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Second Quarter Review of Monetary Policy for 2011-12
Press Statement by Dr. D. Subbarao, Governor

At the outset, on behalf of the Reserve Bank of India, I want to welcome all of you to this Second Quarter Review of Monetary Policy for 2011-12.

2. Earlier this morning, we put out the monetary policy measures accompanying this Review. Based on an assessment of the current macroeconomic situation, we have decided to:

- increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points. The repo rate will accordingly move up from 8.25 to 8.5 per cent.

3. Accordingly, the reverse repo rate under the LAF, determined with a spread of 100 basis point below the repo rate, gets calibrated to 7.5 per cent. Similarly, the marginal standing facility (MSF) rate, determined with a spread of 100 bps above the repo rate, stands adjusted at 9.5 per cent.

4. These changes have come into effect immediately after the announcement.

5. We have also decided to deregulate the savings bank deposit interest rate with immediate effect. I will come to its details later.

Considerations Behind the Policy Move

6. The decision to persist with monetary tightening has been informed by two broad considerations.

7. First, both inflation and inflation expectations remain high. Inflation is broad-based, and is above the comfort level of the Reserve Bank. We expect these levels to persist for two more months. There are potential risks of expectations becoming unhinged in the event of a pre-mature change in the policy stance. However, reassuringly, momentum indicators, particularly the de-seasonalised quarter-on-quarter headline and core inflation measures, indicate moderation. This is consistent with the projection that inflation will decline beginning December 2011.

8. The second consideration that shaped the policy decision is that growth is clearly moderating on account of the cumulative impact of past monetary policy actions as well as some other factors. As inflation begins to decline, there will be growing room for the policy stance to give due consideration to growth risks, within the overall objective of maintaining a low and stable inflation environment.

9. While the impact of past monetary actions is still unfolding, based on our growth-inflation dynamics, we considered it necessary to persist with the anti-inflationary stance.

Monetary Policy Stance

10. The policy document also spells out the three broad contours of the monetary policy stance. These are:

- to maintain an interest rate environment that contains inflation and anchors inflation expectations;
- to stimulate investment activity to support raising the trend growth; and
- to manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.

Guidance

11. As in the past, we have also given guidance for the period forward. The projected inflation trajectory indicates that the rate will begin falling in December 2011 and then continue down a steady path to 7 per cent by March 2012. It is expected to moderate further in the first half of 2012-13. This reflects a combination of commodity price movements and the cumulative impact of monetary tightening. Further, moderating inflation rates are likely to impact expectations favourably. These expected outcomes provide some room for monetary policy to address growth risks in the short run. With this in mind, notwithstanding current rates of inflation persisting till November, the likelihood of a rate action in the December mid-quarter review is relatively low. Beyond that, if the inflation trajectory conforms to projections, further rate hikes may not be warranted. However, as always, actions will depend on the evolving macroeconomic conditions.

12. It must be emphasised, however, that several factors – structural imbalances in agriculture, infrastructure capacity bottlenecks, distorted administered prices of several key commodities and the pace of fiscal consolidation – combine to keep medium-term inflation risks in the economy high. These risks can only be mitigated by concerted policy actions on several fronts. In the absence of progress on these, over the medium term, the monetary policy stance will have to take into account the risk of inflation surging in response to even a moderate growth recovery.

Expected Outcomes

13. We expect that today's policy action and the guidance we have given will result in the following three outcomes:

- first, on the basis of a credible commitment to low and stable inflation, medium-term inflation expectations will remain anchored.
- second, the emerging trajectory of inflation, which is expected to begin to decline in December 2011, will be reinforced.
- and, finally, it will contribute to stimulating investment activity.

Global and Domestic Developments

14. As always, our decision has been based on a careful assessment of the global and domestic macroeconomic situation. Let me summarise that.

Global Economy

15. On the global front, the growth momentum in the US and the euro area economies has weakened. In the euro area, macroeconomic prospects are intimately tied in to its ability to credibly resolve its sovereign debt and financial sector problems. The adverse feedback loops among sluggish growth, weak sovereign balance sheets, large exposures of banks to sovereign debt and political compulsions coming in the way

of a credible solution have created a crisis of confidence, which is a potential threat to regional and global financial stability.

16. The trade and financial linkages increase the risks of the euro area instability transmitting through to emerging market economies (EMEs), which have already experienced large volatility in their financial markets, particularly their currency markets. Significantly, while the prices of many commodities declined over the quarter, crude oil prices remained firm. The impact of this on commodity importing EMEs has been exacerbated by currency depreciation.

Indian Economy

17. Turning to the domestic macroeconomic situation, the growth of Indian economy decelerated to 7.7 per cent in the April-June quarter of 2011-12 from 7.8 per cent in the previous quarter. Industrial growth, as measured by the index of industrial production, decelerated to 5.6 per cent during April-August 2011, down from 8.7 per cent in the corresponding period of last year.

18. Growth in the service sector is holding up well, although some moderation is possible here too on account of inter-sectoral linkages. Based on the normal south-west monsoon and first advance estimates that suggest a record *kharif* production, agricultural prospects look good. However, investment demand has slackened reflecting slower clearance and execution of projects, concerns about inflation and rising interest rates.

19. In its May Statement and the July Quarterly Review, the Reserve Bank projected GDP growth of 8.0 per cent for 2011-12. The mid-quarter review of September, however, pointed out that the risk to the growth projection was on the downside.

20. Based on the current and evolving macroeconomic situation, we have revised downwards the baseline projection of GDP growth for 2011-12 to 7.6 per cent.

Inflation

21. Inflation continues to be a major macroeconomic concern. The headline WPI inflation has remained stubbornly high averaging 9.6 per cent during the financial year so far. Inflation has been broad-based, and driven by all the three major groups, *viz.,* primary articles; fuel and power; and manufactured products.

22. As indicated in the First Quarter Review, both the level and persistence of inflation remain a cause for concern. Of larger concern is the fact that even with the visible moderation in growth, inflation has persisted. Reassuringly, there is some comfort coming from de-seasonalised sequential quarterly WPI data which suggest that inflation momentum has turned down.

23. Going forward, the inflation path will be shaped by both demand and supply factors.

- First, it will depend on the extent of moderation in aggregate demand. Some signs of demand moderation are evident, although the impact is being felt more on the investment side.

- Second, the behaviour of crude prices will be a crucial factor in shaping the outlook of domestic inflation in the near future. The benefit of a decline in global crude prices in the recent period has been more than offset by the depreciation of the rupee in nominal terms. Thus, the exchange rate will also have some impact on the behaviour of domestic petroleum prices.

- Third, the inflation outlook will also depend on the supply response in respect of those commodities characterised by structural imbalances, particularly protein items.
- Finally, there is still an element of suppressed inflation in the economy. Domestic prices of administered petroleum do not reflect the full pass-through of global commodity prices. Prices of coal and a few other commodities do not reflect the current market conditions. As and when price adjustments take place, they will add to inflationary pressures.

24. Keeping in view the domestic demand-supply balance, the global trends in commodity prices and the likely demand scenario, the baseline projection for WPI inflation for March 2012 is kept unchanged at 7 per cent. Elevated inflationary pressures are expected to ease from December 2011, though uncertainties about sudden adverse developments remain.

Liquidity and Monetary Conditions

25. The systemic liquidity deficit remained within one per cent of banks' net demand and time liabilities (NDTL), the comfort zone assessed by the Reserve Bank and consistent with the anti-inflationary stance of monetary policy.

26. This year so far, the money supply (M_3) and credit growth remain above the indicative trajectories of the Reserve Bank. We expect that monetary aggregates will evolve along the projected trajectory indicated in the First Quarter Review. Accordingly, we have retained the M_3 growth projection for 2011-12 at 15.5 per cent and non-food credit growth at 18 per cent.

Risk Factors

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

- first, a major downside risk to growth emanates from the global macroeconomic environment;
- second, despite recent moderation, global commodity prices remain high;
- third, the Government has announced increased market borrowings, which can potentially crowd out more productive private sector investment; and,
- fourth, structural imbalances in protein-rich items such as pulses, milk, egg, fish and meat will persist and consequently, food inflation is likely to remain under pressure.

Developmental and Regulatory Policies

28. This Review also includes developmental and regulatory policies. Let me explain briefly some of the important initiatives we have announced.

29. As alluded to earlier, we have decided

- to deregulate the savings bank deposit interest rate with immediate effect; banks are free to determine their savings bank deposit interest rate, subject to the following two conditions:
- First, each bank will have to offer a uniform interest rate on savings bank deposits up to ₹ 1 lakh, irrespective of the amount in the account within this limit.
- Second, for savings bank deposits over ₹ 1 lakh, a bank may provide differential rates of interest, if it so chooses. However, there should not be

any discrimination from customer to customer on interest rates for similar amount of deposit.

30. Considering the requirement of penetration of banking in rural and semi-urban areas, the Reserve Bank has been liberalising branch authorisation policy. Banks, at present, are permitted to open branches in Tier 3 to Tier 6 centres (with population of up to 49,999) under a general permission, subject to reporting.

31. This liberalisation has led to increased pace in the number of branches opened in Tier 3 to Tier 6 centres. However, it is observed that branch expansion in Tier 2 centres has not taken place at the desired pace. To provide enhanced banking services in Tier 2 centres, it is now proposed:

- to permit domestic scheduled commercial banks (other than RRBs) to open branches in Tier 2 centres (with population 50,000 to 99,999) without the need to take permission from the Reserve Bank in each case, subject to reporting.

32. In the area of financial markets, four important initiatives have been announced.

- First, the Reserve Bank will issue the final guidelines on the cash settled 5-year and 2-year interest rate futures (IRFs), including the final settlement price by end-December 2011.
- Second, guidelines on credit default swaps (CDS) will be made effective by end-November 2011.
- Third, guidelines on short sale in government securities will be issued by end-December 2011.
- Fourth, a Working Group will be constituted to examine and suggest ways for enhancing secondary market liquidity in the G-Sec and interest rate derivatives markets.

33. Moving on to the regulatory measures for commercial banks, let me highlight a few important initiatives we have announced in this review:

- First, the Reserve Bank will issue the final guidelines on internal rating based (IRB) approach for credit risk by end-December 2011.
- Second, a discussion paper will be issued by end-March 2012 on the dynamic provisioning approach for comments.
- Third, a Working Group will be constituted to look into principles governing proper, transparent and non-discriminatory pricing of credit.
- Fourth, another Working Group will be constituted to review the existing prudential guidelines on restructuring of advances by banks/ financial institutions and suggest revisions taking into account the best international practices and accounting standards.

34. Customer service has always been on top of the Reserve Bank's policy agenda. Recognising the need for revisiting the issues of customer service in banks, the Reserve Bank constituted the Damodaran Committee to make recommendations for improving customer service. The Committee has made several recommendations to improve customer service. We have decided to implement the recommendations of the Committee, on which a broad consensus has emerged, as also the action points which were identified by the Indian Banks' Association (IBA) and Banking Codes and Standards Board of India (BCSBI) in the last Banking Ombudsmen conference.

35. The Reserve Bank has also announced two important measures with regard to NBFCs.

- First, a new category of NBFCs called, Non-Banking Financial Company – Micro Finance Institutions (NBFC-MFIs), has been introduced.
- Second, a separate set of guidelines for overseas investment by core investment companies (CICs) in both financial and non-financial sector companies will be issued.

36. Before I close, let me mention that the Reserve Bank is firmly of the view that controlling inflation is imperative both for sustaining growth over the medium-term, and for increasing the potential growth rate. The potential growth rate is not a long term constant; nor is it exogenously determined. It is critically dependent upon policies that create a congenial investment climate and encourage investment activity. The challenge for the Government and the Reserve Bank is to ensure that demand is constrained in the short term to bring inflation down, but at the same time to encourage supply response so as to improve productivity and expand the potential output of the economy in the medium term.

37. I thank you for your attention and best wishes for a Happy Diwali.

Ajit Prasad
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