markets.

At the same time, some concerns persist. There are clear signs of rising inflation stemming largely from the supply side, particularly from food prices. Private consumption demand is yet to pick up. Agricultural production is expected to decline. Services sector growth remains below trend. Bank credit growth continues to be sluggish.

Government Borrowing

Management of the large government market borrowing programme in a non-disruptive manner has been a major challenge for the Reserve Bank. Consistent with the accommodative monetary stance, the Reserve Bank expanded its domestic assets through open market operations (OMO) and unwinding of market stabilisation scheme (MSS) securities to provide primary liquidity to support the borrowing programme. During 2009-10 so far, the Central Government has already completed over 80 per cent (Rs.3,19,911 crore) of its net market borrowing and State Governments have mobilised Rs.58,683 crore (net) through the market borrowing programme. Because of the front-loading of the market borrowing programme, net issuances under the Central Government borrowing programme in the remaining period of 2009-10 will be only around Rs.62,500 crore. In the context of the debate on raising the held to maturity (HTM) investment limit for banks, on considerations of the merits and demerits of the issue, the Reserve Bank has determined that it is not advisable to raise the HTM ratio.

Liquidity Situation and Interest Rates

The liquidity situation has remained comfortable since mid-November 2008 as evidenced by large absorption of nearly Rs.1,20,000 crore on a daily average basis under the liquidity adjustment facility (LAF) window of the Reserve Bank. With most commercial banks reducing their deposit rates, the cost of funds has declined enabling banks to reduce their lending rates.

Growth Outlook

On current assessment, the growth projection for GDP for 2009-10 has been retained at 6.0 per cent with an upward bias, unaltered from that made in the July review. This assumes a modest decline in agricultural production, as the South-West monsoon rainfall this year has been the weakest since 1972 affecting both yield and acreage of agricultural crops, but a faster recovery in industrial production.

Inflation Outlook

Inflation assessment has become increasingly complex in recent times in view of the wide divergence between the inflation rate based on the WPI and the various CPI inflation measures. The situation was aggravated by the deficient monsoon rainfall and drought condition in several parts of the country. While CPI inflation is now in double digit, the WPI inflation rate remains low.

Taking into account the global trend in commodity prices and the domestic demand-supply balance, the base line projection for WPI inflation at end-March 2010 is placed at 6.5 per cent with an upward bias. This is higher than that of 5.0 per cent WPI inflation projected in the July 2009 Review as the upside risks have materialised.

Money Supply

Keeping in view the borrowing requirement of the Government and of the commercial sector in the remaining period of 2009-10, the indicative projection of money supply growth of 18 per cent set out in July 2009 Review is revised downwards to 17 per cent. Consistent with this, aggregate deposits of scheduled commercial banks are projected to grow by 18 per cent. The growth in adjusted non-food credit, including investment in bonds/debentures/shares of public sector undertakings and private corporate sector and CPs, is also revised downwards to 18 per cent from 20 per cent set out earlier. Banks are urged once again to step up their efforts towards credit expansion while preserving credit quality, which is critical for revival of growth.

Managing the Recovery: Some Issues

The attention around the world, as also in India, has shifted from managing the crisis to managing the recovery. The policy dilemma for India is different in some important respects from that of advanced economies as well as other emerging market economies for the following reasons:

- Most of these countries do not face an immediate risk of inflation, whereas India is actively confronted with an upturn in inflation.
- India has the challenge of reviving domestic consumption and investment demand, the traditional, dominant drivers of our growth, although households, firms and financial institutions in India are not struggling with impaired balance sheets unlike in advanced economies.
- India has traditionally been a supply constrained economy in contrast to advanced economies which are demand starved. The supply constraints, which remained subdued during the crisis period due to weak demand, will re-emerge and may indeed become binding.
- India is one of the few large emerging economies with twin deficits – fiscal and current account deficits.

Exit Strategy

Around the world there is an active debate on the timing and sequencing of exit from the expansionary monetary stance. ‘Exit’ is a central issue in our policy matrix too. The challenge for the Reserve Bank is to support the recovery process without compromising on price stability. Growth drivers warrant a delayed exit, while inflation concerns call for an early exit. Premature exit will derail the fragile growth, but a delayed exit can potentially engender inflation expectations. This calls for a careful management of trade-offs.

We have studied all the arguments for and against reversal of monetary easing. These arguments are detailed in the policy review document. The balance of judgment at the current juncture is that it may be appropriate to sequence the ‘exit’ in a calibrated way so that while the recovery process is not hampered, inflation expectations remain anchored.

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:

- Keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments to stabilise inflation expectations.
- Monitor the liquidity situation closely and manage it actively to ensure that credit demands of productive sectors are adequately met while also securing price stability and financial stability.
- Maintain a monetary and interest rate regime consistent with price stability and financial stability, and supportive of the growth process.

Way Forward

The Reserve Bank will continue to monitor the price situation in its entirety and will take measures as warranted by the evolving macroeconomic conditions swiftly and effectively.

Monetary Policy Measures

For now, the Reserve Bank has decided to keep the policy repo rate unchanged at 4.75 per cent, the reverse repo rate unchanged at 3.25 per cent and the CRR of banks unchanged at 5 per cent of their NDTL.

The following measures constitute the first phase of ‘exit’:

- The statutory liquidity ratio (SLR), which was reduced from 25 per cent of demand and time liabilities to 24 per cent, is being restored to 25 per cent.
- The limit for export credit refinance facility, which was raised to 50 per cent of eligible outstanding export credit, is being returned to the pre-crisis level of 15 per cent.
- The two unconventional refinance facilities: (i) special refinance facility for scheduled commercial banks; and (ii) special term repo facility for scheduled commercial banks [for funding to mutual funds (MFs), non-banking financial companies (NBFCs), and housing finance companies (HFCs)] are being discontinued with immediate effect.

Further, the liabilities of scheduled banks arising from transactions in collateralised borrowing and lending obligations (CBLO) with Clearing Corporation of India Ltd. (CCIL) would now be subject to the maintenance of the cash reserve ratio (CRR).

Developmental and Regulatory Issues

Let me now turn to development and regulatory issues. While India has been less affected by the crisis than most other countries, there are lessons from the crisis for India too, which include: (i) further strengthening regulation at the systemic and institutional levels; (ii) making our supervision more effective and value adding; and (iii) improving our skills in risk management. Further, we need to actively pursue the challenge of financial inclusion. I will highlight a few actions being taken by us:

Financial Stability

- Releasing of the first Financial Stability Report for India by December 2009.

Interest Rates

- Considering the recommendations of the Working Group on the Benchmark Prime Lending Rate (BPLR) system after receiving feedback.

Financial Market Products

- Proposal to introduce plain vanilla over-the-counter (OTC) single-name Credit Default Swaps (CDS) for corporate bonds for resident entities subject to appropriate safeguards. The operational framework will be finalised in consultation with market participants.
- Permitting recognised stock exchanges to offer currency futures contracts in currency pairs of Rupee-Euro, Rupee-Pound Sterling and Rupee-Japanese Yen, in addition to the existing Rupee-US dollar contracts.

Regulatory Measures

- Increasing the provisioning requirement for advances to the commercial real estate sector classified as ‘standard assets’ from 0.4 per cent to 1.0 per cent.
- Liberalising the extant branch authorisation policy for domestic non-RRB scheduled commercial banks.
- Allowing banks to build up capital for take-out exposures in a phased manner.
- Advising banks to augment their provisioning cushions consisting of specific provisions against non-performing assets (NPAs) as well as floating provisions so that their total provisioning coverage ratio, including floating provisions, reaches 70 per cent by September 2010.
- Issuing guidelines to private sector and foreign banks with regard to sound compensation policies.
- Introducing a category of NBFCs as ‘infrastructure NBFCs’, defined as entities which hold minimum of 75 per cent of their total assets for financing infrastructure projects.
- Linking the risk weights of banks’ exposure to infrastructure NBFCs to the credit rating assigned to the NBFC by external credit assessment institutions (ECAIs).

Financial Inclusion

- Allowing banks to (i) appoint the additional entities as business correspondents (BC); and (ii) collect reasonable service charges from the customer in a transparent manner for delivering the services through BC.
- Advising the lead banks to take steps to draw up a road map by March 2010 to provide banking services through a banking outlet in every village having a population of over 2,000, by March 2011.
- Constituting a Working Group to examine the issues involved in the introduction of priority sector lending certificates (PSLCs).

Currency Management

- Mandating banks to install note sorting machines in all their branches in a phased manner in terms of a road map to be approved by the Reserve Bank."

G. Raghuraj
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